INSTITUTIONS IN RURAL DEVELOPMENT:
THE CASE OF RURAL BANKS IN SIERRA LEONE

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The Candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made to the work of others.

Abstract

Over the last four decades Sierra Leone established several credit schemes to help farmers increase production, productivity and incomes. This was motivated by several factors including the high proportion of the population in agriculture, the relative poverty of farmers and their subsistence level of production. Cheap credit was seen as the appropriate instrument to achieve market-oriented production. But these schemes failed due mainly to concessionary interest rates, high default, lack of savings mobilisation, mismanagement and poor economic policies.

In March, 1985, a rural banking scheme was launched to replace these failed schemes; and by 1994, eight rural banks were in operation. The main objectives were to mobilise savings and to provide credit to agriculture and other rural enterprises. In early 1990, it was realised that these banks were far from achieving these objectives.

This study examines and identifies the factors responsible for their low levels of achievement. The study reveals that huge losses were made due to several reasons among which are low interest rates for savings and loans which were typically below market rates and inflation suggesting negative returns on interest income, high default, poor economic environment and poor market infrastructure. These factors made rural banks unsustainable and highly subsidy dependent. The study further reveals that informal financial sources (i.e. moneylenders and *osusu* clubs) have been rendering services for which rural banks were not designed. In addition, rural banks and their clients were incurring relatively higher transaction costs compared to the informal sources and their clients.

The study therefore recommends a restructuring of rural banks and suggests policies to improve their operations. In the main, institution-building is recommended, and that the operational flexibility of the informal financial sector be incorporated into the policies of rural banks.

We recognise that Sierra Leone is going through a period of internal conflict. But these recommendations need to be urgently implemented to forestall the collapse of these rural banks.

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DEDICATION

To my late parents, Mama Burah and Pa Ali who love unconditionally.

Faithful service is their hallmark.

May Allah grant them peace and eternal rest.

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ABBREVIATIONS

ALCS	Agricultural Loans and Credit
ASC	Authorised Share Capital
BANCOSOL	Banco Solidario South America
BOD	Board of Directors
BRB	Bombali Rural Bank
BSL	Bank of Sierra Leone
CARE	Catholic Agency for Relief Everywhere
CBs	Commercial Bank
CGS	Credit Guarantee Scheme
CSO	Central Statistics Office
DRB	Daru Rural Bank
EDI	Economic Development Institute
FAO	Food and Agricultural Organisation
FF	Fixed Fund
FFM	Formal Financial Market
FFI	Formal Financial Institution
FRC	Fixed Rotating Circle
GASCA	Greater Accra Susu Collectors Association
GDP	Gross Domestic Product
GNP	Gross National Product
IADP	Integrated Agricultural Development Project

IBD	Inter-American Bank for Development
IDA	International Donor Agency
IFI	Informal Financial Institution
IFM	Informal Financial Market
ILO	International Labour Organisation
IMF	International Monetary Fund
KRB	Kunike Rural Bank
Le	Leone
LIC	Low Income Country
LLC	Local Loans Committee
M&A	Memorandum and Articles of Association
MAIDP	Magbosi Integrated Agricultural Development Project
MANF&F	Ministry of Agriculture Forestry and Fisheries
MANR	Ministry of Agriculture and Natural Resources
MMRB	Marampa/Masimera Rural Bank
MOARB	Moamale Rural Bank
MRB	Mattru Rural Bank
MRM	Multiple Regression Model
NCDB	National Co-operative Development Bank
NDB	National Development Bank
NGO	Non-Governmental Organisation
NIE	New Institutional Economics
OPPCOST	Opportunity Cost

RB	Rural Bank
RCLS	Registrar of Co-operatives Loan Scheme
RF	Rotating Fund
RFM	Rural Financial Market
ROSCA	Rotating Savings and Credit Association
SAP	Structural Adjustment Programme
SDI	Subsidy Dependence Index
SLG	Sierra Leone Government
SRB	Sewama Rural Bank
TPU	Total Paid-up Share Capital
USAID	United States Agency for International Development
USFSA	United States Farm Security Administration
WB	World Bank

INSTITUTIONS IN RURAL DEVELOPMENT:

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PART 1 RESEARCH OBJECTIVES AND METHODOLOGY

Chapter 1 INTRODUCTION

1.00. BACKGROUND TO THE RESEARCH

1.10. The Setting

The objective of this chapter is to outline the background and methodology used in this study. The chapter is divided into five sections. The first gives the background and describes the setting of the research. Section two explains the objectives, justification and hypothesis of the research. The third section discusses the expected contribution of the study to improve the operations of rural banks. Section four deals with the methodology, from the survey design to the analysis of the data and the fifth section explains how the study is organised.

Sierra Leone is located on the west coast of Africa. It has a land area of approximately 72,000 square kilometres and a coastline that is approximately 570 kilometres along the Atlantic ocean. It is bordered by the Republic of Guinea on the north, north-east and north-west and by Liberia on the south-east. The average temperature is about 27 degrees Celsius, with marked variations between the coolest areas in the north-east and the hottest areas in the north-central interior plains. There are two distinct seasons. The wet or rainy season runs from May to October and the dry season from November to April. The average rainfall varies between 80 inches in the north and 200 inches in the south-east. The vegetation ranges from tropical savannah, mainly in the north-central plain to tropical rain forest in the east and south and riverrain

grasslands and mangrove swamps in the south-east and north-east. Although 75 per cent of the geographical area is considered arable, yet only about 11 per cent of this is under cultivation each year using the bush fallow system[1] (CSO, 1970/71).

Table 1.1 **Some Indicators of Development since Independence in 1961**

Indicator	1961	1965	1970	1975	1980	1985	1989	1990
Population (m)	2.08	2.37	2.69	3.05	3.3	3.6	3.8	4.2
GDP growth rate (real)	N/A	4.8	6.4	3	3.2	-2.6	-0.4	2.3
Real GDP per capita	280	297	354	388	320	350	220	260
Exports to GDP (%)	N/A	25.6	23.5	19.9	16.9	17.5	15	20
Imports to GDP (%)	N/A	31.2	27.4	29.2	34.7	20.3	17.3	25
Adult literacy	N/A	7.7	13	13	13	13.3	16.3	21
male	N/A	10	18	19	19.2	21	17	31
female	N/A	4	8	12	11	6	9	11
Life expectancy	31.5	32.5	34	34.6	35	40	41	42
Infant mortality	225	220	225	227	200	175	151	154
Primary school enrolment ratio	30	29	32	38	52	45	53	61

Note:- N/A = not available.

Source:- Annual Statistical Digest, (CSO, 1992)

The population is estimated at 3.76 million (1985 census), growing at a rate of 2.5 per cent per annum (CSO, 1986 and World Bank, 1989). An estimated 70 per cent of the population lives in the rural areas, of which about 80 per cent are small farmers (CSO, 1992). Per capita annual income which was US$338 (constant prices) in 1984/85 fell by 23 per cent to US$260 in 1989/90 due mainly to a fall in production and increase in population. The literacy rate, defined as the ability to read in English, is very low at

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[1] The bush fallow system is a system of farming in which the land is left idle to regenerate its own fertility (fallow) for a period of years. The fallow period can be as long as 20 years. In Sierra Leone, the fallow period has been shortened from 15 - 20 years (1950-60) to 8-10 years (1961-1980) mainly due to population pressure and the demands of the market (FAO, 1990).

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21 per cent level in 1990 (Table 1.1). Less than 50 per cent of the population has access to health and social services including electricity, education, sanitation and water.

Sierra Leone became independent in 1961 and adopted a Republican Constitution with an executive President. The country is divided into four administrative regions - the Western Area, in which the capital, Freetown, is situated and three Provinces, namely: Northern, Southern and Eastern (Map 1). The provinces are subdivided into twelve Districts and these are further subdivided into one hundred and forty Chiefdoms, each headed by a Paramount Chief (PC)[2].

The economy is dominated by the agricultural sector which is largely small-scale, employing about 62 per cent of the total labour force (CSO, 1986; FAO, 1992). Between 1984/85 and 1990/91 the agricultural sector accounted for an average of 45 per cent of Gross Domestic Product (GDP) at constant prices, and 6.5 per cent of exports (Chapter Three, Tables 3.1 and 3.2). The industrial sector, including mining, accounted for 17.3 per cent of GDP and 21 per cent of the labour force. Mineral endowment includes diamonds, gold, bauxite, iron ore and rutile. Their production, up till 1990, accounted for about 15 per cent of GDP and about 78.7 per cent of export earnings (Table 3.2).

Rice is the staple food crop and is grown by over 80 per cent of the farmers in the country (CSO, 1991). This high proportion of farmers has been unable to produce enough to satisfy domestic demand. Annual domestic demand for rice in Sierra Leone has been estimated at between 400,000 and 500,000 tons (CSO, 1991). Production has,

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[2]The Paramount Chief (PC) is the head of the Chiefdom administration, custodian of all land under the customary land tenure system and custodian of all tribal rites. It was a hereditary position until 1973, when it became necessary for him or her to be elected by popular vote.

however, been under 400,000 tons per annum on average since 1981 (MAFF, 1992). The deficit is filled by imports. Rice imports have risen steadily from 11,000 tons in 1983 to 287,000 tons in 1992 (Table 1.2).

Table 1.2 **Rice Production and Imports (000 tons)**

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Production	641	556	515	498	326	415	451	314	109*	100*
Imports	11	74	108	119	99	96.7	80	124	251**	287**

Note:- * Estimate (MAFF, 1993).
** Includes relief supplies for refugees fleeing the war in Liberia and 'rebel' war zones in Sierra Leone.
Source:- CSO (1991) and BSL Economic Review (1990).

One of the goals of government since independence in 1961 has been to achieve self-sufficiency in rice and other foodstuff production. But this goal has not been realised. The numerous small farmers still produce at subsistence level. The major reasons forwarded for low agricultural output and the lack of progress towards market-oriented production are poor farming technology, poor market infrastructure and the lack of finance. Farmers were deemed to lack savings which would enable them purchase new and improved technology. Government was also keen to compensate them for urban-biased pricing policies. Thus one of the main agricultural policies has been the provision of cheap credit to help the farmers move from subsistence to market-oriented production by the adoption of new technology.

1.11. Statement of the Problem.

Over the past four decades, more than five kinds of credit programmes ranging from direct to indirect government intervention have been instituted to supply credit, particularly to small farmers, in the rural areas. The majority of these credit programmes have failed. The reasons for their failure include high default rates, lower than

equilibrium interest rates charged on loans, negative real interest rates returns on loans, lack of savings mobilisation, shortage of well trained and qualified staff, poor appraisal of projects, inadequate loan supervision, poor market infrastructure (poor roads, poor or non-existent market centres and storage facilities), poor extension and research services, misappropriation of funds and inappropriate economic policies. The overall outcome has been limited access to credit for the farmers for whom these credit programmes were created and poor financial intermediation. Consequently, the small farmers have had to turn to informal credit sources. These informal sources include relatives, friends, the Rotating Savings and Credit Associations (ROSCAS) i.e. the *Osusu*[3] clubs; and moneylenders[4].

Researchers concerned with rural financial markets in developing countries, over the last two decades agree that informal credit sources have continued to operate successfully in the rural areas even when formal credit programmes have floundered (USAID, 1973; Bouman, 1977; Adams, 1983; Bell, 1990; Floro and Yotopoulos, 1991). In developing countries, informal credit sources still meet 50-80 per cent of the credit needs of rural people (World Bank, 1975). In Sierra Leone, for example, the percentage of rural people receiving credit from informal sources was estimated at between 70-80 per cent in the mid-seventies (Taylor, 1979). Our survey, hereafter referred to as the Survey, showed that no fewer than 73 per cent of respondents are still receiving credit from informal sources in Sierra Leone.

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[3] *Osusu* is the local name for the type of ROSCA common in Sierra Leone.

[4] Credit needed by farmers include both consumption and production credit. It has been established that although the main credit flow is directed at consumption, moneylenders and *osusu* clubs do grant loans which can be used for production activities (Bouman, 1995, pp. 373)

Governments in some developing countries have been hostile to moneylenders and have viewed them as exploiters of helpless peasants (Bell, 1990). The interest rates charged by them have been perceived as usurious and exploitative (World Bank, 1975; Bouman, 1979). Some governments have gone as far as legislating against them (Bell, 1990). Regardless of this hostility, moneylenders have survived in the developing world. This suggests that they have been more adaptable to rural conditions and more acceptable to rural people than formal sector credit agencies (Bell, 1990).

In Sierra Leone, the government has been silent on the matter of informal sources of credit. Attention has, however, been focused on the establishment of credit schemes including the Agricultural and Credit Loans Scheme (ACLS), the Registrar of Co-operatives Loan Fund (RCLF), the Integrated Agricultural Development Projects (IADPs) and the Credit Guarantee Scheme (CGS) for small farmers. These programmes have failed to meet their objectives and most have collapsed due to the reasons mentioned earlier. Nevertheless, in 1985, a rural banking scheme was launched. Rural banks (RBs) were established to replace these failed schemes with a view to, among other objectives, mobilising savings and providing credit to rural residents. But these rural banks are in danger of suffering the same fate as their predecessor institutions.

Meanwhile, moneylenders and *osusu* clubs (ROSCAS) have continued to coexist with formal credit institutions and have even survived them. In this study, the terms *Osusu* and ROSCAS will be used interchangeably.

1.20. THE OBJECTIVES AND JUSTIFICATION OF THE RESEARCH

The objectives of the research are:

(a) to examine the operations of RBs with a view to determining their viability, using Outreach and Subsidy Dependence Index (SDI) analysis and to identify the factors that hinder their operations and contribute to their nonviability.

(b) to analyse factors which have made moneylenders and ROSCAS viable in the rural areas of Sierra Leone. Moneylenders' operations will be analysed to determine the costs they incur for screening borrowers, administrative and opportunity costs of time and capital and pursuing delinquent loans. A regression model using Ordinary Least Squares (OLS) will be used to determine factors which influenced the level of interest rates observed.

(c) to discuss the operations of the *osusu* clubs, highlighting their adaptability and pervasiveness in the rural areas, as well as their advantages in some respects over other forms of informal credit sources.

(d) to use the knowledge gained from these analysis of the modes of operation of RBs, moneylenders and the *osusu* clubs as a basis for suggesting a model which will enhance rural banks' financial intermediation role in the rural areas of Sierra Leone and also improve their self-sustainability.

The rural banking scheme in Sierra Leone is a response to the failure of previous formal credit schemes introduced under the institution-elasticity or "supply-leading" approach to rural finance. The "supply-leading" phenomenon, according to Patrick (1966), "is the creation of financial institutions and the supply of their financial assets, liabilities and related financial services in advance of demand for them in the modern

growth-inducing sectors". The credit schemes that were introduced, using this 'supply-leading' approach, failed not only to meet their objectives of providing credit to a large proportion of the rural population for whom they were set up, but also proved to be unviable due to high default rates, negative real returns on loans, high transaction costs and lack of savings mobilisation (Adams, 1983). These credit schemes also failed to attract rural borrowers from informal financial intermediaries (IFM), especially moneylenders (op. cit.).

Following evaluations of credit schemes in LICs (USAID, 1974), most donor agencies including the World Bank and USAID began to review past credit policies. The USAID report, *"Spring Review of Small Farmer Credit"* (op. cit.), concluded that these policies were not only faulty but also counterproductive. Less than 5 per cent of farmers in sub-Saharan Africa, for example, benefited from credit programmes established in accordance with these policies (World Bank, 1975). Following the failures of the credit schemes the Sierra Leone Government (SLG) also reviewed its credit policies and programmes and concluded that most had not met their objectives. They were unviable and depended heavily on annual budgetary appropriations which the government could ill afford (Deen, 1977). Consequently, a new policy on credit was adopted (BSL, 1980). It involved the setting up of RBs when it was certified that the demand for this kind of institution existed. In short, the "supply-leading" approach appeared to have been abandoned in favour of the "demand-following" approach, which, according to Patrick (1966), "is the creation of modern financial institutions, their financial assets and liabilities, and related financial services in response to the demand for these services by investors and savers in the real economy". A rural bank

was set up only after the residents had demonstrated a demand for it and the micro-economic climate was certified to be conducive for a rural bank. A decision on this last issue has usually been taken after a socio-economic study and evaluation of the potential of the area have been undertaken by the Bank of Sierra Leone (BSL), the Central bank. The participation of the rural population to be serviced by the RB has been secured by encouraging them to buy shares as well as to take a keen interest in the running of the RB. In other words a sense of belonging and ownership have been encouraged.

The rural banking programme was launched in March, 1985 and by the end of 1993, eight RBs had been established (Table 6.1). It is becoming clear, however, that some of the factors which affected the previous credit schemes were still present and the collapse of some of these RBs is imminent. There is heavy reliance on central bank funds. Default rates and transaction costs are also high. In addition, mismanagement and fraud are common. All of these factors have rendered the RBs unviable and unsustainable. The main question now is, why are the RBs encountering the same problems that plagued the old schemes? The answer to this question is explored in Chapter Six.

It has been established by a number of studies (Moinuddhin, 1969; CSO, 1970/71; Kamara and Turay, 1972; Deen, 1977; Richards and Karimu, 1981; Johnny, 1985), that informal credit sources have typically operated alongside formal credit institutions and provided useful services to rural residents. They are still operating today while most of the official credit schemes have collapsed. It is therefore important to

examine these informal credit sources and use the lessons learned as a basis for helping RBs to operate viably and to provide the kinds of services rural residents require.

1.21. Significance of the study

Evaluation of the impact of RBs on the rural economy in Sierra Leone is limited. In particular, the operations of the eight RBs have yet to be critically and comprehensively analysed. Much of what is known tends to be anecdotal and requires more empirical data and analysis to provide a more reliable basis for policy changes.

This research is designed to fill this gap and to assist policy makers, both in government and in the private sector, in developing appropriate policies to enhance the operations of RBs. The study is also expected to supplement and complement past and on-going research work geared towards the improvement and monetisation of the rural areas and, in particular, the agricultural sector.

By analysing the performance of RBs it may be possible for the management of these institutions and the BSL to formulate policies and actions that will control some of the operating costs and enhance their viability. The result of the outreach and viability analysis will also help in identifying the factors that have caused RBs to be unviable and ineffective in their financial intermediation role and to highlight those factors which have hampered the achievement of their objectives. In addition, the information can also be used to evaluate the performance trends of RBs. An analysis of the performance of the informal credit sources will help to determine the reasons for their survival and such reasons will in turn be invaluable in proposing a model for successful rural financial intermediation in Sierra Leone.

The results, conclusions and recommendations that will emerge from this study will make a modest contribution towards a better understanding of the operations of rural financial markets (RFMs) not only in Sierra Leone but in West Africa and will add to the growing literature on rural financial markets and their impact on the development of rural areas in Low Income Countries (LICs).

1.22. Working Hypotheses

The analysis will be based on three main hypotheses:

(a) that rural banks are unlikely to be viable and sustainable sources of credit for rural residents given their present operational (internal) and external constraints.

(b) that RBs will perform better if some of the operational mechanisms of the informal sector (particularly moneylenders), such as market interlinkage, flexible loans procedures and low transactions costs for borrowers are incorporated into their policies and

(c) that credit by itself would be ineffective if supporting services such as the road network, market infrastructure, research and extension services are poor or absent.

1.30. Expected Contribution of the Research

This research is expected to contribute to a better understanding of the rural financial market (RFM) in Sierra Leone in a number of ways.

First, the research is expected to contribute to a growing body of work on RFMs. Extant knowledge about RBs at the organisational and operational levels in Sierra Leone is limited largely because of the paucity of data linking overall economic policies to operations of RBs.

Second, this research aims at deepening our knowledge about the organisation, modes of operation and practices of both the formal and informal credit sources in Sierra Leone and at providing some evidence on factors influencing success or otherwise of rural financial intermediaries (RFIs).

Third, this research is expected to provide a basis for policy changes in the field of credit with a view to improving financial intermediation, accessibility and viability of rural banks in Sierra Leone.

In summary, this research will try to advance the general knowledge about RFMs and factors influencing their performance. A better understanding of how government policies and regulations affect the operations of the RFM in general is important for the design of appropriate credit policies.

1.40. Survey Design.

1.41. The Survey

Sierra Leone is divided into four major administrative regions with RBs distributed as shown in Map 1. The Northern Province is the largest both in terms of size and population and has four RBs located within it. The second largest is the Eastern Province with three RBs, followed by the Southern Province with just one RB. The Western Area has no RB at present; but there are plans to establish one at Waterloo, 17 miles from Freetown. It should be noted that the Western Area is over 80 per cent urban and the agricultural activities taking place in it are small compared to the provinces.

The study uses secondary (published) data and official sources, especially the audited statements of account of RBs, to assess how viable RBs have been and what can be done to eliminate or minimise their problems. In addition, use is made of data from a survey involving three questionnaires: a household questionnaire, an informal sources questionnaire and an institutional sources questionnaire, which were administered in the service areas of the selected RBs (see below). The survey was conducted from late February to the end of March, 1994, a period during which farmers were beginning to prepare for the next cropping season and were applying for loans.

Four RBs were selected for study out of the eight that have been established (Table 6.1). These are, (1) Yoni Rural Bank (YRB), (2) Marampa/Masimera Rural Bank (MMRB), (3) Mattru Rural Bank (MRB) and (4) Kunike Rural Bank (KRB) (Map 2). The choice of the RBs was influenced by several factors. Among them was our intention to cover the main occupations in the country i.e. agriculture, fishing, trade, mining, and some cottage industries (basket making, cloth dyeing, blacksmithery, tailoring etc.). Rural Banking in Sierra Leone commenced in March, 1985 and each of the selected RBs has operated for more than six years and generated enough data to facilitate some meaningful analysis (Table 6.1). Of those not selected two, Sewama rural bank (SRB) and Bombali rural bank (BRB), have been operating for less than three years (Table 6.1). The other two, the Daru rural bank (DRB) and the Moamale rural bank (MOARB) suspended operations in 1992 due to the on-going rebel war which has affected their areas of operation. While not selected for the survey, they are, however, included in the analysis where data on them are available.

The YRB was the first to be established and has become a training ground for all RB staff. In consequence, any mistakes made at YRB may have been replicated in other RBs, given that the operations and structures of all RBs in Sierra Leone are similar. The YRB is located at Mile 91, a market town situated 91 miles from the capital, Freetown, and services a predominantly agricultural area, producing a variety of crops including chillies (pepper), maize, sweet potatoes, cassava, vegetables and rice (the nation's staple food). Some poultry and pigs are also reared in this area. In addition, the YRB is located in an area that was serviced by the Magbosi Integrated Agricultural Development Project (MIADP[5]). When this project was closed down in 1985, the YRB's establishment was intended to bridge the credit gap created by its closure. Thus the YRB's choice provides an opportunity to compare the operations of the MIADP to the YRB in relation to meeting farmers' credit needs.

The Marampa/Masimera RB is located at Lunsar, a mining town for iron ore and the Headquarters of the joint Chiefdoms of Marampa and Masimera. It is about 66 miles from Freetown. Since the closure of these mines in 1975, agricultural activities and trade have become the dominant occupations. Rice is also produced mainly in the inland valley swamps. Some oil palm, citrus plantations and animal husbandry enterprises are also undertaken in this area.

The MRB is located at Mattru, about 200 miles from Freetown. The predominant economic activities in the area it services include mining (Bauxite), fishing, agriculture and trade. Agricultural products include rice, oil palm, coffee and cocoa. The last three are mainly export crops. The mining of bauxite is carried by a

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[5] The Magbosi Integrated Agricultural Development Project, like all IADPs in Sierra Leone, has as one of its components a credit revolving fund to provide loans to farmers.

Multinational company, Sieromco. The MRB is the only RB in the Southern Province at the moment.

The KRB is located at Makali in the Tonkolili District. This area is more famous for its gold mining than for its agriculture and it adjoins the main diamond mining area, the Kono District. Young and able-bodied men and women move in between these two mining areas in search of gold and diamonds. Thus mining activities make it very costly to attract labour into agriculture in these areas. In addition, because Islam is the predominant religion in this area, women are required to obtain permission from their husbands or fathers (who are usually accepted as guarantors) in order to contract loans. Although this custom is widespread in rural Sierra Leone, it is strongest in the Northern Province. The agricultural sector in this area produces rice, cassava, maize and vegetables. The rearing of cattle and chickens also takes place.

1.42. Sampling Technique

A random sampling technique was used for the household questionnaire, with the sampling frame being the list of customers of selected RBs. A random selection of 50 customers from each of the RBs' ledger cards was made. The cards were recorded and addresses noted. Twenty five non-customers, as a control sample, from the areas serviced by each selected RB were also randomly selected. For this purpose, the sampling frame was the chiefdom taxpayers' list acquired from the District Councils Offices. The list was cross-checked with the RBs' records and management teams to ensure that those selected are not customers of the RB. It should be noted that each RB services a specific number of chiefdoms (Table 6.1), located within a twenty-five-mile radius, as a rural banking policy (BSL, 1980). In the MMRB operational area, for

example, a random selection of non-customers was done as shown in the Table 1.3. This method was adopted for all enumeration areas for the random selection of the non-customers of the RBs in order to minimise location bias. The household questionnaire was administered to a total of 50 customers and to 25 non-customers within the service area of each RB so that in all, 200 customers and 100 non-customers of rural banks were interviewed.

The Informal sources questionnaire was administered to 20 moneylenders (five each from the areas serviced by the four RBs selected for the survey). The moneylenders were identified through information from RB Management teams and from respondents to the household questionnaire. It should be noted that obtaining a statistically random sample of moneylenders was impossible, given the size of the areas selected, the reluctance of most moneylenders to identify themselves to, or discuss their operations with, 'strangers' as well as financial constraints. We were, therefore, forced to choose interviewees on the grounds of availability and access rather than representativeness.

The Institutional questionnaire was administered using the RB's manager and/or the loans officer as respondents. The questionnaire was distributed to managers of RBs

Table 1.3. **Selection of Respondents (non-customers) for MMRB Service area.**

Chiefdom	No. of Taxpayers	% of Total Taxpayers	No. Randomly Selected
Marampa	32245	37	10
Masimera	30985	36	9
Buya Romende	24013	27	6
Total	**87243**	**100**	**25**

Source:- The Survey (1994).

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and discussed with the managers and or loans officers[6]. The discussion took the form of explaining the objectives of the survey, the type and importance of the data required and a brief discussion with the responding officials to test the kinds of response one might receive. After a week or two, the questionnaires were collected and cross-checked with the published audited statements of accounts to ascertain correctness and consistency. The purpose of the institutional questionnaire was to collect information on the operations of the RBs, including data on issues relating to viability, factors influencing operations, new policies (if any) and new directions. In addition to these questionnaires, discussions were held with officials of the Bank of Sierra Leone (central bank) given that it has the responsibility not only of influencing the establishment of RBs but also monitoring and supervising their operations. Discussions were also held with officials of two commercial banks (Barclays and Standard Chattered Banks) and the National Development Bank (NDB) in order to get a feel of the impact of macro-economic policies on their credit operations.

1.43. The Questionnaires

The purpose of this survey was to collect empirical data on the informal sources of credit i.e. moneylenders and the *osusu* and the formal credit sources i.e. the RBs in the rural areas. It was intended to gauge the impact of transactions costs, outreach, sustainability or viability, flexibility of operations, as well as, the influence of RFMs in Sierra Leone. It was also intended to obtain an impression of the reaction of rural residents to rural credit sources and to determine whether these credit sources are providing the services needed by rural residents.

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[6] Respondents were Manager; Manager and Loans officer; Loans Officer; and Manager and Loans Officer for YRB, MMRB, MRB, and KRB respectively.

The principal topics covered in the questionnaires are the following:

1.431. The Institutional Questionnaire:

General information: A brief background of the RBs i.e. name, location, number of years in operation, ownership and contribution to employment in the rural areas was obtained.

Employment: This section was designed to collect information on the various manpower categories, their shortage or surplus situation and the reasons for such.

Training: this section was intended to assess the extent to which RBs in Sierra Leone develop and utilise human resources through training and retraining and to what extent training policies contribute to the enhancement of operations.

Operations: information was also collected on the overall operations of RBs including the quantum of loans granted, the level of outreach (achievement) in savings mobilisation, lending, the proportion of paid-up share capital by the class of shares and outreach.

1.432. The Household Questionnaire

General Information: A brief background of the respondents (customers and non-customers) was elicited. This section was intended to provide information on age, date of birth, educational attainment, religion, position in the community and occupation(s).

Relationship with the RBs: Information was elicited on the type of relationship with the RBs, the number of years as customer, number and type of loans secured, flexibility of loan procedure, reasons for RB customers' default, connection with other sources of credit, especially moneylenders and *osusu* clubs, and the general impression of respondents about the operations of RBs.

1.433. The Moneylenders Questionnaire

General information: Information on occupation(s), date of birth, the level of education, and location was elicited.

Operations: this section was intended to elicit information on modes of operation, i.e. how borrowers are selected to reduce risk, how loans are granted, modes of

repayment, cost of operations (transactions costs), and to gauge their relationship with rural residents and RBs.

The design of the questionnaires was guided by several principles, the first of which was brevity. The aim was to minimise the response burden and yet be sufficiently specific to elicit information needed for the analysis. The second was the inclusion of some open-ended questions to provide respondents the opportunity to express their opinion. Attempts were made to ask follow-up questions when the need arose.

1.434. Interviews and Problems

Socio-economic research in developing countries is fraught with many difficulties. One problem we faced in this study was the paucity of data and the absence of benchmark or baseline studies. Spencer (1977), describes this problem in regard to his field work on employment in Sierra Leone by noting that: "the scarcity of data for anything but the most rudimentary analysis is still a problem for scholars and policy makers". A similar situation is also observed in Nigeria by Stopler (1966), who calls it "planning without facts." A second problem experienced was the number of customers of RBs who had absconded. Some of these were captured by our RB customer samples. When the issue was raised with management teams of the various RBs, the reply was that it was one of the problems faced by the RBs in Sierra Leone. However, note was made of the proportion which absconded and the gap was filled by re-selection from the ledger cards.

A third problem was inaccessibility of some of the enumeration areas. Enumerators had to walk long distances to contact respondents at their homesteads or farms because some of the roads were not motorable. During the interview proper, a

fourth problem was encountered. Due to the high level of illiteracy, which is about 70 percent (Table 1.1), most respondents relied on memory recall instead of written records. Richards and Johnny (1981a) also reported a farmers' memory recall of ± 25 percent of measured figures related to farm size in their field work in Sierra Leone. Apart from the RB passbooks which are issued to customers for their deposits, respondents had few if any written records of their own. Cross-checking with RB records and reference to market prices was done to put answers in proper perspective and to minimise errors.

Interviews with moneylenders were particularly difficult partly because of their concern that information offered might be passed on to government authorities. Assurances had to be given to allay such fears. Confidence building, probing and enumerator's familiarity with the local language and the socio-cultural settings were very helpful in dealing with this problem. Regardless of the above problems enough data were generated from the survey which could be useful to policy makers who are interested in creating a conducive economic environment for the successful operations of credit institutions in Sierra Leone.

1.435. Data Analysis

The raw data collected from the survey was analysed using the Statistical Package for Social Sciences (SPSS), version 6.0. Several runs were made to ascertain that both the data and the programme files were error-free and to check for consistencies in the responses. Frequency distribution and tabulation were generated on salient variables.

The secondary data, which is mostly published audited statements of accounts and financial statements of RBs, has been used to carry out the Outreach and the Subsidy Dependence Index (SDI) analysis.

1.50. Organisation of the Study

The thesis is organised in three parts. Part One examines the research methodology, the relevant literature and the recent economic policies with a brief discussion of the history of credit in Sierra Leone. Part Two reports the findings of the field studies on the RFM particularly moneylenders, RBs and the *osusu* in Sierra Leone. Part Three reviews the findings and introduces a model for improving the financial intermediation role of RBs in the rural areas of Sierra Leone and outlines suggestions for further research.

The study begins in chapter two with a review of the literature comprising, inter alia, works by Patrick (1966), Gonzalez-Vegas (1984), Stiglitz (1990) and the New Institutional Economics. The behaviour of RFMs in relation to the provision of credit is emphasised with the objective of providing the necessary background to the research and placing the research in proper context.

Chapter three traces the policy environment within which RBs and moneylenders operate and emphasises some policies which have direct links with the provision of credit to the rural sector. It also provides an overview of past credit programmes as a background to the present rural banking scheme in Sierra Leone.

Chapter four discusses the operations of the moneylenders, addressing the issues of monopoly profit, transactions costs, credit interlinkage and their impact on rural credit arrangements. A regression analysis is used to determine factors which influence

the indicative interest rates observed at the moneylender level of operations. The view is advanced that the informal sector should be allowed to operate without hindrance and be provided with better competition by formal institutions.

The fifth chapter is devoted to the local ROSCA, commonly known as *osusu*, in Sierra Leone. Its organisation and different modes of operation are discussed, highlighting its pervasiveness and acceptance in both rural and urban settings.

Chapter six examines the operations of RBs in Sierra Leone in order to assess their levels of achievement in savings mobilisation and extension of credit to rural residents. The Outreach and Subsidy Dependence Index (SDI) analysis are used to determine levels of achievement, identifying the factors which influence performance and highlighting reasons for such performance.

Chapter seven discusses the research findings and proposes a model to enhance the performance of the RFM, involving both the RBs and the moneylenders. It is argued that supporting services such as research and extension services, improved infrastructure and a conducive economic environment, are necessary conditions for the successful operation of the rural banks in particular and the RFM in general.

The research is concluded in chapter eight with a summary of the conclusions drawn from the preceding chapters and analysis and some suggestions for further research.

Chapter II AGRICULTURAL CREDIT IN LOW INCOME COUNTRIES: A LITERATURE REVIEW.

2.10. Introduction

The provision of credit to support and develop the agricultural sector in low income countries (LICs) dates as far back as the 1950s. Governments of developing countries, largely supported by friendly foreign governments, international donor agencies and financial institutions, made several efforts to channel funds to rural residents, particularly farmers, with the objective of helping to improve their standard of living. The emphasis on developing the rural areas is predicated, among other reasons, on the fact that at least 60 per cent of the population of LICs live in rural areas, deriving their incomes and living from agriculture and its related pursuits. But the production has largely been at the subsistence level (Lewis, 1954; Schultz, 1977; World Bank, 1975). Cheap credit is seen as one of the instruments for helping farmers.

The purpose of this chapter is to review the literature on the supply of credit to the rural areas of developing countries, highlighting the views of some of the proponents of the cheap credit delivery system based on traditional assumptions. The chapter is divided into five sections. The first discusses the rationale for providing credit to rural residents, particularly farmers. Section two examines the major traditional assumptions underlying the provision of cheap credit, outlines the traditional model of credit supply and notes the failure of the model. The third section discusses the main issues in the debate on why the traditional model failed. It also discusses the pertinent issues in the debate such as, the interest rates charged, the rationing behaviour of lenders, the default problem, and the role of the informal credit sources. The impact these issues have had on

the overall performance of credit institutions that were created under the traditional model are also noted. Section four highlights the emerging consensus under the New Institutional Economics (NIE). The final section discusses the prospects of the new consensus with conclusion.

2.11 Rationale for Credit in LICs

The debate on how to modernise the agricultural sector in LICs assumed a high profile after World War II. The majority view at the time was that credit should be provided as a means of raising the standard of living of rural peoples in LICs. Many notable economists put forward arguments in support of this hypothesis. Among them were Harsoadi (1952) who said that: "since the vast majority of farmers are small holders, the raising of the economic level could be attained by developing and organising credit to small holders". Lewis (1955) also noted that: "farmers need much more capital than they can afford to save". Leibenstein (1957) remarked that: "if capital, labour, entrepreneurial facilities, technical knowledge, and available credit facilities were increased, the income per head will rise". Higgins (1959) said that: "credit may be necessary for expansion in some areas, especially small agriculture and small industry". The aforementioned views tend to support the traditional views in Louis Tardy's report, *Systems of Agricultural Credit and Insurance,* published by the League of Nations in 1938. These views were still espoused by many people concerned with rural development programmes (especially credit), design and operation through the mid 1970s. In addition, policy makers in LICs were also influenced by the views of others such as Hugh Patrick (1966), who provided a theoretical basis for intervention through the financial system for the sake of development, by describing the advantages of

"supply-leading" finance. He suggested the establishment of financial institutions and "the supply of their assets, liabilities, and related financial services in advance of demand for them, especially the demand of entrepreneurs in the modern, growth-inducing sectors", as a means of stimulating investment and economic activity. These initiatives were viewed as easy to implement and at minimum cost compared to, for example, a land reform (op cit.).

In the evolution of economic development, Keynesian economic doctrine also provided a justification for government intervention and economic planning was viewed as a very promising tool. The success of the Marshall Plan for countries of Western Europe was also regarded as clear evidence that large-scale foreign assistance for investment could enhance progress. In the early 1970s, the World Food Crisis and the mounting concern for involving the poor in economic development added to the attractiveness of supplying credit through government intervention with external assistance. In the early 1950s, the United States Farm Security Association (USFSA), a predecessor of the United States Agency for International Development (USAID), began a series of farm credit projects in many LICs, especially in Latin America. These credit programmes were expanded in the 1960s and marked the beginning of donor agencies' and international institutions' lending activities in farm credit in LICs. The World Bank provided huge funds for this purpose. The Food and Agricultural Organisation (FAO) of the United Nations (UN) also provided funds through technical assistance, studies, publications, seminars and world conferences on agricultural credit in LICs. These commitments greatly expanded the supply of loanable funds at the disposal of institutions implementing credit projects (Adams, 1971).

There were, however, some dissenting views. Galbraith (1952), warned that: "a credit system can be an instrument of progress, stagnation or repression". But he noted that credit can only be an instrument of progress after some development has occurred. Li (1952), argued that: "governments should only start credit programmes when farmers are on their way to becoming commercially oriented". Miller (1975), noted that: "Co-operative credit programmes might better accompany or follow programmes of technical change, not precede them as has been the general case". These views were largely ignored. Funding of a large number of credit programmes and the establishment of many rural financial institutions were undertaken in many LICs such as Brazil, Ghana, India, Jamaica, Mexico, Thailand, the Philippines and Sierra Leone. The policies used to supply credit to small farmers in LICs were based on a set of traditional assumptions.

2.20. Traditional Assumptions of Credit Supply in LICs

The principles of state intervention established during the colonial era, also influenced post-independence credit policies. The governments of the emerging nations did not question the basis of such policies. Beginning in the 1950s, development strategies in LICs emphasised, among other things, an increase in agricultural production, helping the poor and meeting the basic needs of the rural populations. Thus, the main traditional assumptions were centred on the conditions of the rural areas, particularly by the situation of the small farmers.

2.21. High Proportion of the Population in the Agricultural Sector.

It is estimated that at least 60 per cent of the population of LICs live in the rural areas and derive their living and incomes from agriculture and its related pursuits (Schultz, 1977; World Bank, 1989). In Sierra Leone, for example, the proportion of the

population in the rural areas is about 62 per cent (CSO, 1991). In the developed countries, this proportion has fallen to below 5 per cent (Schultz, 1977); but this small proportion produces adequate food supplies with surpluses that are often exported to LICs. In contrast, the high proportion of the population in the agricultural sector of LICs is still producing below domestic demand. The deficit is met by imports. In most LICs, agriculture contributes less than 40 per cent to GDP (op. cit.). In Sierra Leone, for example, agriculture's contribution to GDP (at constant prices) ranges from 40 to 45 per cent (Table 3.1). The main factors underlying the low performance of the agricultural sector in LICs is the lack of improved technology and capital (finance) to increase production and productivity. Low economic growth was quickly identified as a consequence of a viscious circle of poverty (low output, low income, low savings, low investment); and the provision of credit was perceived to be one of the major means of breaking this viscious circle (Rostow, 1960; Wharton, 1964, p. 264).

2.22. Cheap Credit

To achieve this objective the main feature of such credit was its cheapness. The interest rates charged for loans in many credit programmes were lower than the rates for loans in other sectors of the economy. Another common feature is that the interest rate was concessionary, often below the rate of inflation in the economy (Adams, 1971; Donald, 1976; Ladman and Tinnermeier, 1983).

A few policy makers argued that cheap credit was justified because developed countries charged low interest rates on government loans to farmers. The USFSA was frequently cited as an example. During the 1930s, the interest rates on most loans made by this United States Agency were between 2 and 7 per cent (Ladman and Tinnermeier,

1983, p. 338; Adams, 1984, p. 67). Many of the technicians trained by this institution later became involved in the design and implementation of credit programmes in LICs. Thus, cheap credit became part of the package recommended for credit programmes in LICs.

2..23. Adoption of New Technology

The World Bank (WB), which is a major donor of funds for many credit programmes in LICs, also believed that agricultural credit was necessary for easing the financial constraint facing the small farmers in LICs. Consequently, help was recommended to enable them adopt new technology. It was also believed that farmers were too poor and could not afford the cost of new technology (Kindleberger, 1958; McNamara, (1973). In his address to the Board of Governors of the World Bank Group, McNamara (op. cit.) emphasised this view:

> "The miracle of the Green Revolution may have arrived; but the small farmer has not been able to participate in it. He simply cannot afford to pay for the irrigation, the pesticide, the fertiliser. For the small farmer operating with virtually no capital, access to credit is crucial".

Von Pischke (1978), referred to this assumption as; "the small farmer credit need creed".

It was also assumed that farmers in LICs do not save and therefore lacked the resources to expand production, suggesting that a demand for credit existed (Kindleberger, 1958; Walinsky, 1963; McNamara, 1973). Thus cheap credit was required to satisfy this demand and also enhance production.

2.24. The Existence of Unsatisfied Demand for Credit.

The creation of credit programmes was also frequently justified by the presumed presence of an unsatisfied demand for credit in the rural areas of LICs. Commercial

banks do not reach and service many farmers, presumably because farmers are assumed to be uncreditworthy or the information needed by banks to determine their creditworthiness is too costly to collect and interpret. This led to the conclusion that credit programmes were needed to reach these potential customers even if costs exceeded interest receipts. In addition, maintaining such costly schemes was justified on the grounds that social benefits outweigh social costs (Wharton, 1964; Kindleberger, 1958). This unsatisfied credit demand was also justified by assuming that informal sources, particularly moneylenders, were exploiting farmers by charging them high interest rates because there were no financial institutions to provide competition in the rural areas.

2.25. Exploitation by Informal Sources of credit

The lack of understanding of the operations of the informal credit markets at the time led researchers, aid agencies and governments to adopt a negative attitude towards the informal credit sources, especially the moneylender. Most farmers in LICs depend on the informal sector for their credit needs; but development technocrats believed that: "Informal finance is anti-developmental, exploitative, geared towards consumption and incapable of providing adequate volumes and range of financial services" (Von Pischke and Adams, 1983). Informal credit was, therefore, seen as counterproductive. Thus it was argued that informal sources should be replaced with formal lending institutions which were presumed to be more efficient and socially more desirable. In addition, it was held that these formal lenders should dispense cheap credit to enable farmers to free themselves from the 'evil' grip of the moneylender and enhance their capability to adopt yield-increasing technology, thereby increasing their incomes (Walinsky, 1963; FAO,

1975; Kallon, 1978). Another view was that the moneylenders extracted monopoly profits through the high interest rates they charged for their loans. But research by Singh (1983) and Harris (1983) show that informal lenders do not necessarily receive monopoly profit. They noted that the high returns informal lenders often receive are a result of high transaction costs related to collection of information about customers and potential borrowers and the opportunity cost of time and investment funds. It has also been shown that the average borrowing costs from informal sources is much less than widely thought (Adams and Nehman, 1974). The widespread use of informal lenders amidst the high rate of interest charged suggests that moneylenders do perform valuable services for rural residents (Floro and Yotopoulos, 1991; Aleem, 1990).

2.26. Credit Policies are Easier to Adopt

Credit was often viewed as an easier policy option than, for example, land reform. It was believed that rural markets could easily be operated to conform to state policy and overcome the shortcomings of the rural labour market. Hugh Patrick's 'supply-leading' hypothesis (1966) provided the impetus to this assumption. Its underlying rationale was that cheap credit would stimulate the demand for loans, providing an indication that small farmers need credit to increase rural incomes (Von Stockhausen, 1980).

2.27. Adverse Impact of Other Economic Policies.

Many policy makers believed that the agricultural sector is often penalised by policies such as food price controls, taxes on farm inputs, overvalued exchange rates and too little public investment aimed at creating a more productive agriculture (Gonzalez-Vegas, 1984a; Vogel, 1984). Adams (1984, p. 73), refers to this argument as 'the

Goliath of the justification for cheap credit.' Cheap credit is defended on two main grounds. It would reverse the adverse production and equity effects of these taxes and was also expected to provide the income transfer to solve the equity problem. Adams (1984); Bouman (1977); Gonzalez-Vegas (1984b), and others, however, have refuted these arguments. First, all producers of a good are taxed by the levy, whereas only those who get cheap loans receive the subsidy. Second, because of the fungibility of financial instruments, loans could be diverted to other uses; a loan allows the borrower to gain command over any real resource or service in the market. Third, a poor investment does not become profitable because the loan is cheap. Fourth, even if these loans are granted in kind (production inputs) the problem will still not be solved. Because inputs are divisible, they can be sold in the open or black market, and the proceeds used to buy other goods and or services that would provide more satisfaction (Adams, 1984). Thus the 'Goliath' of the arguments for cheap credit, as applied to multiproduct and widely dispersed agricultural firms is unsound on both efficiency and equity grounds.

There have been other arguments counteracting traditional assumptions. Von Pischke (1984a), for example, questioned the need for providing cheap credit prior to the adoption of new technology. Some governments in LICs assumed that the adoption of new technology such as high yielding varieties of seed, fertilisers, and machinery could be achieved by providing cheap credit to farmers. In other words, farmers would have to be "bribed" with cheap credit to make them adopt an innovation.

The evidence on the use of credit to get farmers to adopt new technology is inconclusive. In the Philippines, a study by a Presidential Committee (1978), concluded that credit could be a vehicle for the adoption of new technology. However, it

underscored the importance of adhering to the proper stages of the adoption process, six of which were identified: (1) the definition stage (i.e. identifying and defining the problem such as low milk production, unproductive soil or lack of adequate moisture in the soil), (2) the awareness stage (i.e. exposure to the innovation), (3) the interest in the innovation stage, which involves the how-to-do-it aspect of the innovation. (4) the evaluation stage, (5) the trial stage and (6) the resolution stage. Not all of these stages depend on the availability of credit. Farmers could go through some without having to borrow. The need for capital comes in the last stage of the adoption process and a farmer will adopt if he or she is convinced that the new innovation will bring increased output and higher returns to his or her labour and management, when compared to the technology used before the new one arrived (Schultz, 1977; Richards, 1985 and 1986). The Philippine study stressed that where agricultural credit is involved, it is important that these stages be followed because credit involves complex linkages not only between the lender (i.e. the formal financial institution) and the borrower (i.e. the farmer), but between these two and the prevailing economic environment. Schultz (1977) argued that, although the poor farmers are often illiterate, they are rational in the use of resources. There is no reason, therefore, to believe that the farmer will behave irrationally when it comes to using credit. A study carried out in the Punjab, in India, revealed that the availability of credit was instrumental in the adoption of the medium-sized technology (Harris, 1983). In Zimbabwe, the access to credit played a major role in the adoption of irrigation technology in the country's farming system (Norman, 1984)). In the USA, records indicate that credit and extension policies have been important tools in disseminating new technology among the farming population. The above studies

suggest, however, that credit at whatever price is not the only missing link in the development process. Other economic policies have to be in place. The traditional model, however, ignored the impact of other economic policies and information asymmetry on the performance of credit programmes (Stiglitz, 1981).

2.28. The Traditional Model of Credit Programmes in LICs.

Between 1960 and 1970, over US$1.0 billion was transferred to LICs by the United States Agency for International Development (USAID), the Inter-American Bank (IAB), The World Bank (WB) and other international donor agencies (IDAs). The programmes that were set up to dispense cheap credit include, among others, Co-operative Societies, Agricultural Development Banks (ADBs), Integrated Agricultural Development Projects (IADPs) and Rural Banks. In the main, these institutions operated on the basis of the assumptions discussed above (Yaron, 1992a).

External agencies would typically fund a programme and production costs through a Central Bank or Development Bank for on-lending to small rural producers. The expectation was that with the additional physical resources obtained through loan funds, combined with the surplus labour (Lewis, 1954), these borrowers would be able to increase their output and incomes and repay their loans. The interest charged by the lending institution was expected to cover its loan transaction costs, defaults and capital erosion on account of inflation. The loan capital originally provided would become a revolving fund. This was the credit model that was widely used in the LICs (Wharton, 1964; Adams, 1971). But the results of the traditional model were disappointing.

2.29. The Results of the Traditional Model.

By early 1970s, many evaluations of rural credit programmes came up with some disturbing conclusions. It was revealed that a major portion of the credit had not reached small farmer for whom the credit was intended (USAID, 1974; World Bank, 1974). Except for the Republic of Korea, Columbia and the Republic of China, formal credit had reached less than 30 per cent of farm families. In Africa, formal credit reached less than 5 per cent of the rural population (Table 2.1). It also became clear that many of these programmes were unable to meet their operating costs from their interest incomes. Many others failed to recover large amounts of outstanding loans. The consequence was over-reliance on external funds from government, international donor agencies and through re-discount facilities at the central bank (Adams, 1971). By the mid 1970s, outstanding credit in LICs was over US$90 million (Adams, 1971; Yaron, 1992a). In addition, much of the credit in the rural areas of these countries was still being provided by the informal credit sources (Yaron, 1992a).

These revelations disturbed donor agencies. Some academics were already questioning the outcome of these credit programmes, chief among them were Penny (1968) and Adams (1971). Penny expressed grave reservations about government credit programmes on the basis of his observations of small farmer behaviour in Indonesia. Adams (1971) suggested that: "the objectives of externally funded rural credit programmes in Latin America were frustrated by faulty interest rates policies"; and he questioned the basic assumptions on which these projects were based. A comprehensive review of rural credit programmes in LICs was undertaken by the USAID in the early 1970s. More than sixty evaluation reports from over thirty-seven countries were

prepared. The whole collection (20 volumes), came to be known as the *Spring Review of Small Farmer Credit* (USAID, 1974). During 1974 and 1975, small farmer credit reviews and seminars were organised by the WB, FAO and the Rockefeller Foundation to further examine the conclusions of these reviews.

Table 2.1 **Percentage of Farmers Receiving Credit from Institutional Sources in Selected Countries (Percentage of all Farm Families)**

Country	Per cent	Country	Per cent
Africa		Sri Lanka	14
Ethiopia	1	China, Rep. of	95
Ghana	1	Thailand	7
Morocco	10	Turkey	23
Sudan	1	Vietnam, Rep. of	21
Tunisia	5	**Latin America**	
Uganda	3	Bolivia	5
Western Nigeria	1	Brazil	15
Asia		Chile	15
Bangladesh	15	Colombia	30
India	20	Ecuador	18
Jordan	8	Guatemala	2
Korea, Rep. of	40	Honduras	10
Malaysia	2	Mexico	15
Pakistan	5	Nicaragua	20
Philippines	28	Panama	4
		Paraguay	6
		Peru	17

Note: Figures suffer from upward bias. Some farmers borrow from more than one source and it was difficult to eliminate such duplication. Secondly, some of the statistics represent potential borrowers, as in the case of Korea and Taiwan. In addition, some of the statistics are based not on national data but on those reporting institutional loans in a sample survey. If the sample was taken, as is often true, in an area in which an institution was active, this too could lead to over-estimation of coverage.

Source: World Bank, Agricultural Credit Sector Policy Paper, 1974, p. 71.

In addition, David and Meyer (1983) noted that due to the fungibility, divisibility and substitutability of money, it is difficult to attribute specific increases in production

and incomes to credit alone. In some countries credit expansion coincided with output decreases (Graham and Bourne, 1984). In Sierra Leone, for example, agricultural credit has been increasing but domestic output, especially of rice (the country's staple food), has not matched domestic demand (Table 2.2). These research findings led to the overall conclusion that cheap credit has largely failed to achieve its objectives and the traditional assumptions which supported its supply must be seriously questioned (Penny, 1968; Adams, 1971; USAID, 1974; World Bank, 1974). These conclusions sparked off a debate about the about limitations of credit programmes in LICs.

Table 2.2 **Credit Expansion, Rice Production and Imports in Sierra Leone**

Year	Loans (Le M)	Rice Production (000 tons)	Rice Imports (000 tons)
1983	3.9	641	11.3
1984	5.3	556	73.5
1985	6.2	516	107.5
1986	14.2	498	119.2
1987	68.7	326	98.6
1988	213.3	415	96.7
1989	298.9	451	79.9
1990	362.2	314	123.7
1991	409.7	*	250.5**
1992	404.1	*	286.7**

Notes:- Annual total domestic demand for rice is estimated at 358,000 tons (FAO, 1992)
* 'Rebel' war which started in 1992 has had adverse effect on production and no reliable estimates are available for these years.
** Include relief supplies for refugees from Liberia

Source :- Agricultural Statistical Survey, 1980 and Bank of Sierra Leone figures.

2.30. The Debate

The debate that ensued explored reasons for the poor performance of formal credit programmes in LICs. At its centre were several issues. One is the difference between viewing finance as a process of intermediation or as a productive input. A related issue involved the desirability of controls and direct intervention in contrast to incentives and indirect regulation. One central concept in the debate was the rural financial market (RFM). An RFM consists of relationships between buyers and sellers of financial assets who are active in rural economies, which are based on transactions including borrowing, lending and the transfer of ownership of financial assets. Financial assets consist of debt and ownership claims. Debt claims are promises to pay such as verbal promises, pieces of paper signed or thumb-printed as well as the more formal evidence of indebtedness by individuals; and deposit accounts which are debt claims on banks (Adams, 1971). Intermediation occurs when financial claims provided from the savings of individuals and firms are recycled by third parties to others who seek command over resources by borrowing or selling ownership claims (op. cit.). Traditionally, credit has been regarded as having to do more with agriculture than with finance; but this perception changed through the course of the debate.

2.31. The Main Issues

As stated earlier, the issues emerging within the debate revolved around the reasons why credit programmes have been failing in LICs. Some of the major issues in the debate are interest rates, credit rationing, monopoly profits and transaction costs.

2.32 Interest Rates

One of the most visible signs of duality in RFMs is the observed difference in interest rates between formal and informal credit sources. Interest rates in the former tend to be low and uniform whereas in the latter they are widely dispersed and relatively high. In this study, institutional and non-institutional are used interchangeably with formal and informal respectively. This difference in the variation of interest rates is seen as a symptom of rural financial market segmentation even within a specific market (such as, in a market town). Table 2.3 gives rates for two separate surveys, which broadly ranged from 6 to 12 per cent. Rates higher than 12 per cent are almost all in high inflation countries. Table 2.4 provides the rates charged by informal lenders as obtained in the same two surveys. A comparison of the two tables reveals that the informal rates are invariably much higher than the formal rates observed in the same countries. There has been no explanation as to why the rates should be so widely divergent (Mckinnon, 1973; Shaw, 1973; Stiglitz, 1990; Aleem, 1990). The literature hardly addresses this issue except by implying that variations in the perceived risk of default or the size and duration of the loan are the main contributory factors (Bouman, 1977). This explanation appears to be plausible though partial, as we note in Chapter Four.

We are interested in interest rates on two counts. Firstly, the high degree of variability appears, intuitively, to be a result of the imperfect flow of information. Borrowers are either imperfectly informed or there are implicit and explicit costs which prevent borrowers from moving to cheaper sources of credit. Our data and analysis (see Chapter Four) support the hypothesis that interest rates variation could be due to differences in the risk of default, size and duration of loans, transaction costs and credit

Table 2.3 **Nominal Interest Rates Charged by Agricultural Institutions (Per cent per Year)**

Country	Wai Survey* 1957	Bank Survey** 1974	Annual Rate of Inflation** 1967-1970
Africa			
Ethiopia		12	4
Ghana		6	6
Ivory Coast		10	4
Kenya	4.5	7	0
Morocco		5	2
Nigeria	10	6	8
Sudan		7	0
Tunisia		6	3
Uganda	3.5	12	11
Asia			
Afghanistan	5.5	9	n. a.
Bangladesh		12	3
India	7.5	9	10
Indonesia	16	14	11
Iran	7.5	6	2
Jordan	6	7	5
Malaysia		18	2
Pakistan	5	7	3
Philippines	6	12	6
South Korea		16	11
(South)	8	30	28
Vietnam			
Sri Lanka	7.5	12	6
Taiwan		10	7
Thailand	6.5	11	2
Latin America			
Bolivia	7	15	22
Brazil	6.5	14	30
Columbia		12	8
Costa Rica	6	8	4
Ecuador	6.5	10	3
El Salvador	6	10	2
Honduras	6.5	9	3
Mexico	10	10	3
Nicaragua		10	2
Peru	7	10	7

* **Source:** U. Tun Wai, 1957, p.134. Rates for the Institutions specialising in agricultural credit.
** **Source**: Bank Policy on Agricultural Credit, World Bank, 1974, Annex Table 9.
Note: Rates are averages of the reported rates charged on various types of agricultural loans by one or more institutions in given countries. Generally the rates in private banks are higher than those in public institutions by about 3 percentage points.

Table 2.4 **Interest Rates Charged by Informal Commercial Lenders in Selected Countries (Per cent per Year)**

Region/Country	Wai 1957 Survey* "usual" rates (over 50% of loans)	Mid-points	World Bank Survey (1974)** "Occasional" rates (10-20% of loans)	Nominal Rates
Africa				
Ethiopia	25-40	33		70
Ghana				700
Ivory Coast				150
Nigeria	45	45		200
Sudan				120
Asia				
Afghanistan				33
India	12-50, 25-50	32		25
Indonesia	50	50	200	40
Iran			200	
Jordan	60, 24-40	45	"exorbitant"	20
Malaysia			100	60
Pakistan	30, 20-25	28		30
Philippines	60-200, 25-30,20	59	100-200	30
South Korea				60
Latin America				
Bolivia				100
Brazil				60
Chile				82
Colombia	18-24	21	48	
Costa Rica				24
El Salvador				25
Guatemala			100	
Honduras	24-36	30		40
Mexico	60	60		60

*Source: U. Tun Wai, IMF Staff Papers, Vol. 6 No. 1 (Nov.), 1957, p. 140-42. Interest rates found in a single credit study on a country are given either as a single figure or a range; results of additional studies on the same country are placed on the same line separated by commas. Credit studies are cited in the original.

** Source: Bank Policy on Agricultural Credit, World Bank, 1974, Annex Table 9. Each nominal rate is a representative figure from materials available on a given country in one or more studies, either in credit studies or in less fully documented reports.

Note:- Midpoints of ranges in the "usual" rates were used. When several studies are given for a country, the midpoints or single figures from each study are averaged and rounded. The "occasional" rates were not used. **Source of midpoint adjustments**: Donald, 1976, p. 89.

interlinkage. Moreover, barriers to exit from moneylenders for borrowers exist, and these further prevent them from taking advantage of cheaper sources of credit. Secondly, nominal interest rates in formal credit programmes are lower than in other sectors in almost all LICs (Adams, 1971). For example, in the 1970s, nominal interest rates in the agricultural sector in Costa Rica were 8-9 per cent compared to 13-15 per cent for non-agricultural loans while inflation was running at over 100 per cent (op. cit.). A similar situation existed in Sierra Leone. Between 1985 and 1992, interest rates on agricultural loans in the RBs were between 35 and 38 per cent while inflation was, on average, over 83 per cent during the same period (Tables 3.3 and 6.11).

The financial repression school argues that distortions which characterise financial markets in LICs are largely due to government manipulation of free-market prices. The low and often negative real interest rates that prevail in formal lending tend to disrupt the supply side of the financial system and distort the demand for loans (Shaw, 1973 and Mckinnon, 1973). The result is a redirection of the flow of credit to larger borrowers and those with political clout and patronage (Gonzalez-Vegas, 1984b). Negative real interest rates also have other serious implications for both the lenders (the financial institutions) and the borrowers. Negative interest rates can erode the loan portfolio of the lenders (Vogel, 1984; Gonzalez-Vegas, 1984b). The long run consequence is the collapse of the institution if external assistance is not available. For example, if the nominal interest rate (rate in the loan contract) is 10 per cent and inflation is 25 per cent, a negative real interest rate of 15 per cent is implied. Under such conditions, the loan portfolio of the lender could be reduced by half of its value in little

over four years, at a rate of 12 per cent each year (Adams, 1984)[7]. The erosion of loan capital leads to FFI seeking resources either from the government, the central bank or from international donors agencies. When these sources can longer provide funds to replenish the loan portfolio, the credit institution closes down and borrowers turn to other sources, usually the informal sector, to satisfy their credit needs (Floro and Yotopoulos, 1991). Yotopuolos and Floro (1991) referred to this role of the informal sector as complementary.

Low interest rates have often been mandated with the best of intentions, although sometimes also to satisfy political objectives. But such preferential rates have largely failed to achieve their objectives and have more frequently distorted the allocative function of interest rates. Ladman and Tinnermeier (1983) argue that: "when resources are allocated to satisfy political objectives, less than optimal results for long term development can be expected". In their study of Bolivia, they discovered that between 1971 and 1978, the distribution of agricultural loans was not only skewed towards a particular region, Santa Cruz, because of its potential power base, but also that over 70 per cent of the value of loans went to less than 10 per cent of the population. This small proportion was composed of large farmer-borrowers. They further suggest that low priced loans produce a 'demand illusion' combined with the disproportionate transfer of income. According to these researchers, if loans to agriculture are subsidised and interest rates lowered without lowering interest rates for non-agricultural loans, two effects will occur. Firstly, 'an agricultural illusion' will be observed as other borrowers take

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[7] This figure is derived by using the formula $[(1+i)/(1+p)]-1$, where i= nominal interest rate, p = change in prices (measured by some price index) (Adams, 1984). In Sierra Leone, the Consumer Price Index (CPI) is used.

advantage of the cheap funds and apply for agricultural loans, thereby increasing the demand (demand illusion)[8] for agricultural loans. The fungibility of money allows credit to be ostensibly acquired for agricultural purposes but diverted to either consumption or non-agricultural activities or to more profitable investment. Secondly, a concessionary income transfer will occur and add to the skewed transfer of resources. A concessionary income transfer can be caused by a loan default, which can either be temporary or permanent. The former is due to the late repayment of loans (loan delinquency) i.e. when the loan is not paid on the due date, and the latter when the loan is not paid at all. The permanent income transfer is equal to the value of the loan principal plus the real value of interest charges, less any real amounts repaid on the loan principal plus interest. Thus, those with access to credit under interest rates restrictions and high inflation will gain at the expense of others. Concessionary interest rates lead to lower interest revenues for the lending institution, if demand for credit is inelastic or the supply of loanable funds is restricted over the relevant range of the demand schedule. Coupled with the recognised high administrative costs of agricultural credit programmes in LICs, the financial viability of lending institutions is seriously threatened (Richards and Karimu, 1981; Ladman and Tinnermeier, 1983). This threat to long term viability causes lenders to react by employing measures to forestall the demise of the institution. The measures used vary from cutting down costs of operations, passing the extra costs to borrowers and savers or using non-price mechanisms i.e. rationing (quantity closure) (Stiglitz and Weiss, 1981; Gonzalez-Vegas, 1984b). In any event, the low, non-equilibrium level of interest rates have implications for the misallocation of resources. Thus, Gonzalez-Vegas (1984a),

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[8] See Ladman, J. R. and R. L. Tinnermeier (1983): pp. 337-345.

Adams (1984), Ladman and Tinnermeier (1983), and others have argued that a low interest rate policy creates an excess demand, building up arbitrage pressure and necessitating non-price allocation.

2.33. Credit Rationing.

The commonest credit rationing methods used include specifying crops or enterprises for direct lending, detailing loan size for specific crops or enterprises or regions (as in the case of Bolivia) and introducing extra collateral requirements (Gonzalez-Vegas, 1984a). The negative effects low interest rates and credit rationing have on formal financial markets became one of the strong arguments against the traditional view. Credit rationing is not limited to formal financial markets in rural areas alone. Commercial banks have also used credit rationing to dispense credit to their clients (Adams, 1983; de Juan, 1990).

A loan to a borrower has three aspects, namely, the loan size, the interest charged (nominal interest rate stipulated on the loan contract) and the non-price (non-interest) elements (Gonzalez-Vegas, 1984a). The first two aspects are recognisable but this less is true for the non-interest elements. The latter involve the transaction costs and the opportunity cost to the borrower. The transaction costs include fares to and from the credit institution, purchase of application forms, bribes and in some cases a fee (usually called a commitment or administrative fee). This fee is usually deducted before the loan is disbursed[9]. The opportunity cost is the cost of time spent out of the farm or enterprise to transact the loan contract. The amount of time spent out of the farm/enterprise could be as high as several weeks. In a survey carried out by the BSL (Moinuddhin, 1969), it

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[9] See Chapter Six.

was found out that farmers could spend as much as 320 hours, or about two weeks, to complete a loan contract. Our survey found that applications for loans in rural banks took, on average, between 3-4 weeks from lodging to sanctioning, compared to 2 days for loans from moneylenders[10]. Farmers could also spend long hours trying to get documents completed and signed. An Oxfam study (1987) in Maharashtra in India, discovered that bank loan applications had to be supported by eight or more documents, each requiring costly official stamping. Farmers had to travel from 2 to 55 kilometres to reach the bank offices. An average loan involved 10 to 12 visits over a period of between 6 and 8 months. In addition to loss of wages during this time, borrowers had to incur costs such as fees, bribes and costs of refreshments/entertainment for middlemen. Given the risks, transaction and information costs associated with lending to different borrower classes, most FFIs in LICs try to optimise the adjustment of these three aspects of the loan (Gonzalez-Vegas, 1984a). When ceilings on loan rates become binding, however, lenders adjust the non-interest terms of the loan contract or reduce the term structure of the loan. The result is that borrowers receive a less attractive combination of these three aspects (op. cit.).

Several models have been used to explain this kind of lender behaviour. Among them are the portfolio theory, which provides insights into uncertainty and risk, and the theory of the multiproduct firm, because of its usefulness in explaining transactions costs, product differentiation and heterogeneity. Theories about non-price credit rationing have, however, been associated mostly with the controversy over the availability doctrine. This doctrine, whose most articulate exponent is Roosa (1952), emphasises

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[10] See Chapter Four.

that reductions in the money supply could have significant restrictive effects on spending, even if such restrictions result in only a small increase in interest rates. This is because banks are usually forced to reduce the amount of credit they could extend to their customers, even if the latter did not lower their demand for money. Hodgman (1960) nevertheless argues that because of the existence of default risk, any borrower will reach a loan size beyond which he or she will not be able to obtain additional funds by promising to pay a higher rate of interest. The supply of credit to a borrower becomes totally inelastic because each borrower's wealth and ability to repay are finite. To demonstrate the existence of credit rationing, however, it must be shown that an excess demand for credit exists at the rate charged in equilibrium (op. cit.). Jaffee and Modigliani (1969), note that credit rationing is not profitable for a lender acting as a discriminating monopolist, i.e. one who maximises expected profits with respect to each borrower and is free to charge each borrower a different interest rate. It has, therefore, been recognised that credit rationing takes place even without interest rate restrictions (op. cit.).

In his theory of agricultural lender behaviour Gonzalez-Vegas (1984b) argues that the loan portfolio of formal financial institutions (FFIs) accommodates both rationed and non-rationed borrower classes. Because of interest rates restrictions, the non-rationed classes, who are mainly the large farmers, receive bigger loans whereas the rationed borrower classes, the small farmers, receive smaller loans[11]. As the rate becomes more restricted (i.e. lower), the rationed borrower classes are squeezed out of the credit market (crowding out). This occurs as a result of the larger farmers taking advantage of

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[11] See Gonzalez-Vegas (1984b): pp. 78-95.

the low interest rate to demand bigger loans. The implications of the changes in loan size granted as a result of rationing are threefold. Rationed borrowers get a smaller share, non-rationed borrowers get a larger share of the loan portfolio; and as the interest rate ceiling becomes more restricted some borrowers are excluded from formal loans. Another implication is that the progressive concentration of the loan portfolio and the exclusion of marginal producers (small farmers) from access to institutional credit worsens income distribution. In addition, when interest rate ceilings are imposed in a situation of high inflation, implying negative real interest, the lenders will be unable to cover costs in the long-run. The institution will collapse if subsidies are not available. The rural financial landscape of LICs is littered with examples of FFIs which have operated under such conditions and have ultimately collapsed (Seibel, 1994; Bouman and Hospes, 1994). When losses of FFIs are too high, fiscal sources may not possess sufficient resources to continually provide the transfers needed. Some of the above implications have manifested themselves in rural credit programmes in Sierra Leone between 1972 and 1985[12].

The traditional analysis of the impact of interest rates ceilings posits a market characterised by an aggregate demand for loans inversely related to the loan rate of interest and an aggregate supply of deposits that is directly related to the deposit rate of interest. Furthermore, interest rate restrictions on loans are assumed to lead to a decline in the interest rates paid to depositors (Gonzalez-Vegas, 1984b). Consequently, most FFIs in LICs end up mobilising fewer deposit resources (where savings mobilisation is part of the functions of the FFI), and an erosion of loan portfolio (where the FFI is

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[12] See Chapters Three and Six for more details.

merely a credit outlet). This further deepens portfolio concentration and ends up excluding marginal borrower classes (op. cit.). The model's basic prediction that lenders adjust their loan portfolios in favour of large borrowers through quantity restrictions has not received clear support. Although the model has also been criticised (Cuevas, 1988) for its failure to include different loan procedures, information asymmetry and transaction costs, empirical work supports its price adjustment prediction and it is still useful in explaining the behaviour of agricultural lenders in relation to credit rationing (op. cit.).

2.34. Default and Delinquency Rates

The problems of delinquency and default have also been identified as some of the major obstacles associated with the failure of formal credit institutions in LICs. It has

Table 2.5. **Loan Delinquency in Selected Institutions in Africa, 1970-1973 (%)**

Country	Institution	Arrears Rate*
Ethiopia	WAMAMO	3
Ghana	CADU	50
Ivory Coast	BNDA	55
Kenya	GMR	33
	AFC	36
Niger	CNCA	29
Nigeria	WSACC	80
	FAID	95
Morocco	SOCAP	50
Sudan	COOP	26
	ABS	13
Tanzania	NDCA	50
Tunisia	BNT	50
Mean		**38**
Std. deviation		**26**

Note:- *loans not paid at due date.

Source: Agricultural Credit Sector Policy Paper; World Bank, 1974, p. 83.

often been difficult to distinguish between delinquency and default because of the variations in how default is calculated (Yaron, 1992a). The former denotes delay in repayment after the due date whereas, the latter is non-repayment. However, delinquency often leads to default. The traditional model presumed that formal lenders would be able to cover costs even with default. What is not addressed is the magnitude of the default that a lender can accommodate without impairing performance. USAID (1974), concluded that:

> "As would be expected, delinquency rates are a good indicator of project success. Unsuccessful projects had delinquency rates that ranged between 10 and 75 per cent, with most falling between 25-50 per cent. The successful projects had delinquency rates ranging from 0-15 per cent with most falling below 5 per cent. Although comprehensive data are not available, it appears that successful projects had rates of 2-3 per cent".

It has also been argued that default rate in excess of 10 per cent poses a threat to the credit institution (World Bank, 1974; USAID, 1974; Wahid, 1993). Wahid, however, cautions that formal credit institutions operating under high inflationary and restrictive interest rate regimes are unlikely to perform well if default rate is in excess of 2 or 3 per cent. Table 2.5 provides delinquency rates for selected institutions of countries in Africa, with a mean and standard deviation of 38 and 26 per cent respectively. Apart from CNCA in the Sudan and WAMAMO in Ethiopia, all other institutions experienced very high delinquency rates. The World Bank (1974) reports that most of these institutions were kept afloat by huge subsidies from governments and donor agencies including the World Bank itself.

The default issue is relevant on two main counts. Firstly, it reinforces the understanding that the structure and functions of rural credit markets also stem from the high financial losses faced by formal lenders while informal lenders experience little, if

any, default (Graham and Bourne, 1984). Secondly, the lender, whether formal or informal, can reduce the risk of default in a number of ways including a better sorting of risk categories through the use of contract terms, such as collateral, land titles, credit interlinkages[13]; a better screening of loan applicants; and choosing the right level of loan size and interest rate. The experience of the Grameen Bank in Bangladesh suggests that the reasons for its low default (about 3 per cent), was the careful screening of potential borrowers, as well as the pooling of information about customers (Rahman and Mahabub-ul Islam, 1993). Aleem (1990) also came to the same conclusion in his study of rural credit markets in Pakistan. Our study[14] also supports this observation. By comparison, RBs in Sierra Leone experienced default rates in excess of 35 per cent compared to about 1-6 per cent default rates reported by moneylenders[15]. This high default rate has contributed to RBs being incapable of improving financial intermediation. Our assessment is that a minimum level of screening and the absence of any attempt to pool information on defaulters are also contributory factors. The above observations tend to support the imperfect information hypothesis (Stiglitz and Weiss, 1981).

The non-payment of loans has several undesirable consequences. The first is that it gradually destabilises the credit system. In addition, when defaulters are the large farmers, the system becomes unjust inasmuch as these large farmers are subsidised by small farmers who tend to repay promptly (Vogel, 1984). It has been found that in many countries such as Colombia, Bolivia, Bangladesh, Costa Rica, Ethiopia, Sri Lanka and

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[13] See Chapter Four for details.
[14] See Chapter Four for details
[15] See Chapter Six

Ghana, the large farmers default the most (USAID, 1974; World Bank, 1975). Costs of overdue loans are high and default pushes up lending costs without any corresponding increase in loan turnover. Default also reduces the resource base for further lending, weakens staff morale and affects borrowers' confidence in the institution (Moinuddhin, 1969; World Bank, 1975; Singh, 1978; Vogel, 1984).

2.35. Activities of Informal Credit Sources in LICs.

The presence of informal credit sources (moneylenders, Rotating Savings and Credit Associations, relatives and friends) has also been blamed for the failure of FFIs in the rural areas of LICs (Bouman, 1977). In 1973, for example, two agricultural credit programmes in the Philippines, the Masagana-99 and the Masaganang Maisin, were introduced to modernise agricultural production and to achieve self-sufficiency in rice production by providing cheap loans to farmers. The cheap loans were expected to provide adequate resources for the farmers to afford the new technology (Floro and Yotopoulos, 1991). An evaluation by Esguerra (1981), however, revealed that the majority of the farmers in these programmes did not have access to the credit funds of the programmes due partly to the strong bias of the Masagana-99 project towards large farmers and to farmers' indebtedness to moneylenders. The latter get priority treatment when loan repayment is due, leaving inadequate or no resources to repay project debt. According to Yotopoulos and Floro (1991), the number of participants in the Masagana-99 programme alone dropped by about 90 per cent from 531,249 in 1974 to 54,250 in 1980. The majority of those who remained with the programme were large farmers. Yotopoulos and Floro added that: "correspondingly, the share of the formal sector in the rural credit market declined to the level of the 1960s. This meant that farmers who had

entered the government programmes and had adopted the use of modern inputs, such as seeds and fertilisers, were abruptly left without government credit and reinforced the farmers' dependence on informal lenders". Manto and Torres (1974), discovered that although the government of Bangladesh provided huge subsidies to credit programmes, informal sources were still a significant source of loans among programme recipients.

2.36. Other Views

Several other explanations have been put forward for the continued lack of access of formal credit to the rural poor. Lipton (1976), views the problem as a result of urban bias. He argues that urban interests conspire against the rural poor and deny them access to a significant amount of formal credit. Gonzalez-Vegas (1984a), provides an alternative explanation which focuses on supply allocation problems within the financial institutions. He argues that widely used concessional interest rate policies, combined with relatively large loan transaction costs of the lender for servicing small or new borrowers, discourage financial institutions from lending to the rural poor. It has also been argued by Bouman (1977), that many rural poor do not seek credit from formal sources because they lack profitable investment opportunities or do not know how to use formal credit or are unaware of its availability.

Furthermore, many rural poor do not take advantage of formal credit because of the type of collateral demanded (Moinuddhin, 1969; Kallon, 1978). In most African countries land is the most single tangible asset owned by the farmer; but the land tenure is mainly communal. It is usually held in trust for the community or for families and is not fee simple. In Sierra Leone, for example, the rural land tenure system is mainly communal. The Paramount Chief holds it in trust for families or the community. It

cannot be transferred through sale. In cases where usufruct rights are transferred to another family or individual for a period, the PC is consulted to make sure that an outright sale does not occur. This kind of transfer takes place when the head of a family defaults or uses the land to acquire a loan which is a pledge or part of a loan contract or a 'gift to a respectable stranger'[16] (Richards, 1986; Udry, 1990). Land/credit interlinkages[17] are very common in Africa. The land will, however, be returned to the pledgee or defaulter after the loan has been repaid or after the lender has exercised his usufructuary rights conferred upon him by the default or the pledge (Johnson, 1972; Udry, 1990). In parts of Asia, such interlinkages can result in a permanent transfer of land to the lender (Bardhan, 1989).

Thus, while the formal financial institutions in LICs carry out credit transactions within the limits set by the market environment and government policies, informal institutions evolve by particular selection of modes of economic behaviour that are responses to the intrinsic imperfections of the market. The informal market enhances trust by making existing ties an integral part of credit contracts (Richards, 1979; Floro and Yotopoulos, 1991)[18].

The debate has led to a general consensus that traditional assumptions were faulty. But it has not provided clear direction on the level of interest rate to be charged, the default rate that could be accommodated by a credit institution without impairing its intermediation role and the role of the informal financial market. This inconclusiveness

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[16] 'Gift to a respectable stranger' who may have married a daughter of the soil; such land may or may not revert to the original owners.
[17] See Chapter Four for more details.
[18] See Chapter Four for more details of this mode of operation of the informal credit market.

has led to a fresh look at the policies and operations of rural financial markets, especially the informal sector, under the New Institutional Economics.

2.40 The New Institutional Economics

The New Institutional Economics (NIE)[19] appeals to both logic and facts to dispute the claims of the 'traditional' view. In the first place, cheap credit does not make an unprofitable activity profitable. A sufficiently profitable activity will have returns that will adequately cover costs of the resources employed. Since in the NIE farmers are assumed to be efficient and make rational decisions, they also allocate borrowed funds in an efficient manner (Vogel, 1984; Adams, 1984; Aleem, 1990, Floro and Yotopoulos, 1991).

Second, credit is not a binding constraint to agricultural development. The NIE argues that many inputs and technologies are divisible and can be adopted in small quantities or utilised in other ways (Adams, 1984). Thus, credit is not like any other inputs, such as fertilisers, seeds, etc. It is a facilitator in the sense that the borrower who obtains it has a claim over resources. An important characteristic of credit is that it is fungible (Von Pischke, 1983). Consequently, a special credit programme may not achieve its desired results because the target borrowers can divert cheap credit to non-priority uses, to more profitable ventures and to consumption (Bourne and Graham, 1984).

Third, cheap credit provided by formal financial institutions is not necessarily cheap. The effective cost of borrowing which includes the nominal rate of interest and the transaction costs per Leone borrowed may be very high. The latter comprise out-of-

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[19] see Chapter Six for relevance of the New Institutional Economics on the operations of rural banks.

pocket costs and opportunity costs of the borrower's time spent to complete the loan procedures. For example, farmers can incur out-of-pocket expenses on transportation, refreshment to follow up loan applications[20]. These costs increase with the distance travelled and the number of visits to the bank (Adams, 1983; Aleem, 1990; Floro and Yotopoulos, 1991). Sometimes credit is not available to farmers when it is required. Processing of a loan application could take several weeks before the loan is disbursed (Adams, 1984; Richards and Karimu, 1981). Since some agricultural production activities are time-specific, it may be more risky to use the credit for agricultural production activities when the loan is disbursed late. Thus, a loan could be better used for purposes other than those for which it was intended. To farmers, accessibility and timeliness of credit are more important than the interest rate they have to pay (Vogel, 1984; Richards and Karimu, 1981).

Fourth, rural people do save, although most of their savings are in the form of real assets such as jewellery, livestock, building materials, crop inventories (Adams, 1984). This may be due to the negative return on financial instruments on which interest rate ceilings have been imposed, especially in periods of high inflation, making physical assets more attractive than financial instruments.

Fifth, cheap credit stifles the growth of formal financial institutions. Ceilings on interest rates decrease their ability and capacity to increase resources through savings mobilisation (Gonzalez-Vegas, 1984a). Our data and analysis in Chapter Six tends to support this view. Consequently, such institutions continually depend on subsidies from either foreign donors, governments or the central banks' rediscount mechanisms.

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[20] See Chapter Six for more details.

Most importantly, interest rates in the informal sector reflect the transaction costs of lending as determined by the level of trust (personalistic relationships) between contracting parties (lenders and borrowers) and the market interlinkage. The NIE sees markets and the economic rent they create not as a result of government manipulation, but rather as a natural outcome of the existence of non-zero transaction costs. These costs are not normally included in the conventional production costs of neo-classical theory. The NIE tries to isolate these costs with a view to explaining why an apparent economic rent is not in fact an economic rent and, thus, it is not a profit opportunity for new entrants. (Floro and Yotopoulos, 1991; p 13).

2.50. Retrospect, Prospects and Conclusions.

The assessment that rural credit markets play a passive or limited role in the development process[21] has been challenged with the increasing availability of data. The stimulus for this reassessment comes from the increased emphasis on rural/agricultural development and the realisation that past government policies to direct more funds to this sector and to intervene directly in rural credit markets have not been successful. This has led to a new orthodoxy which recognises that rural financial markets play a much bigger role than previously thought. Their operations are complex and contain imperfections that are not well understood, but which can adversely affect their operations and that of the rural economy. The new orthodoxy posits that financial markets provide a number of services such as the mobilisations and allocation of funds, transformation and distribution of risk, and the stabilisation of economic activity. It further recognises that these services are provided by both the informal and formal

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[21] See theoretical perspective in Chapter Four for more details.

sources. In this NIE, the moneylenders flourish not because they receive monopoly rent but because they perform varied and legitimate services and are better suited to the rural environment than the formal sources which were created to replace them (Seibel, 1994). Economists now believe that where the development of the market is suppressed by government controls or market imperfections, the flow of financial services will be sub-optimal and the pace of development will suffer. The NIE thus shifts the emphasis away from increasing the flow of credit as a farm input to one of improving the overall performance of the market, both formal and informal.

The NIE further argues that past government interventions failed because they were based on faulty traditional assumptions. For example, interest rates kept low by government policy led to credit rationing which discriminates against small borrowers, the group that governments aim to support. Low interest rates have also increased the losses of formal financial institutions already facing high default rates and operating in a high inflation environments. They have failed to provide a viable alternative to the moneylender whose displacement they seek to achieve.

More fundamentally, rural financial markets are widely observed to be fragmented. Fragmentation of money markets can prevent the optimal allocation of funds to investment opportunities thereby reducing the yield on capital and the level of output. There is no agreed explanation as to what causes fragmentation or how it affects the operations of the market or why this phenomenon is absent in the goods market. Perceptions about the role of credit markets are still evolving. More research, both empirical and theoretical is required into their complexities before their contribution can be fully understood. Our thesis represents a small step in this direction.

Chapter III Economic Background and Brief History of Agricultural Credit in Sierra Leone.

3.00. Introduction

The purpose of this chapter is to give a brief overview of the economic policies under which rural banks operated between 1985 and 1993, highlighting the role of the financial system in shaping the credit policy in Sierra Leone. Emphasis will be placed on those policies that impact directly on credit supply, especially for the rural areas. The chapter also gives a brief history of agricultural credit and the reasons for the failure of past credit schemes. This background lays down, to a large extent, the factors that led to the establishment of rural banks in Sierra Leone.

The chapter is organised into three sections. The first gives an overview of economic conditions during the 1980s, highlighting the commercial banks' aversion to supplying credit, especially to farmers, and reviewing some policies directly related to credit supply. The second discusses the contribution of agriculture to the economy and the third gives a brief history of the supply of credit in Sierra Leone, reiterating the interpretations given by various studies (Moinuddhin, 1969; Conteh, 1978 and 1979; Karimu and Richards, 1980; Karimu, 1981; Reddy, 1885; Johnny, 1985) for the failure of the various credit programmes that were established prior to the launching of the rural banking scheme.

3.10. Overall Economic Performance (1980 to 1993)

Sierra Leone has substantial economic potential given that it possesses mineral and other natural resources, as well as a climate and soil conditions that favour the cultivation of most tropical crops (Saylor, 1967, World Bank, 1989). These resources,

Table 3.1 **Gross Domestic Product At Factor Cost (constant 1984/85 prices)**

(Le Million)

Sector	1985	1986	1987	1988	1989	1990
Agriculture, forestry, hunting & fishing	2069.5 (44.5)	2008.1 (44.1)	2152.4 (45.5)	2309.5 (47.7)	2225.6 (44.9)	2341.3 (44.7)
Mining & quarrying	290.0 (6.2)	340.7 (7.5)	354.9 (7.5)	353.6 (7.3)	399.7 (8.1)	449.3 (8.6)
Manufacturing & handicrafts	165.9 (3.6)	159.5 (3.5)	147.1 (3.1)	141.2 (2.9)	127.1 (2.6)	133.5 (2.5)
Electricity & water supply	12.2 (0.3)	13.4 (0.3)	9.8 (0.2)	8.2 (0.2)	8.2 (0.2)	8.6 (0.2)
Construction	127.9 (2.7)	131.8 (2.9)	136.5 (2.9)	100.0 (2.1)	147.0 (2.9)	138.0 (2.6)
Wholesale & retail, hotel & Restaurants.	758.3 (16.4)	762.6 (16.7)	781.8 (16.5)	796.0 (16.5)	875.6 (17.7)	963.2 (18.4)
Transport, storage & Communications.	545.9 (11.7)	439.7 (9.7)	399.6 (8.5)	360.0 (7.4)	414.0 (8.3)	434.7 (8.3)
Finance & business services	433.9 (9.3)	436.4 (9.6)	456.6 (9.7)	461.0 (9.5)	461.5 (9.3)	476.1 (9.1)
Other services	102.8 (2.2)	106.0 (2.3)	107.4 (2.3)	109.4 (2.3)	109.4 (2.2)	109.4 (2.1)
Producers of govt. services	181.7 (3.9)	191.7 (4.2)	218.7 (4.6)	237.5 (4.9)	225.7 (4.6)	225.7 (4.3)
Less imputed charges of financial intermediaries	-35.0 (-0.7)	-36.9 (-0.8)	-38.3 (-0.8)	-39.0 (-0.8)	-40.0 (-0.8)	-41.0 (-0.8)
GDP at factor cost	4653.1 (100)	4553.0 (100)	4726.5 (100)	4837.4 (100)	4953.8 (100)	5238.8 (100)
Growth rate	-	-2.2	3.8	2.3	2.4	5.8

Note:- Figures in brackets represent percentage contribution to GDP.

Source:- CSO, Sierra Leone, 1992.

together with good economic management could be a basis for self-sustainable growth and raising the standard of living of the rural population (op. cit.). But Sierra Leone is still among the poorest countries in the world (The Economist, 1995).

The economy is basically agricultural with over 80 per cent of the rural population engaged in agriculture and its related pursuits (CSO, 1880). This sector about 40 to 45 per cent of GDP (Table 3.1) and is characterised by numerous small farmers cultivating, on average, less than two acres mainly in the upland (CSO, 1987). These small farmers still use rudimentary tools such as hoes, cutlasses, machetes etc. Less than 10 per cent of them make use of mechanical cultivation (CSO, 1987). Production has therefore remained mainly at the subsistence level. Economic and financial conditions in Sierra Leone during the period under review (1980-1993) were relatively poor. There were widespread shortages of essential commodities such as petroleum products, medicines, spare parts and rice (the nation's staple food). The major reasons are economic mismanagement, corruption and the failure of government to respond adequately to the changing economic circumstances. In particular, there was acute fiscal indiscipline and fiscal profligacy (Conteh, 1985). Social and other infrastructure deteriorated severely (IMF, 1987), leading to poor health and a high death rate. According to The Economist (1995, p. 66), Sierra Leone has the highest death rate (21.6 per thousand) in the world.

During the first decade of independence (1961-71), however, the economy grew at nearly 4 per cent a year. The fiscal and foreign exchange position was healthy. The first oil price shock in 1973 notwithstanding, economic growth exceeded 3 per cent per

year up to 1975. GDP growth slowed to about 1 per cent a year during 1975-80 mainly because of the decline in diamond output as a result of depletion of alluvial deposits, as

Table 3.2 **Value of Domestic Exports in Sierra Leone, 1984-1992 (constant $)**

($million)

	1984	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**
Total Agric.	**36.4 (28.1)**	**48.6 (37.2)**	**23.3 (19.7)**	**38.1 (28.0)**	**35.2 (33.3)**	**20.8 (15.3)**	**15.8 (11.4)**	**11.2 (7.6)**	**10.0 (6.1)**
Coffee	6.5	25.8	10.9	15.9	13.7	7.9	7.6	2.4	2.9
Cocoa	23.2	20.3	12.0	18.4	12.2	9.0	6.1	4.8	2.3
P. kernels	4.6	1.2	0.3	-	0.2	-	-	0.06	0.02
Piassava	0.04	0.06	0.02	0.07	0.07	0.04	0.03	0.08	0.1
Ginger	0.2	0.08	00.03	0.01	-	...	0.02	-	-
Fish & Shrimps	N/A	N/A	N/A	N/A	5.4	1.8	1.1	0.4	0.07
Raw Tobacco	-	-	-	-	0.8	1.4	0.6	1.6	1.5
Others	1.9	1.2	3.0	3.7	2.8	0.7	1.2	1.9	3.1
Total Minerals	**93.2 (71.9)**	**82.0 (62.8)**	**95.0 (80.3)**	**98.0 (72.0)**	**70.4 (66.7)**	**115.0 (84.7)**	**121.7 (88.6)**	**137.7 (92.4)**	**153.3 (93.9)**
Gold	8.4	5.0	3.7	3.5	0.5	2.3	0.2	0.2	0.5
Diamonds	40.1	27.6	27.8	31.4	3.3	20.9	12.6	33.4	33.6
Bauxite	19.8	22.1	22.6	21.1	22.2	25.1	25.9	24.6	42.6
Rutile	24.9	27.3	40.9	42.0	44.4	64.6	78.8	75.2	71.9
Ilmenite	-	-	-	-	-	2.1	4.2	4.3	4.7
Total Exports	**129.6**	**130.6**	**118.3**	**136.1**	**105.6**	**135.8**	**137.3**	**148.9**	**163.3**

Note:- N/A = not available

... is negligible

Figures in brackets represent percentage of total exports.

Source: - BSL Economic Reviews and Annual Reports, 1984 - 1992.

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well as the cessation of iron ore mining. GDP growth has been at a virtual stand-still since then, with an annual average growth rate of only 0.2 over 1980 to 1985 (IMF, 1992). The current economic crisis began when huge expenditures were made for

hosting the Organisation of African Unity Annual (OAU) conference without any corresponding increase in revenue in 1980, which led to a serious drain on the country's reserves. The second oil price shock in that same year and the decline in prices of some of Sierra Leone's main exports, particularly cocoa reduced the country' purchasing power (IMF, 1987). Partly because of an overvalued exchange rate, an increasing proportion of diamonds and gold exports have been traded in the parallel market, constituting an important form of capital flight. Official cocoa and coffee exports declined as smuggling increased. Consequently, total recorded exports declined by about one quarter between 1985 and 1989, but increased by 17 per cent in real terms in the fiscal year ending June, 1990 (IMF, 1992). Total recorded imports also declined by about 25 per cent (value-wise and in real terms) between 1985 and 1988, but rebounded subsequently and by June, 1990 stood at 95 per cent of their 1985 level (op. cit.).

Table 3.3 **Selected Rates in the Economy of Sierra Leone, 1980-1993 (%)**

Year	Savings Rate*	Loans & Advances Rate*	Central Bank Discount rate	Exchange Rate (Le/US$)	Inflation Rate
1980	10.5	18	10	.76	12.9
1981	10	20	10	.90	23.3
1982	10	20	10	1.16	26.9
1983	11	22	12	1.86	68.5
1984	12.5	23	12	2.51	66.6
1985	13	25	12	5.12	76.6
1986	14	25	14	15.24	80.9
1987	15	26	16	34.04	178.7
1988	16	27	16	32.51	32.7
1989	30	50	16	59.82	62.8
1990	40	50-60	55	151.41	111
1991	55	65-80	55	295.34	102.7
1992	50	55-75	45	499.08	65.5
1993	35	45-55	30	560.38	34.8

Note:- * Commercial banks' rates.

Source:- Bank of Sierra Leone Economic Reviews (various issues, 1980-1994)

Overall economic performance in the 1980s was therefore unsatisfactory. GDP declined in every year, except 1983/84 and 1986/87 (Table 3.1). Official exports declined overall, as trade was diverted from official channels into the parallel market. The disparity between the official and parallel market rate of exchange attracted most commodities underground especially in the face of acute shortages. Per capita income has also been declining reaching an estimated US$167 in 1995 (The Economist, 1995, p. 24). Total government revenues in relation to GDP declined steadily from 8.3 per cent in 1982/83 to 5.5 per cent in 1985/86, before gradually rising to the 1982/83 level in 1988/89. Although expenditure on wages, goods and services as well as capital expenditure fell as percentage of GDP in the first half of the decade (IMF, 1987; CSO, 1992), the ratio of subsidies and transfers to GDP declined to 1.6 per cent in 1988/89. Government borrowed from the banking sector mostly to finance its rising deficit, crowding out the private sector (IMF, 1989). By June 1990, government accounted for over 60 per cent of total domestic credit outstanding (IMF, 1991). This had the effect of fuelling inflation, which peaked to about 179 per cent in 1987 (Table 3.3). The decline in economic activity recorded by official national accounts, continued in 1987/88 and 1988/89 (CSO, 1989).

In 1986, government attempted to address the problems of the declining economy through exchange rate adjustments; but these were limited, applied too late and not sustained. In June of the same year, government introduced comprehensive economic reforms including a market-determined exchange rate regime, a liberalised import regime and decontrolled prices for many basic goods. This programme was the basis for an IMF stand-by arrangement approved in November, 1986, which was supplemented by

Structural Adjustment Facility resources. But government failed to meet the programme's fiscal and monetary targets. In March, 1987, the programme was suspended (IMF, 1987). In November, 1987, government issued restrictive regulations called the Public Emergency Economic Regulation (PEER) which were characterised, among other things, by rigid controls on currency holdings, cross border trade and prices of domestic products (PEER, 1987). These measures were largely bypassed by the majority of the business community and resulted in significant reduction in official trade and foreign exchange flows into the banking system. The parallel market thrived, especially on account of the banking system's inability to supply adequate foreign exchange to meet domestic demand.

Government also devalued the Leone from Le32/US$ in March, 1988 to Le 60/US$ in 1989 (Table 3.3). But due to insufficient foreign currency in the banking system to satisfy demand, parallel market rate of the US dollar rose to about Le 81.00, almost five times the official rate. Under the PEER, government also liberalised the trade regime. Importation of rice was privatised and the Sierra Leone Produce Marketing Board's (SLPMB) monopoly in export crops (coffee, cocoa etc.) was abolished in June, 1990 (Budget Speech, 1990). Special import licences were also abolished. It became clear that these reforms were not enough to forestall further economic decline in economic performance. Because of extra-budgetary expenditure, the overall budget deficit in 1988/89 amounted to 7.8 per cent of GDP, on a commitment basis (op. cit.). This was in deference to other measures instituted by government such as the elimination of 'ghost workers'[22], cancellation of supply contracts and the introduction of a bonus

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[22] People receiving salaries even though they are not on the payroll.

scheme for tax collection. The budget deficit was financed by borrowing from the banking system. This financing led to an increase in money supply (Table 3.4) which further fuelled inflation.

As the banking system had virtually no foreign exchange to sell to the private sector and real interest rates remained negative, there was little incentive to save in financial form. Currency outside banks grew (Table 3.4) as parallel market activities increased further. Despite an increase in money supply by over 50 per cent, banks faced acute shortages of currency notes. The economy could arguably be called, at the time, a parallel market economy and confidence in the banking system and economy waned. The PEER was abolished in June, 1989. Since that time government has had frequent discussions with the IMF on the components of an adjustment programmes. A new Structural Adjustment Programme called a Rights Accumulation Programme began in 1992. Its objectives include, among other things, liberalisation of trade and interest rates,

Table 3.4 **Currency in Circulation and Money Supply in Sierra Leone (as at 30th June).**

(Leone Million)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Currency notes	96	141	233	369	649	1529	1980.	2897	6069
Coins	5	6	6	6	-	-	-	-	-
Currency issued	101	147	239	375	649	1529	1980.	2897	6069
Currency in Com. banks	9	13	13	22	37	29	118	60	224.
Currency outside banks	92	134	226	353	612	1500	1862	2837	5844
Demand deposits	77	123	134	249	572	1616	1955	3150	4013
Money supply	169	257	360	602	1184	3116	3818	5987	9857
Savings deposits	70	89	131	168	243	408	689	988	1447
Time deposits	85	96	64	96	124	145	302	380	687
Quasi money	156	185	195	264	367	553	991	1368	2134
Total monetary assets	325	442	555	866	1551	3669	4809	7355	11991

Source :- CSO, Sierra Leone, (1992).

removal of subsidies, abolition of the monopoly of the SLPMB. Special import licences were also abolished and simplified export procedures instituted.

3.11. Overview of the Financial System

The financial system in Sierra Leone is relatively small, underdeveloped and shallow in financial assets when compared, for example, to Nigeria and Ghana. The structure consists of the Bank of Sierra Leone (the Central Bank), Six Commercial Banks[23], the Post Office Savings Bank, National Co-operative Development Bank, twelve Insurance Companies (the number may have increased as at time of writing), numerous Pension Funds and eight rural Banks. The financial system expanded in the late 1970s to early 1980, mainly due to the increase in trade and other economic activities (CBs, 1978). Previously, there were only three commercial banks and a couple of insurance companies. Two of these commercial banks were 100 per cent foreign owned[24] until the late 1970s when shares were floated in the open market. The branch network of these commercial banks is mainly concentrated in the urban areas especially Freetown. As at March, 1994, commercial banks had 39 branches, 40 per cent of which were located in Freetown alone (the Survey, 1994). The banking system is dominated by three banks, Barclays, Standard Chartered and Sierra Leone Commercial bank, which share close to 80 per cent of the banking services in the country (BSL, 1992). In terms of branch network, the situation suggests limited access to banking services. A rough picture of the adequacy of banking (access to banking services) could be determined by calculating the ratio of population in relation to the number of bank offices. This ratio

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[23] These are Barclays Bank, Standard Chartered Bank, Sierra Leone Commercial Bank, National Development Bank, Meridien (BIAO) Bank and the International Bank for Trade and Industry (closed down in late 1992).

[24] These are Barclays and Standard Chartered Banks.

ranges from 0.01 to 0.5 in LICs, compared to above 1.0 in developed countries (Cameron, 1967). In Sierra Leone, the ratio dropped from 0.16 in 1983 to 0.10 in 1994 due to the closure of two banks namely, Bank of Credit, Commerce and Industry (BCCI) and its branches in 1991, the International Bank for Trade and Industry (IBTI) and its branches and closure of branches in parts of the country by Barclays and Standard Chartered banks. These closures have been attributed to poor liquidity management arising from imprudent banking, the harsh economic environment and the 'rebel' war which has affected major production areas in the provinces. The ratio suggests inadequacy and limited access to banking services for the majority of the population in Sierra Leone.[25]

The financial system has been depressed throughout the 1980s. Financial depth measured by the ratio of broad money (M2)[26] to GDP, declined during the early 1980s, but increased slowly to reach 2.3 in 1990 mainly on account of economic liberalisation measure instituted as discussed above. Some bankers argue that this is reasonable for the country's stage of economic development (CBs, 1978); but the World Bank (1989) holds a different view, maintaining that the financial depression is the result of restrictive policies, especially interest rates and distortions in the economy (op. cit.) and recommends a restructuring programme.

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[25] The ratio = [number of bank offices (commercial banks) x 10,000 people/population].
The figures for Sierra Leone are, 51 and 39 bank offices in 1983 and 1994 respectively (survey), with a population 3.26 and 3.765 million for the respective periods (CSO, 1986). Therefore, the ratio of bank concentration in Sierra Leone = 51x10,000/3,765,000 = 0.16 (1983) and 0.10 (1994). According to Cameron (1967, p. 297) if the ratio is 1 and above, it is adequate. If it is between 0.5 and 1.0, it is moderate. If it is below 0.5, it is inadequate.

[26] In Sierra Leone, M2 includes Quasi money and time and savings deposits.

3.12. Regulating the Financial System and Some Credit Policies in Sierra Leone

Under the Banking (Amendment) Act, 1978, and the Bank of Sierra Leone (Amendment) Act, 1970, the central bank has authority to licence, regulate and supervise commercial banks including the rural banks. The Ministry of Finance (now Department of Finance) through the central bank, monitors the financial sector and establishes monetary and economic targets and policies. The central bank administers these policies using a set of instruments which are adjusted in accordance with changing economic circumstances. Some of these policies which have a direct impact on credit supply include,

1. Interest rates guidelines (which set the minimum and maximum for savings and lending rates),
2. The discount rate,
3. The reserve requirement which has usually been set in terms of liquid assets requirement, but occasionally also specifies cash ratios and
4. Selective credit controls over the expansion and direction of credit.

It is worth noting that interest rates guidelines have been abandoned under the Rights Accumulation Programme (a version of Structural Adjustment) sponsored by the International Monetary fund (IMF) which commenced in 1992. Interest rates are now determined by the market. Similarly, selective credit controls have also been abolished together with foreign exchange restrictions. But it should also be noted that the effects of the current IMF programme are being overshadowed by the on-going 'rebel' war, which has engulfed over three-quarters of the production areas and stifled investment in the economy.

Before 1991, interest rates were determined administratively, and were largely negative in real terms due to inflation. This trend continued up the beginning of 1991.

The argument then was that maintaining low interest rates, as in many LICs, would stimulate investment. But as discussed in Chapters Two and Six, the impact of this is still unclear because of the opposing income and the substitution effects[27]. According to the BSL (1992), the impact of this regulation has not been clear. It would appear that the response of savings and investment to interest rates has been largely neutral. It has not produced a significantly marked effect in the amount of savings (BSL, 1992). But this statement should be treated with caution. The lack of a marked increase in savings in the banking system after liberalisation of interest rates in the economy may be due to two main factors. First, interest rates were still below inflation until 1992 (Table 3.3) and savings may have been in terms of real assets. Secondly, the 'rebel' war is still on-going and potential savers may be converting their savings into hard currency. The continued buoyant activity in the parallel market, especially for hard currency suggests that the latter may be more significant in explaining the indifference of savings to interest rates (IMF, 1989). The low levels of interest rates and their negative return on interest incomes introduced distortions in the economy. Commercial banks have, therefore, been rationing credit by non-price means. They have emphasised collateral requirements such as land and life insurance policies which the average farmer in Sierra Leone cannot provide.

The sector which has received most of the loans and advances from commercial banks is trade. It received 34 per cent of commercial bank loans between 1981 to 1991 (Table 3.6). Given that most trade is in imported commodities (BSL, 1992), some observers have argued that commercial banks have been financing consumption at the

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[27] see chapter six for more details.

Table 3.5

COMMERCIAL BANKS' LOANS AND ADVANCES BY ECONOMIC SECTOR

As at 30th June of each Year (in Million Leones)

Sector	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Agriculture	4	3.9	3.3	2.5	3.8	8.1	13.7	24.8	133.8	198.9	563.7	537.5
Mining	12.7	13.8	10.9	15.6	4.2	20.4	20.3	31.4	57	109.6	337.6	578.5
Manufacturing	6.8	3.8	8.1	6.8	7.5	21.5	48.8	30.4	160.2	258.8	863.9	1280.8
General Commerce	28.2	20.8	33.2	41.3	70.9	69.3	148.4	252.2	695.7	924	2486.6	2494.9
Exports	3.7	3.8	6.9	9.4	12.1	10.3	23.7	26.2	174.2	235.2	367.3	336.4
Imports	15.2	23.7	18.4	14.4	28.5	25.3	49.8	150.8	270.6	414.1	1136.2	915.1
Local Govt. Authorities	0.2	0.3	0.7	0.2	0.2	...	...	...	...	0.1	3.9	19.7
Financial Institutions	2.1	2.4	2.1	1.8	1.1	0.8	6.3	...	1.2	75.1	0	8.2
Non-Financial Public Sector Institutions	3.4	1	1.6	0.8	1	1.1	0.5	10.8	2.9	19.4	19.4	4.7
Miscellaneous	8.3	16.9	21	18.7	14.2	17	40.5	115.8	123.2	290.5	1402.4	2557.3
Total	**89.3**	**97**	**114**	**121.9**	**153.4**	**182.9**	**359.6**	**671.9**	**1802.2**	**2712.3**	**7685.3**	**9771.8**

Note:- ... Negligible

Sources:- Bank of Sierra Leone Economic Reviews (Various issues 1982 - 1993)

Table 3.6 **PERCENTAGE DISTRIBUTION OF COMMERCIAL BANKS LOANS AND ADVANCES**

SECTOR	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Agriculture	4.5	4	2.9	2	2.5	4.4	3.8	3.7	7.4	7.3	7.3	5.5
Building & construction	5.3	7	6.8	8.5	6.5	5	2.1	4.4	10.2	6.9	6.6	10.6
Mining	14.2	14.2	9.6	12.8	2.7	11.2	5.6	4.7	3.2	4	4.4	5.9
Manufacturing	7.6	3.9	7.1	5.6	4.9	11.8	13.6	4.5	8.9	9.5	11.2	13.1
General Commerce	31.6	21.4	29.1	33.9	46.2	37.9	41.3	37.5	38.6	34.1	32.4	25.5
Exports	4.1	3.9	6.2	7.7	7.9	5.6	6.6	3.9	9.7	8.7	4.8	3.4
Imports	17	24.4	16.1	11.8	18.6	13.8	13.8	22.4	15	15.3	14.8	9.4
Local Govt.Authorities	0.2	0.3	0.6	0.2	0.1	...	...	...	...	...	0.05	0.2
Financial Institutions	2.4	2.5	1.8	1.5	0.7	0.4	1.8	...	0.1	2.8	...	0.1
Non-Financial Public Institutions	3.8	1	1.4	0.7	0.6	0.6	0.1	1.6	0.2	0.7	0.25	0.05
Miscellaneous	9.3	17.4	18.5	15.3	9.3	9.3	11.3	17.2	6.8	10.7	18.2	26.2
Total	100	100	100	100	100	100	100	100	100	100	100	100

Source:- Calculated from Table 3.5

expense of production (Moinuddhin, 1969, Conteh, 1987). The agricultural sector received, on average, less than 6 per cent of loans from the commercial banks for the same period. The commercial banks' argument for low agricultural loans include lack of trained staff to handle the appraisal and monitoring of agricultural loans and projects, Although subsidisation of credit has been motivated by broadly recognised development and social objectives in many LICs, this policy has rarely proved to be the best means of targeting subsidies (Adam, 1971, Tommy and Roberts, 1978). The effects of this policy have already been discussed in Chapter Two and will be examined more fully in the Sierra Leone context in Chapter Six. The reluctance of commercial banks to devote a large proportion of their loans portfolio to agriculture led the SLG to use other means in getting their co-operation in this regard. In December, 1988, the BSL issued sectoral guidelines to commercial banks for lending. This was motivated by the failure of moral suasion as a general policy when dealing with the commercial banks. The guidelines indicated that commercial banks' loans portfolio should reflect the following proportions.

- 30 per cent of loans to agriculture
- 30 per cent to trade
- 20 per cent to mining and
- 20 per cent to other sectors (BSL, 1988).

As Tables 3.5 and 3.6 show, these targets have largely been ignored. The commercial banks devoted less than 20 per cent to agriculture, most of which was directed at agricultural trade (especially purchasing of export produce). The guidelines did not specify, as was the case in Nigeria (Ogundipe, 1990; Okorie, 1992), the proportion that was to be devoted to agricultural production. Consequently, commercial banks

circumvented this guideline by concentrating on agricultural trade. Most of the beneficiaries were large businesses and companies (i.e. buying agents for the SLPMB) who held accounts with commercial banks. The arrangement was also convenient since payments to these buying agents made by the SLPMB, that bought produce, were lodged with the commercial banks in cheques. Thus, the commercial banks deducted the repayment at source as soon as these cheques were deposited in the agents' accounts (CBs, 1978). The Central Bank has also used its reserve requirement for controlling the supply of credit. But commercial banks were also quick in limiting their credit to trade and squeezing out lending to the agricultural sector.

A Credit Guarantee Scheme (CGS) for small borrowers had been launched in 1974 an attempt to cajole commercial banks to lend to the agricultural sector. The guarantee cover was 70 per cent (raised to 80 per cent in 1978) for all loans to the agric-

Table 3.7 **Sectoral Analysis of Loans under the Credit Guarantee Scheme in Sierra Leone, 1974-1985 (Le'000')**

Year	Trade		Agric.		Transport		Industry		Services		Total	
	no.	amt.	no.	amt	no.	amt.	no.	amt.	no.	amt.	no.	amt.
1974	130	387	8	22	2	7	10	82	2	2	152	500
1975	89	369	22	72	12	69	8	84	5	4	136	598
1976	54	248	10	33	4	43	7	22	-	-	75	346
1977	44	178	9	57	4	23	3	14	-	-	60	272
1978	28	127	6	44	1	10	1	1	1	1	37	183
1979	6	21	2	3	2	37	-	-	1	1	11	62
1980	4	17	1	2	-	-	4	44	1	3	10	66
1981	3	26	1	3	1	20	-	-	1	1	6	50
1982	8	55	-	-	-	-	-	-	-	-	8	55
1983	8	64	30	207	-	-	-	-	-	-	38	271
1984	6	62	15	101	-	-	-	-	-	-	21	163
1985	5	32	5	24	-	-	-	-	-	-	10	56
Total	385	1586	109	568	26	209	33	247	11	12	564	2622

Source:- Development Finance Department, BSL (1986).

cultural sector and $66^2/_3$ per cent for loans to other sectors. The cover provided some kind of insurance to commercial banks, in the event of a default. In such a case, the Guarantee Organisation i.e. the Central Bank, reimburses the commercial bank to the tune of the cover for the amount of loan outstanding (CGS, 1974 and 1978). A fundamental mistake was that the CGS did not give a cut-off date for the commencement of guarantees. Thus the commercial banks made good their old and outstanding debts and losses through the CGS. Table 3.7 gives the number and amount of guarantees honoured by the scheme. The figures should be treated with caution in the light of the foregoing point. The increase in amount and number of loans in 1974 and 1975 is mainly due to the laundering of bad debts by commercial banks. After 1976, loans guaranteed under the scheme declined as commercial banks reverted to their reluctance in lending to the agricultural sector. The figures also show that the trade sector received the highest proportion of total loans, 61 per cent as against 22 per cent for agriculture. The percentage distribution is reminiscent of the commercial banks aversion to agricultural credit. Against the background of the foregoing discussion, it could be concluded that government has not succeeded in persuading commercial banks to lend to the agricultural sector. The CGS is still in operation, but is mainly providing guarantee cover to rural banks. Commercial banks aversion to aversion to agricultural credit in Sierra Leone is summed up in their joint paper presented at the National Workshop on Agricultural Credit and Banking:

> "farmers are still mostly illiterate and bound by strong concepts and customs. They are completely ignorant of business methods and have little notion of the meaning and obligations of institutional credit" (CBs, 1978: p. 64).

It could therefore be concluded that commercial banks in Sierra Leone are not yet interested in agricultural credit. It should, however, be noted that the above credit policies were motivated by a recognition of the importance of the agricultural sector in the economy and government's objective of achieving self-sufficiency in food production, especially rice. But this objective remains largely unfulfilled.

3.20. Agriculture in the Sierra Leone Economy

As stated earlier, agriculture is the dominant sector of the Sierra Leone economy. About 60 per cent of the population earn their living and incomes from agriculture and its related pursuits (CSO, 1992). Overall, the sector contributes about 45 per cent to GDP (Table 3.1). Agriculture also contributed over 80 per cent to export earnings during the 1970s. But this proportion decreased to about under 40 per cent in 1985 and to less than 10 per cent in 1992 (Table 3.2), due to decreased production and the deteriorating macro-economic environment within which the sector has had to operate.

Although the agricultural sector employs over 60 per cent of the population yet its contribution to GDP between 1980 and 1992 has been low, indicating the inefficiency of the sector. This sector was largely ignored in Sierra Leone's post independence development strategy. This neglect coupled with rural out-migration contributed to the low growth observed since independence as Sierra Leone like most emerging nations adopted import substitution policies (Byerlee et al. 1976).

The overall growth rate of the economy was around 3.8 per cent in the decade after independence and less than 1 per cent during the 1980s; the agricultural sector grew at 1.6 per cent and -0.1 per cent respectively (Byerlee, et al., 1976; CSO, 1989).

Agriculture's contribution to the Sierra Leone economy can be summarised through three major categories;

(a) source of food supply,

(b) source of foreign exchange and

(c) source of employment.

3.21. Source of Food Supply

Sierra Leone was virtually self-sufficient in rice production until 1954 in the wake of the discovery of diamonds. Although production was at subsistence level, it largely satisfied domestic demand. The discovery of diamonds in the early 1950s attracted large numbers of young and able-bodied men and women from farms in search of quick wealth in the diamond mines (Byerlee et al. 1976). From 1954 onwards, importation became necessary to bridge the gap between production and domestic demand. From 1954 to 1982, imports of rice increased significantly from about 4.6 thousand tons valued at Le 0.58 million to 89 thousand tons worth Le 48 million (Johnny, 1985). Imports soared through the eighties reaching about 300 thousand tons in 1992, valued at over Le 500 million (Table 1.2). The low level of production has been attributed to several factors, among which the most important is migration to diamond mining areas (Byerlee, et al., 1976). Levi (1976) estimated that over 70,000 men moved to the mining areas from the farms between 1954 and 1960, while others went to urban areas in search of jobs. Another important factor is the overall population growth which has outstripped the growth in food production. While the rate of growth of agricultural production was, on average, below 2 per cent, between 1980 and 1990, population growth was estimated at about 2.6 per cent (CSO, 1986). Government pricing policies have also been urban-

biased. Prices, especially for rice have been fixed low, creating a disincentive to production. Some observers (Tommy and Roberts, 1978; Johnny, 1985) have noted that low prices were intended to appease the powerful urban groups. The above factors have not only caused shortages in food supplies but have also led to a reduction in foreign exchange inflows.

3.22. Source of Foreign Exchange

The major foreign exchange earners are minerals (diamonds, gold, bauxite, Illmenite) and agricultural products (coffee, cocoa, ginger, piassava and palm kernels). Table 3.2 gives export earnings for the period between 1984 to 1992. The Table indicates that export earnings from the agricultural sector have been decreasing and its contribution to total export revenue declined from 37 per cent in 1985 to less than 10 per cent in 1992. Most of this export revenue has been used to pay for the huge imports of not only food (mainly rice) but also other essential commodities such as petroleum products. The declining trend in the agricultural sector has been further exacerbated by the effect of the on-going 'rebel' war which has engulfed over 80 per cent of the production areas.

3.23. Source of Employment

As stated earlier, over 60 per cent of Sierra Leone's population of 3.76 million live in the rural areas, of whom about 80 per cent are farmers or obtaining their incomes and livelihood from agriculture and its related pursuits (CSO, 1986). This huge proportion is still producing below domestic demand. Per capita incomes in rural areas is below two-thirds of the 1995 national figure of US$167 (The Economist, 1995). The overall objective of government is to encourage farmers to increase production to market

level. Since poverty and lack of capital have been identified as the main bottlenecks towards achieving this goal, government has tried several schemes to provide cheap credit to the rural areas, especially to farmers. The current development strategy is, therefore, both growth and welfare oriented[28]. Some of the schemes which have been established by the government of Sierra Leone to achieve these objectives are the subject of the next section.

3.30. Brief History of Agricultural Credit in Sierra Leone

We are interested in the history of past credit schemes for two main reasons. First, the factors which influenced their creation and the demise of these programmes are important in analysing the factors influencing the level of achievement of the present model of supplying credit (i.e. the rural banks) and provides a basis of comparison of these schemes with rural banks. It will also facilitate an assessment of changes in policy and what effect these changes (if any) have had on rural banks' performance.

The history of agricultural credit in Sierra Leone makes dismal reading. The organisation of agricultural credit was a major concern of the government of Sierra Leone (GSL) even before independence in 1961. The overriding objective has been to provide finance to the numerous small farmers in the form of low cost loans to help them procure modern inputs such as fertilisers and improved seed in order to both move them from subsistence to commercial production and to increase their incomes and standard of

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[28] The most prominent development objectives in the agricultural sector have included the 'stimulation of development from subsistence to market oriented production, diversifying production, self-sufficiency in food production, especially rice, maximising foreign exchange earnings through the expansion of export crop production'. The welfare objectives of development include 'increasing the incomes and living conditions of the rural population' (National Development Plan, 1978/79, p. 130-131).

living. Alongside these schemes, rural residents have also been receiving credit from moneylenders, rural residents and itinerant traders i.e. the informal sector.

Thus, the sources of credit in Sierra Leone can be grouped into two categories, formal or institutional and informal or non-institutional credit sources. The former includes Commercial banks (CBs), Co-operative Societies, the National Development Bank (NDB), Integrated Agricultural Development Projects (IADPs), the National Co-operative Development Bank (NCDB) and Rural Banks (RBs). These are wholly or partly owned and often controlled by government. The latter, the informal credit sources, include moneylenders, Rotating Savings and Credit Associations (the *osusu* clubs[29]), relatives and friends. Informal sources are neither controlled nor monitored by government. It has been estimated that less than 5 per cent of farmers in African countries have access to formal credit (World Bank, 1974). Our Survey and analysis in the Chapter Six suggests that this is still true for farmers in Sierra Leone.

3.31. Credit Schemes

The position of commercial banks regarding agricultural credit and government attempts to induce them to participate in providing loans to the sector has already been discussed and demonstrate, to a large extent, one of the reasons why government has been involved directly in this regard. Before independence, a number of schemes were introduced, the first of which was implemented in 1946 through the Development of Industries Ordinance. Its purpose was to advance loans to farmers who then formed over 80 per cent of the population, as well as to small scale industrialists (CSO, 1970/71). The records show that farmers at the time used simple tools - hoes and cutlasses - without

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[29] The *osusu* is the local name for the rotating savings and credit associations (ROSCA) in Sierra Leone.

any fertilisers, pesticides or insecticides and produced mainly for their own consumption. Consequently, it was decided to provided funds which would enable them to adopt fertilisers, improved seed and new technology. The interest rate charged was 3 per cent compared with 5 to 8 per cent for commercial bank loans. Repayment of loans was in cash and at end of harvest. The loans were short term (6-9 months). Over 60 per cent of beneficiaries were rice farmers. After about fifteen years in operation, an assessment of the scheme revealed that it had not achieved its objectives (Moinuddhin, 1969). The main problems identified include (1) the granting of loans without proper project appraisal (2) the fact that the main beneficiaries turned out to be influential people in the rural areas (PCs, chiefdom speakers, Councillors and Members of the Legislature) who did not repay, (3) high default rates and (4) non-existence of strong legislation to prosecute defaulters. As a result, the scheme was discontinued in 1964 with over Le113,538 or about 67 per cent of the loans still outstanding (MANR, 1965). During this period, another credit scheme to help the fisheries sector was also in force. It was also discontinued in 1961 after Le 85,306 or 55 per cent of loans resulted in default (MANR, 1965).

3.32. The Agricultural Loans and Credit Scheme

When it became apparent that the failure of the first scheme was imminent, the GSL instituted another scheme in 1961 whose objective was to help farmers to increase production of export crops such as coffee, cocoa, oil palm and ginger. The export potential of these crops as foreign exchange earners was beginning to be realised and GSL was motivated to increase exports. Unlike the first scheme which was administered with overdraft facilities to farmers by commercial banks with government guarantees, the

Agricultural Loans and Credit Scheme was financed by budgetary allocations. It was intended to supplement credit from co-operative societies which had been in existence since the 1930s. The scheme used Principal Agricultural Officers (PAOs) to channel the funds to farmers. Applications had to be submitted to the Agricultural Officers (AOs) of the area concerned, who were expected to appraise the applications and make recommendations to the PAO. The applications were then sent to the 'Provincial Loan Boards' after which they were forwarded to the Chief Agriculturist (CA) in Freetown for approval. Thus, applications took not less three months before approval (Moinuddhin, 1969). An evaluation of the scheme revealed that corruption by extension officers was rife. Projects were inadequately appraised and extension officers were unable to monitor farmers because of the high farmer/extension officer ratio. The ratio, which was about 1300:1 (Moinuddhin, 1969). In addition, seeds and other inputs were largely unavailable and farmers who received credit for farming frequently diverted such funds to other uses. The overall result was a depletion of the fund mainly on account of the high default and misappropriation. In his summary of the evaluation of this scheme, Mionuddhin (1969: p. 18) wrote:

> "The Agricultural Loans and /Credit Scheme has suffered both on account of lack of interest of the borrowers in the execution of projects undertaken by them and also as a result of inadequacies in loan management, appraisal of projects and supervision. Market gardening poultry and piggery projects undertaken under this scheme have suffered from lack of marketing facilities and the unavailability of feed. Machinery and equipment purchased by borrowers have been rendered useless and unproductive for want of spare parts, repairs and maintenance facilities."

Meanwhile, Co-operative Societies had also been functioning under the supervision of government.

3.33. Co-operative Societies

The Co-operative Societies are the oldest institutions to be involved in the supply of credit in Sierra Leone. They were established as far back as the 1930s through government encouraging, mainly farmers, to become members. The government official with responsibility for overseeing their formation, supervision, monitoring and auditing is the Registrar of Co-operative Societies (RCS), whose team, made up of civil servants, was frequently ill-equipped to organise and monitor such institutions. In a report by the International Labour Organisation (ILO, 1980), it was revealed that out of 35 civil servants under the RCS, only about one-quarter of them had attended some form of training pertaining to co-operative development.

By the 1950s, these societies were merely engaged in marketing of produce for their members with credit forming just 10 per cent of their operations (MANR, 1967). Credit was mostly in kind consisting of sacks and transport facilities to evacuate produce. Repayment was also in kind. The RCS also operated a loan fund, which was mainly intended to provide credit for labour and consumption needs. The scheme started in 1950 with an initial government appropriation of Le 115,000, and granted loans to co-operative societies at interest rates of 4 per cent. These in turn extended loans to its members at rates ranging from 12 to 15 per cent. The default rate in this scheme was as high as 64 per cent and by the early 1970s it ran out of funds and ceased operations. The ILO report (1980, p. 45) referred to it as the "fund that never operated in the interest of Co-operatives societies", commenting that by 1970, the fund had been depleted mainly as a consequence of corruption and misappropriation. The Co-operative movement meanwhile suffered a loss of membership amidst complaints of misappropriation of Co-

operative funds and loss of confidence in the movement. As at December, 1970, number of Co-operative societies declined to 879 from 13,000. Membership dropped to less than half of the original figure of over 36,500 (ILO, 1980). Attempts were made to revive the co-operative movement by the creation of a National Co-operative Development Bank in 1971.

3.34. National Co-operative Development Bank

The National Co-operative Development Bank (NCDB) was instituted to act as an apex financial institution for all Co-operative societies, to revitalise the co-operative movement, provide banking facilities (savings mobilisation) for its members and grant credit. Ownership of the NCDB belonged to Co-operative societies, although initial funds came from Government of Sierra Leone and a loan from the British government, which together amounted to Le 470,000. Operations of the NCDB have been relatively small. It became credit active in 1975 and up to 1980 only about 70 loans worth about Le114,000 had been extended. The majority were short-term, mainly for marketing activities and were granted at a rate of 12.5 per cent. Although loan recovery was reported to be as high as 85 per cent, yet mismanagement and misappropriation of funds caused serious operational problems (ILO, 1980).

Less than 45 per cent of the 879 co-operatives still operating at the time of its establishment were members. The activities of the NCDB have also been constrained by lack of resources and management problems. The employees have mostly been civil servants (about 90 per cent of them) with dual loyalty to the Managing Director and the RCS. The RCS seats on the Board of Directors (though not its Chairperson) and according to civil service edict, has to sanction decisions emanating from the NCDB's

Board of Directors. This suggests that any decisions he may not be in favour of runs the risk of not being implemented.

Since 1993, the bank has been under new management and signs suggest that decisions are now being taken on the basis of commercial considerations as opposed to civil service edict. The new management is gradually introducing the Grameen Bank model, focusing on women and the poor. However, it remains to be seen what impact the new direction will have on the number of Co-operatives, the membership, savings mobilisation and credit activities.

3.35. The National Development Bank

The National Development Bank was incorporated in 1968 as a limited liability company with a share capital of Le 4.5 million, held mainly by the Government of Sierra Leone, the African Development Bank (ADB), the SLPMB, and other institutions interested in financing the agricultural sector. Its objectives include financing mainly development projects in the industrial, agriculture and commercial sectors. The bank also identifies and promotes projects and provides technical assistance and supervision for projects it finances.

Between 1968 and 1977 the NDB approved 94 projects valued at Le 6.5 million. Repayment on these loans was on average 68 per cent (NDB, 1977). The 1977 report stated that staffing problems relating to both quality and quantity had made it difficult to monitor agricultural loans. It was also noted that the NDB had no branches and that no savings mobilisation was undertaken. In short, the NDB was only dispensing credit. The main conclusion was that the bank had failed over its first decade of operation and that savings mobilisation should be introduced to enable it mobilise resources and move

towards self-sufficiency. The NDB's resources became depleted as subsidies (concessionary loans) from the Bank of Sierra Leone and other international donor agencies were suspended pending a review of its operations. It, however, continued to operate, concentrating on recalling outstanding loans from borrowers.

In 1984-85 a comprehensive review was undertaken and more funds from the African Development Bank were received. It also opened a savings mobilisation wing in 1987 and established a branch in Kenema in the Eastern Province the following year. Demand and time deposits increased from Le 425.9 million in 1987 to Le 1.08 billion in 1991 (NDB, 1991). Loans and advances also increased from Le 0.44 million in 1986 to Le 34.6 million in 1992 (Table 3.8). A sectoral breakdown is not available but recovery analysis indicates that default rates have been high, rising from 11 per cent in 1986 to about 60 per cent in 1992. The reasons for default reported in the Annual Report (1991) states that logistics and staff problems are still hampering operations. The report added that "project visitation and recovery exercises were abandoned in the 'rebel' war affected

Table 3.8 **Analysis of NDB's Development Loans Repayment Performance, 1986-1992 (Le M)**

Year	Amount disbursed	Repayment due*	Repayment made	Arrears	Recovery rate (%)
1986	0.44	15.36	1.76	13.59	11
1987	6.19	15.01	2.86	12.16	19
1988	14.07	18.88	11.87	6.91	62
1989	29.62	26.54	16.13	10.41	61
1990	54.85	42.63	33.74	8.89	79
1991	26.25	67.60	40.71	26.89	60
1992	34.61	67.23	40.04	27.58	59

Note:- *includes old debts.
Source:- NDB (1992).

areas and debtors in these areas soon became displaced persons and citizens of straw" (op. cit., p. 5).

In 1992 a Women's Enterprise Development Unit was opened and allocated 10 per cent of a credit fund of US$1.12 million received from the African Development Bank (NDB, 1992). It was expected that most of this would be injected into Women's associations for both on-farm and off-farm projects.

Generally, however, the NDB, like other formal credit institutions in the past, has not been able to meet its objectives. Default is still high and management and logistical problem still forestall achievement.

The failure of similar specialised institutions and programmes world-wide such as the NDB and others discussed above, led the World Bank to continue the search for a solutions to the development problem of LICs. An integrated approach was identified as appropriate because it was designed to tackle simultaneously, agricultural production, health, education and infrastructural development.

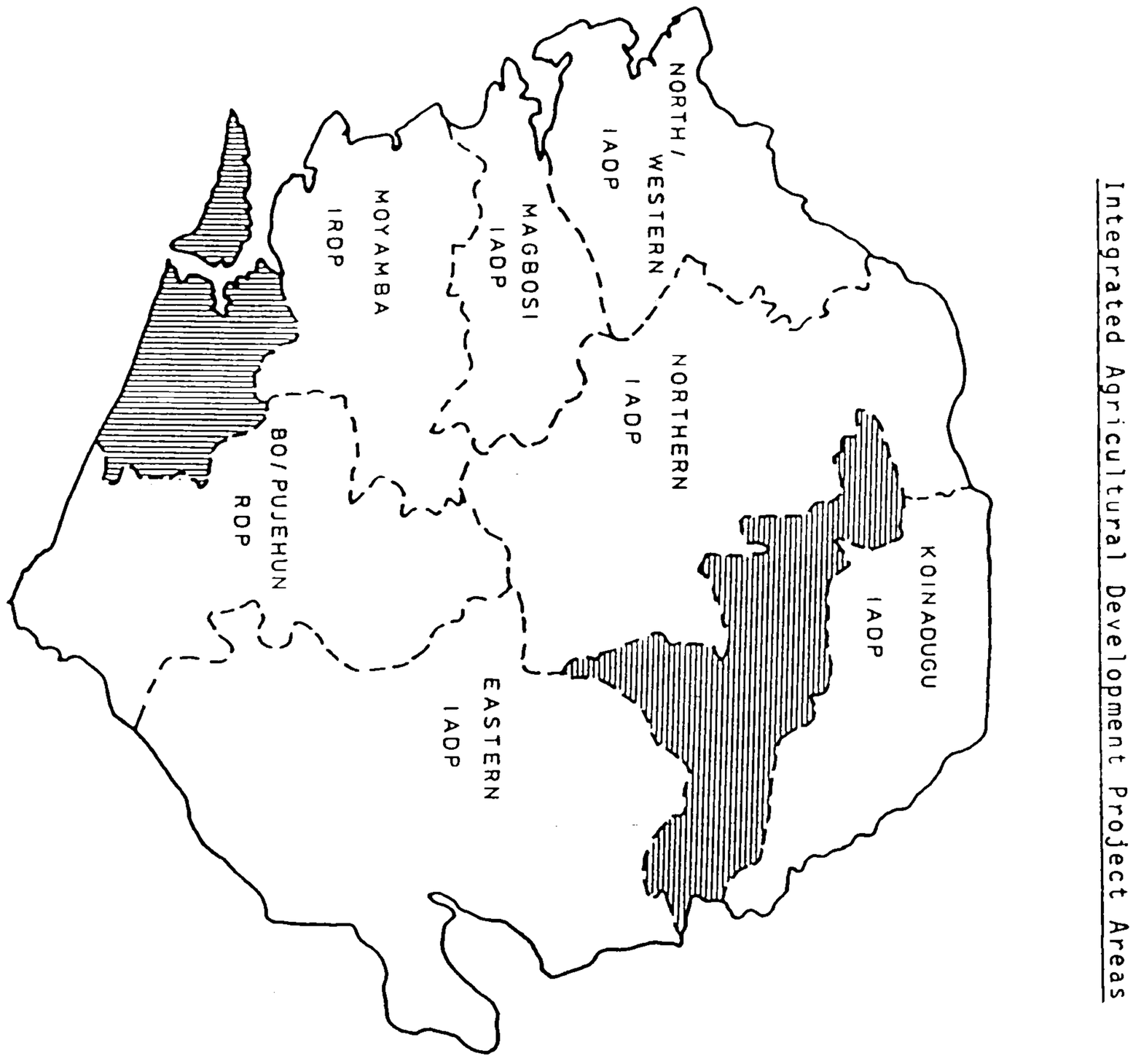
3.36. The Integrated Agricultural Development Projects (IADPs)

The World Bank proposed to tackle LICs' development problems from several angles - production, infrastructure, health, training and credit (Lele, 1975). In Sierra Leone, IADPs started in 1972 with the establishment of the Eastern Area IADP (EAIADP). As the name implies it is situated in the Eastern region of the country. By 1982, seven IADPs had been established, covering about 80 percent of the country (Map 3). Each IADP is location and crop(s) specific. The main objectives of IADPs included,

1. The provision of credit to small farmers for labour, improved seed, fertilisers and pesticides,
2. The training of project farmers (i.e. those participating in the project) in the use of modern methods of production,

Map 3

Integrated Agricultural Development Project Areas



Summary of Major Agricultural Development Projects

Project	External funding agency	Year launched	Area covered km^2	Components: Crops	Components: Others
Eastern Area IAD	IDA	1972	17,350	Swamp rice, upland rice, oil palm (estate and outgrowers), coffee, cocoa, rubber (estate and outgrowers).	Feeder roads.
Northern Area IADP	IDA	1976	3,445	Swamp rice, upland rice, groundnuts.	Feeder roads, water wells, livestock.
Koinadugu IADP	EDF	1978	5,600	Swamp rice, onions, tomatoes, groundnuts, upland rice.	Livestock, roads, wells, market centres.
North-Western IADP	EDF	1980	6,700	Mangrove swamp rice, cassava, cashew and pentadesma research.	Marketing.
Moyamba IRDP	ADB	1980	3,070	Swamp rice, upland rice, ginger, maize, benniseed, groundnuts, oil palm, coconut.	Water wells.
Magbosi IADP	IFAD	1980	3,110	Swamp rice, upland rice, maize, pigeon peas, cassava.	Market centres, rice village water supply.
Bo-Pujehun RDP	GTZ	1981	8,142	Swamp rice, upland rice, cassava, coffee, cocoa, kolanuts, oil palm.	Primary health care, water wells, roads, fisheries, education.
Gambia-Mattru oil palm project	ADB	1974	3,038	Oil palm (estate and outgrowers).	-

Source: PEMSU (1983), Agricultural Statistical Bulletin, No. 1, p. 21

3. The provision of extension services,
4. The construction of feeder roads to link production areas and
5. The development of market centres (Binns, 1977, p. 5).

Projects typically had specific number of funding years, with the expectation that they would continue on their own when funding ended. The World Bank, FAO, The African Development Bank (ADB), International Fund for Agricultural Development (IFAD) and a German technical assistance agency (GTZ) were the major external funding institutions.

The IADPs provided two main types of loans, seasonal and development. The former were provided for improved high yielding seeds, mainly rice, maize, groundnuts coffee, cocoa, oil palm seedlings and fertilisers. Seasonal loans were disbursed in kind at interest rates of 20 per cent, although some loans had been granted at a rate of 10 per cent during the first phases of these projects (Richards and Karimu, 1981). Development loans were granted for both rice (mainly swamp rice development) and perennial (tree) crop development such as coffee, cocoa and oil palm. Loans covered labour costs and improved planting material. The rate of interest was 8 per cent during earlier phases but increased to 15 per cent in 1978 (op. cit.).

All IADPs were plagued by high operational costs and default rates (Karimu and Richards, 1981; Karimu, 1981; World Bank, 1981; Reddy, 1985). A World Bank study (1981) revealed that about 35 and 40 per cent of loan portfolio was expended on operating cost including salaries, rent and vehicle running costs. Another study by Reddy (1985) revealed a similar figure for operating costs and further reported an overall default rate of over 45 per cent.

The reasons for the poor performance of these projects included,

- corrupt practice by credit officials.
- lengthy lending procedures, making loans ineffective when they are disbursed.
- inadequate training for and staff to monitor loan use.
- poor appraisal of projects and uncreditworthiness of borrowers and
- over ambitious expectations (Karimu and Richards, 1980; Karimu, 1981; Reddy, 1985; Johnny, 1985).

By 1985 most of these project reached the end of their external funding phases; but the basis for continuity was non-existent. With the exception of EAIADP which continued as a Farmers Finance company (FFC) and the Bo-Pujehun rural development project which is still operating, other projects have either closed down or are in their final stages of funding. But because of the infrastructure (mainly houses, and the project headquarters) created by these projects, they have been incorporated into the Ministry of Agriculture, Forestry and Fisheries' operations (MAFF). Negotiations with other international funding bodies are underway for some of these projects' funding phases to be extended and new ones established.

The above brief history of agricultural credit in Sierra Leone suggests that government intervention in providing capital (funds) at low interest rates to farmers has largely been unsuccessful. The most recent initiative, the rural banking scheme, is expected to fill the gap left by these projects and to complement those that are being planned.

3.37. Conclusion

The above analysis indicates that the economy has been characterised by high inflation, financial repression, economic mismanagement and corruption. The overview further suggests that although Government of Sierra Leone has focused on credit supply,

the initiatives have been frustrated by high default rates, mismanagement and mis-appropriation of credit funds. The analysis also shows that commercial banks are not yet interested in agricultural credit. Government of Sierra Leone is still searching for a suitable model to provide credit to the agricultural sector because of the important role this sector will continue to play in the economy.

PART II THE CASE STUDY

Chapter IV Analysis of the Operations of the Informal Financial Market in Sierra Leone.

4.0 Introduction

As mentioned in chapter three, the rural financial market (RFM) is divided into two sectors, namely the formal financial market (FFM) and the informal financial market (IFM). The objective of this chapter and the next is to examine the operations of the IFM with a view to putting them in proper context within the RFM. The FFM is made up of commercial banks, development banks, credit unions, insurance companies, rural banks and other formal financial institutions largely regulated by a monetary authority, which in Sierra Leone, as in most LICs, is the central bank. The IFM comprises moneylenders, *osusu* clubs[30] (ROSCAs), relatives, friends and neighbours and is largely unregulated (Nisbet, 1967; Floro and Yotopoulos, 1991; Moinuddhin, 1969; Johnny, 1985; Reddy, 1985). This chapter focuses on moneylenders and the kinds of services they provide in rural areas, contrasting their mode of operation with that of RBs as a basis for suggesting policy initiatives to improve the operation of the RFM, particularly the RBs in Sierra Leone.

The chapter is organised into four sections. The first reviews the literature on RFMs with particular reference to the informal financial sector. The second section is an extension of the first, discussing the common characteristics of RFMs and highlighting,

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[30] The osusu is the local version of the rotating savings and credit association in Sierra Leone. In this study both terms will be used interchangeably.

as it progresses, those that are peculiar to the RFM in Sierra Leone. It also discusses the significance of credit interlinkage in the IFM and briefly reviews the arguments regarding the level of interest rates charged. The third uses a simple linear regression model to analyse the transaction costs faced by the moneylenders in Sierra Leone and attempts to explain the rationale for the level of interest rates they charge. Section four interprets the results of the regression analysis, which will form part of the basis of comparison developed between operations of moneylenders and RBs.

The data used in this chapter are based on a sample of 20 moneylenders (five from each of the service areas of the four RBs surveyed). The sample was identified through information from RBs management teams and household questionnaire respondents. It should be noted that it was impossible to obtain a statistically random sample of moneylenders given their anonymity, reluctance to talk to 'strangers' about their money lending operations, the absence of a baseline survey on them, the size of the area covered, time and financial limitations. The above qualifications notwithstanding, the data is reliable enough to explain their mode of operation in the rural areas of Sierra Leone.

The few studies of the RFM undertaken in Sierra Leone (BSL, 1965; Mionuddhin 1969; Richards and Karimu, 1981; Johnny, 1985) have mainly focused on its demand side. Those of Richards and Karimu (1981) and Johnny (1985), for example, incorporated some critical and quantitative analysis on the factors affecting the demand side of the rural credit market and reasons for default. We have not located any study in the literature relating to the supply side of the IFM in Sierra Leone. This chapter concentrates on the supply side to complement other studies mentioned above with a

view to providing an overall picture of the behaviour of the IFM, especially moneylenders, in Sierra Leone, because such an understanding should help to improve policy on credit supply in rural areas.

4.10 Literature Review.

There has been a growing body of literature on RFMs in LICs. But the role that the RFM plays in the development process of LICs is a relatively neglected area. The reasons for this may be two-fold. Firstly, it may be due to the inaccurate perceptions of this sector (Rahman, 1992) and secondly it may be the outcome of neo-classical development models which have been used to explain the development process; but are inappropriate for analysing RFMs in LICs.

These models by eminent scholars such as Lewis (1955) Rostow, (1960), Ranis and Fei (1961) had as a common feature, in their implicit assumption that the RFMs play a passive role in the development process of LICs. The development models of Ranis and Fei (1961) and Lewis (1955) focused mainly on labour transfer from the rural to the urban industrial sector as development progresses. The main reason for this benign neglect is that money was not considered part of the analysis. To the extent that credit markets were considered to have a supportive role to play, the focus was on the development of formal credit programmes which would influence growth in the modern sector located in the urban areas (Lewis, op. cit.). Rural credit was alleged to be in the hands of 'evil' moneylenders, who charged 'usurious' interest rates and kept the rural borrower, mainly the farmer, in perpetual debt and poverty (Bottomley, 1963a). An extension of these models led to others which emphasised economic dualism and to the argument that there are two sectors in LICs - a traditional, backward and poor

agricultural sector located in the rural areas, and a modern, relatively advanced and rich modern sector, located in the urban areas. In Lewis' classical theory, savings translated into productive investment were thought to be the force behind growth and, as Lewis saw it, only the rich can save: "The central fact of economic development", Lewis wrote, "is that the distribution of incomes is altered in favour of the saving class" (Lewis, 1954, p. 157)

The 'dependent' and 'marginality' versions of economic development (Hayami and Ruttan, 1985), however, do not accord with Lewis' view. They perceive the modern sector as a set of priviledged institutions which tended to distort and inhibit growth rather than expand and transform it. But they are also in agreement with the neo-classical models in identifying the potential for economic dynamism which, in their view, lies in the modern, relatively capital intensive sector. In other words, the rural sector is regarded merely as a passive entity in the development process. This assumption of the passivity of RFMs in the development process in LICs has, however, come under scrutiny over the last two to three decades.

The stimulus for challenging these views came from the increasing realisation of the growing importance of the rural areas, particularly the agricultural sector, in the development process of LICs (Pearse, 1980). As discussed in Chapter Three, the importance of the rural areas, particularly the agricultural sector in LICs, cannot be underestimated. Agriculture forms the backbone of most economies of LICs, supporting 60 - 70 per cent of the labour force and contributing no less than 30 per cent to GDP (World Bank, 1975). Its contribution to export earnings is also substantial. In Sierra Leone, for example, the agricultural sector accounted, on average, for 11.5 per cent of

export earnings between 1981-1992 period (Table 3.1). The agricultural sector provides jobs and incomes for over 60 per cent of the population of which over 80 per cent are farmers. The farmers in this sector, however, tend to cultivate small holdings, on average, below 2.5 acres (CSO, 1980). The small acreage coupled with the use of traditional tools and methods of production and the use of low yielding varieties of seed, keeps farmers at the subsistence level of production (Spencer, 1977).

To help farmers move from subsistence to market-oriented production, governments in LICs, including Sierra Leone, embraced the 'supply-leading' approach and instituted agricultural development programmes ahead of established demand for this service (Patrick, 1966). A majority of these programmes failed (Adams, Von Pischke, and Donald, 1983; Gonzalez-Vegas, 1983; Floro and Yotopoulos, 1991). It is estimated that less than 5 per cent and less than 15 per cent of the target population in Africa and Latin America respectively, received this cheap credit because of reasons discussed in Chapters Two and Six (Adams, 1971, World Bank, 1975). Governments of LICs were supported in this approach by donor agencies such as the United States Agency for International Development (USAID), the Inter-American Development Bank (IBD), the World Bank (WB) and friendly foreign governments. This external support led to an expansion of farm credit programmes in LICs. According to Adams (1971), a total of over $1 billion was provided to set up these programmes by the WB, USAID and IDB in Latin America between 1960 and 1973.

The assumptions on which this massive injection of capital was based include the shortage of credit as a bottleneck in efforts to transform low labour and land productivity. Concessionary credit was regarded as justified on the basis of traditional

assumptions already discussed in chapter two. In addition, it was assumed that little or no savings capacity existed and marginal propensity to save (MPS) was low in the rural areas. Consequently, it was believed that finance for development had to come from outside the agricultural sector. It should be noted that this is an extension of the neo-classical argument which was boosted by Hugh Patrick (1966) who described the advantages of 'supply-leading' finance.

Shortly after it was realised that these interventions had not produced the desired results, a debate ensued[31]. The consensus that emerged after the debate was that past government interventions in providing credit to the rural areas of developing countries had been based on faulty policies. The consensus also observed that even though formal credit programmes were failing, the IFM continued to provide credit using a different mode of operation. The failure of FFM was also blamed, among other factors, on the presence and activities of the IFM, particularly the moneylender. Given that the informal sector charges high and variable rates of interest to its clients, whereas the formal sector charges low but uniform rates, several questions immediately come to mind. Why is the informal sector charging high and differential interest rates? The answer to this question may depend on the transaction costs facing the informal sector, particularly the moneylender. A second question relates to whether it is possible to arbitrage between the low interest rates in the formal credit sector and the informal credit sector charging high interest rates. Tentatively, the answer is likely to be in the affirmative because of the fungibility of money and because some of the moneylenders are also customers of FFM (Adams, 1983). To be able to answer these questions, and to understand the functioning

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[31] see Chapter Two for details of the debate.

of the RFM and in particular the IFM, however, it will be helpful to identify some of the key characteristics of the RFMs.

4.20. Some Common Characteristics of Rural Financial Markets in LICs

Rural Financial Markets in LICs are quite complex, as in evident from the discussion below. Specific features observed in the Sierra Leone context will be noted as the discussion proceeds.

4.21. Segmentation.

Researchers have given various reasons as to why RFMs are segmented into FFM and IFM. According to Seibel and Marx (1987), each segment of the RFM has its own mode of operation, interest rates and clients. The situation in Sierra Leone is, however, slightly different from what Seibel and Marx described. Our survey revealed that some operators in the IFM have links with the FFM. For example, about 30 per cent of our sample of moneylenders had deposit accounts with the rural banks. In the sample of customers of rural banks, it was discovered that a high proportion, over 60 per cent of them, were customers of both rural banks and of moneylenders. Thus, in the case of Sierra Leone, the two segments of the RFM may have different modes of operation and different interest rates, but they also share some common clients, raising the possibility of arbitrage between low interest rates in the FFM and the relatively high interest rates in the IFM as well as in the flow of funds between them. For example, a moneylender who is a customer of a rural bank as in Sierra Leone, could obtain a loan ostensibly for farming, yet uses such funds to on-lend to his clients.

Shaw (1973), described the economies of LICs as highly fragmented by noting that: "firms and households are isolated in the sense that they face different effective

prices for land, labour, capital and commodities and do not have access to the same technologies". Hence the economy consist of several markets. He also mentioned that government policies have unwittingly given rise to market fragmentation. However, Besley (1993), argues that RFMs in LICs tend to be segmented because a lender's loan portfolio is sometimes concentrated on a group of individuals facing common shocks to their incomes in one particular area such as farmers producing one particular crop or an area suffering from drought or other natural hazards or even fluctuation in prices of a particular commodity. Segmentation as defined by these researchers tends to suggest that there is no flow of funds between the two compartments of the RFM.

On the contrary, however, segmentation does not prevent funds from flowing across groups or individuals or regions. For example, rural banks in Sierra Leone are unit banks[32] and they are expected to operate within a twenty-five mile radius. It is also stipulated that funds mobilised in these areas are to be invested within these areas (BSL, 1984). The success of this policy is questionable, as shown in Chapter Six. Substantial funds have been moved from rural banks to the urban areas through the bank clearing mechanism for cheques drawn on RBs by rural residents who have dealings with urban business entities and through malpractices such as cross-firing of cheques[33]. These two aspects, among others, have tended to create an outflow of funds from the rural to the urban areas. Besley (1994), also argues that unit banking further exacerbates segmentation because of the policy of reinvesting a proportion of mobilised funds in the areas from which they have been mobilised.

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[32] See Chapter Six for more details.

[33] See Chapter Six for details of this cross-firing of cheques incident.

The old view that market segmentation was restricted to isolated monopoly markets (Bottomley, 1975), has given way to the idea that segmentation means different term structures of loans and different characteristics and types of loan that meet particular needs not substitutable by other types of loans (Lamberte and Lim, 1988). The heterogeneity of borrowers and their needs tends to characterise lending as a personal activity. Thus in RFMs, personalised transactions tend to predominate mainly as a result of the lack of bankable collateral, which tends to make lenders observationally equivalent (op. cit.).

4.22. Personalised Transactions

In the absence of assets to be used as collateral (see Section 4.23 below), personalistic relationships tend to predominate. Historically developed ties are usually the basis of personal relationships. Moreover, the extended family and kinship set-up help to forge strong personal trust which allows for a high degree of social interaction and co-operation (Hayami and Kikuchi, 1982 p. 12-16). These social bonds and the reciprocal nature of relationships "establish the requisite trust" on which informal credit is founded (Nisbet, 1967; Floro and Yotopoulos, 1991). Loans are sometimes given as character loans extended at zero or near zero interest rates, though normally only in emergencies, for example, providing catastrophic insurance within the extended family context. They are cash-flow-solving loans intended temporarily to alleviate household consumption bottlenecks (Floro and Yotopoulos, 1991). In our survey, character loans formed less than 10 per cent of moneylender's loans. Most of these were given at zero or near zero interest rates mainly because of the expected reciprocity when the lender in time-period one becomes the borrower in time-period two.

Other relationships within the rural context help to cement trust and personal ties such as the one formed between the trader-lender and the farmer-borrower in the markets for farm inputs and output as well as consumerables. Repeated dealings in these markets between such parties build personal ties and feelings of reciprocity which encourage the extension of credit after a period of time. Von Weizsacker (1980) argues that buyers extrapolate market relations on the basis of past experience. They prefer to return to the same seller as long as the opportunity cost of searching for a new seller is higher than the cost they would incur in dealing with the former seller. Buyers and sellers often engage in deferred payment schemes which tend to minimise price competition, facilitate the continuity of repeated sales transactions, provide quick turnover and solidify the seller's position in the market (Szanton, 1972, Silverio, 1982). Thus personal ties tend to be beneficial to both trader-lenders and farmer-borrowers.

But there are some disadvantages associated with personalised transactions. The flow of information within the RFM and between its two compartments, the IFM and FFM, is highly restricted. Table 4.1 provides an indication of the flow of information within the IFM in Sierra Leone. Only 35 per cent of moneylenders are willing to share information about borrowers with other lenders. Information about others' indebtedness and about the terms offered by other lenders is restricted. This bears a significant influence on how the market operates. For example, it may be one of the reasons why the IFM is able to charge differential interest rates and operate on a personalised basis. But banks which lend to farmers and rural residents often find information on borrowers' willingness and capacity to repay loans very costly and difficult to obtain. It is, therefore,

not uncommon to associate losses due to default with information asymmetry (Stiglitz and Weiss, 1981).

Another important result of personal ties and transactions is quantity rationing through which lenders establish their own criteria to determine credit-worthiness instead of using price to clear the market. Furthermore, moneylenders do not lend to all applicants who may happen to be observationally equivalent from the point of view of

Table 4.1 **Flow of Information within the Informal Credit Market [number and (%)]**

Moneylenders aware of interest rates charged by other lenders*	Moneylenders willing to share information about borrowers with other lenders*	Moneylenders who make enquiries and visit farm/enterprise of clients*	Respondents who knew about others' indebtedness**	Respondents who knew terms offered by other lenders**
16 (80 %)	7 (35 %)	18 (90 %)	20 (10 %)	45 (22.5 %)

Note:- * Sample of moneylenders.
** respondents to the household questionnaire.

Source: The Survey, 1994.

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the FFM, suggesting that some form of credit rationing exists and determines who gets loans (Floro and Yotopoulos, 1991). Lending in the IFM even on personalised terms, is also fraught with risk and uncertainty even with the existence of credit rationing.

4.23. High Risk and Uncertainty

RFMs are characterised by many risks and uncertainties and these can be high. Borrowers' demand for loans and capacity to repay are greatly influenced by their incomes. On the supply side, the purveyors of credit also rely to a great extent on the borrowers' incomes for repayment. But incomes in the rural areas, especially in farming,

are typically uncertain (Harris, 1983; Bottomley, 1975; Adams, 1983; Stiglitz and Weiss, 1981).

The risks in the agricultural sector are many. Bad weather can have an adverse impact on output and hence incomes and repayment capacity. Changes in commodity prices also constitute another important risk. Considered together, these risks can affect the operations of credit markets if they are adverse enough to cause borrowers to default en mass. This can be avoided by lenders, who have well diversified loan portfolios; but this rarely happens because of the segmented nature of RFMs (Stiglitz and Weiss, 1981; Floro and Yotopoulos, 1991).

Other risks associated with default include the problem of enforcement of loan contracts. It has been shown that default can be high in RFMs in LICs (Adams, 1971; Gonzalez-Vegas, 1980; Harris, 1983; Botomley, 1963b). Political interference can also help to reinforce default by, for example, government's use of debt forgiveness programmes. Debt forgiveness programmes have been reported, for example, in Haryana State in India (India Today, 1991) and in Bolivia (Ladman and Tinnermeier, 1983). Bell (1990, p.301) notes the widespread view in rural India that institutional credit is in practice a 'grant'. Politicians regularly vie with one another in promising, if elected, to institute debt forgiveness programmes. Harris (1983) reports that "during the election campaign of 1972 (in North Arcot, India) farmers were promised that "a vote in the right direction would write off a loan". In such cases, borrowers have little incentive to use funds for the purposes for which they were borrowed or to repay since, as reported in Sierra Leone, they regard these funds as their own share of the 'national cake' (Deen and Parker, 1978). In Sierra Leone, there have never been any government debt forgiveness

pronouncements; but government inaction to prosecute defaulters is tantamount to a tacit acceptance of such a policy. To escape this problem, FFM demanded collateral. for loans.

Formal financial markets in both developed countries (DCs) as well as LICs concentrate on bankable collateral for credit transactions, making such transactions relatively homogeneous and rendering borrowers observationally equivalent. Collateral enforcement creates two effects. Firstly, it partly or fully shifts the risk of loss to the borrower. Secondly, it provides borrowers, with low disutility of default and additional incentive to repay loans (Floro and Yotopoulos, 1991 p. 44). As a consequence, "collateral becomes a credible instrument of risk-sharing because of its transferability" (Binswanger, 1984; Floro and Yotopoulos, 1991). Transferability is, however, only effective in a well defined property rights market and with a legal framework that ensures not only compliance of loan contract but also assures penalty when violation occurs. These conditions may be limited to certain areas of LICs. In Sierra Leone, for example, legal conditions for compliance and enforcement are virtually absent in the rural areas (Johnson, 1972; Johnny, 1985; Knickel, 1988). In the urban areas, however, a western-styled legal system is predominant and the courts take care of these aspects. In the rural areas, the absence of effective legal penalties has been one of the many reasons why defaulting farmers in government credit projects, such as those discussed in chapter three, have never been prosecuted (Moinuddhin, 1969; Conteh, 1977; Turay and Kamara, 1981; Johnny, 1985). There are other reasons for government inaction against defaulters. In a bid to retain the support of the majority of voters, about 60 per cent of whom are rural residents, governments have turned a blind eye to these violations and no

attempt has been made to prosecute defaulting farmer-borrowers in government projects (Reddy, 1985; Deen and Parker, 1978)[34].

Because of the relative poverty of rural residents, especially farmers, and their lack of bankable assets, the most important collateral often requested for loans is land. But the land tenure system does not support foreclosure and land does not have well defined ownership and transfer codes as is known in urban areas. Land is therefore usually unacceptable as collateral, especially to FFMs such as commercial banks (Johnson, 1972; Besley, 1993). Bull (1983 p. 666), describes this kind of situation a "missing market" and a "non-viable" credit contract following the implicit contract theories. Many LICs, according to Floro and Yotopoulos (1991), are characterised by poverty, making the availability of bankable collateral rare. In addition, the underdeveloped legal systems and the ill-defined property rights make the acceptability of collateral, especially land, questionable (Bull, 1983). The poorly defined property rights for assets, especially land, in the rural areas of LICs also create a risk associated with enforcement of loan contracts (Migot-Adholla, 1991). Land rights are not only undefined and limited to usufructuary rights (i.e. use of land only) but also have limited transferability (Johnson, 1972; Migot-Adholla, 1991). Besley et al. (1994) have argued that such limitations help to explain the widespread use of informal credit in LICs. In other words, informal arrangements are more useful where RFMs are unable to enforce repayment. In Nigeria, Udry (1990) cites cases of delinquent borrowers being forbidden to participate in village ceremonies until repayment is made. In Sierra Leone,

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[34] See Chapter Six for an example of the effects on a RB of the absence of enforcement mechanisms.

moneylenders make use of secret societies and the Paramount Chief (PC)[35] to bring pressure on borrowers to repay loans (Turay and Kamara, 1981; Johnny, 1985) and can lead to public ridicule and ostracism, which are viewed as highly degrading by rural residents. A borrower would, therefore, try to borrow from another lender, if possible, rather than being found guilty of default and forced to face ostracism and humiliation. Such disgrace can also be extended to the defaulter's family members. In Sierra Leone, the act of borrowing from one lender to repay another lender, in order to avoid this kind of humiliation and embarrassment is referred to as 'digging a hole to cover a hole'. Even in the event of the death of the borrower, as explained in chapter seven, the moneylender can still recover loans from surviving relatives. This tends, among other reasons, to support the proposition that the IFM is dominant and more successful in the RFM than the FFM.

4.24. **Dominance of Informal financial sector**.

The dominance of the IFM in LICs is usually associated with the modus operandi of the moneylender (Bell, 1990), which entails easier and lower cost access to credit relative to the FFM. Bottomley (1975), Wai (1957 and 1977), Miller and Ladman (1983) have all reported loans being provided by moneylenders within hours of the applicant's request compared to months in the FFM. Our survey found that the time taken to secure a loan from a moneylender ranges from 1 to 3 days, compared to a range of from 3 to 20 weeks in the RBs (the Survey). The long delays observed in the provision of credit are

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[35] The PC arbitrates all chiefdom disputes (including land disputes) that do not warrant the attention of a western style court. Paramount Chiefs in some chiefdoms still possess a device called *Karinka* (Temne) or *Kpeiwe* (Mende). It is a log of wood with holes carved out to hold an adult's leg. Borrowers who fail to repay a loan, when reported to the PC, will have their legs 'handcuffed' in this contraption and displayed publicly. The debtor in this situation is subjected to public ridicule. This kind of public humiliation acts as a deterrent to defaulters.

cited as contributing to the high level of default on credit from FFMs (Bouman, 1977). Moneylenders usually have first hand knowledge of borrowers and potential borrowers; mainly because they are residents of, or regular visitors to, the village or participants in other markets with clients and potential borrowers (Harris, 1983; Johnny, 1985; Richards and Karimu, 1981). As Bell notes, "There is nothing that escapes his eye about the circumstances of his debtors and potential clients" (Bell, 1990). This knowledge suggests that the moneylender takes the problem of the adverse selection of risk very seriously. Arrow (1985) describes adverse selection as "hidden information", when the lender cannot, at reasonable cost distinguish between bad and good borrowers.

The majority of loans in the IFMs are granted on personalised terms, as discussed above, and sometimes without collateral (Bottomley, 1975, p. 284). The relatively low transaction costs encountered by borrowers in the IFM, compared to what they face in the FFM, also makes the former a favourite source of credit (Adams, 1983). Borrowers incur lower costs in terms of transport cost, opportunity cost of time in visiting lenders and bribes to ensure that their applications are completed and approved (Aleem, 1985; Floro and Yotopoulos, 1991). The moneylender is always there and sometimes lends without requesting to know how funds are to be utilised, gives consumption credit (which most FFMs rarely entertain in some countries, such as Sierra Leone) and performs marketing functions as well as providing social support in the form of contribution towards easing the adverse effects of calamities which may befall his clients. Formal financial institutions can hardly match this operational flexibility displayed by the moneylender. In Sierra Leone, the mean transactions cost of moneylenders surveyed between ranged of 1-3 per cent (Table 4.12), compared to over 20 per cent for some of

the RBs (Tables 6.19 - 6.22). Unlike RBs, moneylenders use simple procedures and very minimal paper work. In contrast, RBs use huge amounts of costly stationery and are required to have 'qualified' staff, all of which increase administrative costs. Most formal financial institutions (FFIs) within the FFM are normally specialised institutions unlike their counterparts, the informal financial institutions (IFIs), in the IFM which, normally, do not specialise (Long, 1968; Gonzalez-Vegas, 1984a).

4.25. **Lack of Specialisation**.

Lack of specialisation is demonstrated in the combination of activities such as trade, lending, farming and merchandising characterising IFIs (Long, 1968; p 277; Wai, 1957, p. 57; Aleem, 1990; Floro and Yotopoulos, 1991). Typically, informal lenders almost always combine credit with other activities such as trade. In many cases, credit involves the delivery of inputs or comsumer items to borrowers with repayment being in kind (mainly harvested crops). The cost of borrowing in such circumstances can only be estimated from the terms of the commodity contract. Many researchers including Wai (1957, p. 66), Long (1968, p. 277), Seibel and Marx (1987), Miller and Ladman (1983), Aleem, (1990), Floro and Yotopoulos, (1991) have noted this lack of specialisation in examples drawn from both Asia and Africa. The main source of informal credit is the moneylender who has been described as a triad i.e. one who combines the functions of a trader, a moneylender, and a farmer (Table 4.3). But engaging in different activities may not necessarily ensure a risk-free outcome. Lack of specialisation may even contribute to inadequate measures being adopted to recover loans (Aleem, 1990). To minimise the risk of default, the lender tends to spread risk across contracts. The above notwithstanding, the risk of default is always present in both IFMs and FFMs.

4.26. **Default rates**.

Default rates are reported to be normally higher in FFMs than in IFMs in LICs (Bottomley, 1975; Adams and Nehman, 1979). Harris (1983), reported default rates of 5 per cent for moneylenders in the Southern rural districts of India, compared to over 15 per cent for FFMs within the same region. In Sierra Leone, Reddy (1985), reported a default rate of under 10 per cent for moneylenders whereas FFMs (i.e. IADPs) suffered default rates of over 30 per cent. The World Bank estimates that 11 agricultural credit programmes in eight developing countries in Asia had an average rate of default of nearly 40 per cent (Saito and Villnueva, 1981). Our survey of moneylenders revealed an average default rate of about 4 per cent (actual), with a range of 1 to 8 per cent (Table 4.10), compared to a range of from 35-74 per cent in RBs (Table 6.15).

The reasons for default have been varied. The ability to repay, as mentioned earlier, is related to the farmer's income. In Kenya, according to Bottomley (1975), defaulters in a particular project had lower average yields than those who repaid their loans. In her analysis of development projects in several African countries including Sierra Leone, Lele (1975) argued that borrowers' incomes and default rates are also related to low prices of output, riskiness of new technology, poor extension, and lack of or limited follow-up of loan utilisation. Other studies have identified more causes of default. Sanderatne (1977) identified no fewer than 17 such causes of default in Sri Lanka which he organised into six categories. Table 4.2 below shows these categories together with the percentage of defaulting farmers and the percentage of the loans that were defaulted in the 1967-70 period.

Table 4.2 **Reasons for Default in Sri Lanka (1967-1970)**

Category	% of defaulters	% of loans defaulted
Defects in Agric. Structure	19	17
Seasonal factors	26	33
Defects in credit organisation	17	12
Attitudinal factors	16	18
Misuse of funds	15	15
Miscellaneous reasons	7	5
Total	100	100

Source: Sanderatne, 1977. p. 27.

In the main, Sanderatne (1977: p. 28) concedes that "in the context of small size holdings, productivity and incomes derived from a significant proportion of farm holdings, are inadequate to meet the basic needs of farm households". Richards and Karimu (1981) forwarded two main reasons for default by project farmers in the Northern Integrated Agricultural Development Project (NIADP) in Sierra Leone. These are (1) over-optimism in the calculations about returns to project investment and (2) the degree of indebtedness of the farmer to other lenders even after they joined the project.

Another survey of 'Grassroots Problems in Sierra Leone' (Kamara and Turay, 1981), deduced several reasons for default including (a) lack of a legal framework to ensure compliance (b) lack of adequate enforcement mechanisms for violation and (c) riskiness of agricultural enterprises. The lack of bankable collateral, risk of default and uncertainty and the need to screen borrowers in the IFM to reduce adverse selection of risk and moral hazard problems, among other reasons, encourage lenders to engage in credit interlinkages.

4.27. Linkage Between Credit and Other Markets (Tie-ins) in the IFM.

Interlinkages in rural financial markets have been observed in many developing countries including India (Bardhan, 1978; Bardhan and Rudra, 1980), The Philippines (Floro and Yotopoulos, 1991), Ghana (Adegboye, 1983) and Sierra Leone (Karimu and Richards, 1981, Johnny, 1985). In Sierra Leone, for example, village moneylenders, traders and itinerant merchants engage in credit interlinkage[36], providing credit in cash and/or in kind and receiving repayment in output and/or cash. The formal credit institutions, in most of the LICs including Sierra Leone do not provide this kind of service. They were not designed to handle credit and output/inputs interlinkages. Interlinkage in the credit markets of developing countries, however, plays a vital role and the ability of landlords, moneylenders, trader-lenders, and farmer-lenders to provide this kind of service has been identified as one of the many reasons why they have been relatively successful and dominant in the rural credit markets (Bardhan, 1989).

An interlinked deal is one in which two or more contracts are simultaneously agreed upon (Gangopadhyay and Sengupta, 1986). Floro and Yotopoulos (1991), describe interlinkage as the linking of two or more market transactions with the terms of one being contigent upon the other. They add that these arrangements operate on the basis of personal relationships. Interlinkage is increasingly being appreciated and used as a basis for understanding many puzzling characteristics of rural financial markets. Braverman and Srinivasan (1981) noted that interlinked deals are transactions in more than one commodity or service made between the same pair of individuals and linked in an essential way. For example a landlord and a tenant entering into a contract in which

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[36] The terms interlinkages and tie-ins will be used interchangeably in this discussion. Elsewhere, they have been described as 'bundle transactions' (Clive Bell. 1988)

the tenant rents a piece of land at a stipulated price, and at the same time the landlord extends credit to the tenant, again on specified terms. However, interlinking covers a much wider range of contracts than those simply created to circumvent the absence of certain markets.

4.271. **Types of Interlinkages**

There are several kinds of interlinkage in the informal sector in the rural areas of LICs. Floro and Yotopoulos (1991), identified five types in the Philippines which they classified according to how the loan is tied: (a) to the provision of services in on-lending and or procuring output, (b) to the sale of output to the lender, (c) to the purchase of inputs or lease of farm equipment from the lender, (d) to the transfer of rights over the usufruct of the land to the lender and (e) to the provision of labour services to the lender. They stated that the first three are more prevalent among trader-lenders and the last two among farmer-lenders. In our survey in Sierra Leone, a sixth type of interlinkage was identified where the loan is tied, not only to the sale of output but also to the purchase of farm inputs and consumer goods such as sugar, kerosene, soap, salt, building material etc.. Repayment is in kind and/or the sale of output to/through the lender. Over 40 per cent of respondents in our survey, reported that they had this kind of arrangement with lenders, whereby the trader-lender collects the repayment output from the farm-gate and buys extra output, thus performing a useful service given the poor state of the road network and marketing facilities (storage, transport etc.). In the absence of any effective competition from formal credit agencies, the farmer has no choice but to rely on the moneylender (Bottomley, 1975). But this does not explain why interlinkage occurs.

4.272. **Some Models of Interlinkage**

Several models have been used to explain market interlinkage. An important characteristic of some of them is their implicit treatment of moneylending as the primary economic activity of trader-lenders (Gongapadhyay and Sengupta, 1986, 1987; Bell and Srinivasan, 1989). The trader is depicted as the principal agent who provides credit to farmers in return for repayment in kind and an undertaking to sell output to the lender. In Sierra Leone, moneylending in rural areas is almost always a clandestine activity in the sense that moneylenders do not operate publicly as moneylenders but rather as farmers, traders, blacksmiths, teachers, chiefdom councillors or even as religious leaders. The point being stressed is that in Sierra Leone, moneylenders in rural areas tend to portray moneylending as complementary to other economic activities they are engaged in. What is visible is a village shop, a blacksmithery workshop, the activities of purchase and sale of consumerables and produce by rural residents or itinerant traders. Floro and Yotopoulos (1991) came to the same conclusion about moneylending activities in the

Table 4.3 **Occupations Reported by Moneylenders**

Occupation	Frequency	Percentage
Trader	5	25
Farmer	9	45
Clergyman/woman	2	10
moneylender	1	5
chiefdom councillor/section head	2	10
Combination (trader/farmer/osusu leader	1	5
Total	**20**	**100**

Source:- The Survey, 1994.

Philippines. Moneylenders in Sierra Leone operate outside the financial regulatory framework and are not recognised by government. At the same time, no laws have been enacted forbidding moneylending activities in rural areas.

In the survey, only 5 per cent of respondents reported that moneylending is their primary economic activity. 45 per cent reported that they were farmers and 25 per cent traders (Table 4.3). The others reported that they combine *osusu* leadership[37], with trade and farming. Others are religious and chiefdom leaders (10 per cent). In contrast, professional moneylenders can be found operating openly in the urban areas especially around markets and business centres and serving micro- and medium-sized enterprises in every conceivable segment of the economy (Johnny, 1985).

Bell and Srinivasan's (1989) market interlinkage model demonstrates the redundancy of charging both a commission rate on crop sales (similar to underpricing of output) and an interest charge on the loan in equilibrium contracts. The interlinking of credit and product contracts enhances the bargaining power of the trader whilst tending to weaken that of the borrower. It implies the reduction in desirability of risk-sharing on the part of the lender and raises the possibility of monopoly power in the form of price stipulation (op cit., 1989).

Gangopadhyay and Sengupta (1986) examined two situations, (1) borrowing from a linked lender (e.g. a trader-lender) and (2) from a pure moneylender. They demonstrated, using profit maximisation analysis, that of the two types of lenders, the farmer would opt to borrow from the trader-lender since he charges a lower interest rate compared to the pure moneylender. The low interest rate offered by the trader-lender is,

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[37] In Chapter Five they are identified as *Master osusu*.

however, deceptive and is compensated for by the low price he or she pays the farmer-borrower for the output. At the end of the day it is the farmer-borrower who tends to lose in the interlinked contract. Given that, why is interlinkage common?

4.273. **Reasons for Interlinkages.**

As discussed earlier, tie-ins or market interlinkages involve contracts between two or more parties that relate two or more market transactions with jointly determined terms of exchange. An example involves traders securing a regular supply of output from farmers whose credit needs they meet in return. Workers in Indonesia (Bottomley, 1963a) have their labour services tied to their employers who provide them with consumption credit. Landlords rent out land to their tenants and at the same time advance loans in cash or kind (mostly food) that are payable upon harvest (Sengupta and Gongapadhyay, 1989). Tie-in contracts can serve as a screening device in a situation of imperfect information regarding the attributes of a heterogeneous population. In a village setting where some attributes such as tenant's managerial skills are not normally observable, interlinked credit and tenancy contracts may serve as screening devices for landlords to identify more reliable and hardworking tenants. Market interlinkage also serves as an instrument for increasing information about the borrower especially when commercialisation in the rural area increases (i.e. reducing the 'hidden information' problem). With increasing volumes of market transactions, the need for additional information over and above what is known through existing personalistic ties becomes important as extant market transactions become additional sources of market information.

The trader-lenders use interlinkage to complement trading activities. Ray and Sengupta (1989) suggest three ways in which the trader-lender achieves this. Firstly, interlinkage is used to expand his or her share of the market. Secondly it involves an alternative use of operating capital during seasonal fluctuations. Thirdly, it reduces the procurement price of output by allowing the lender to negotiate a low price or fix a harvest delivery date when seasonal prices for the commodity are low. In Sierra Leone, for example, the period April to October is the growing season for rice, the country's staple food, and supplies are usually very low. Farmers who borrow under this kind of tie-in arrangement are often quoted low prices for their harvest when the contract is negotiated during this period (Tommy and Roberts, 1978).

Interlinkage may also enable the reputation mechanism to work more effectively. Bardhan (1980) describes one way this can occur with interlinkage: "It can reduce the market costs of work, contract enforcement and collection of information by making possible discovery of dishonesty or shirking by an agent in one transaction, which would have been too costly for him or her in terms of its spillover effects which could threaten other transactions and a general loss of goodwill in the small closed world of a traditional village". When an economic relationship entails transactions in several markets, there is scope for more information gathering and higher profits for the lender.

Market interlinkage is also produced by the existence of moral hazard (Stiglitz and Weiss, 1981). Quite often, the linking of contracts occurs when there is a moral hazard problem which results in an "inappropriate" externality[38]. Moral hazard arises in a risk-sharing contract when one party, often called the agent (tenant, insuree or borrower)

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[38] In the broader sense, even this class of contracts can be defined as arising from the non-existence of markets where the missing markets are themselves defined as the markets for the externalities.

can affect the probability distribution of the outcome (output or accident) through his or her action (effort, driving habits, gambling, laziness etc.), which the other party, often called the principal (landlord, insurer or trader-lender), cannot effectively or cheaply monitor (Bell, 1983). Since the landlord can neither perfectly nor cheaply monitor the borrower's actions and cannot force him or her to exert a certain level of effort because it is too costly, there is an inherent externality from the credit market into the production process. Landlords or lenders are aware of this externality and they try to internalise it and thereby address the moral hazard problem by linking the credit to land, production inputs, and consumer items. Within the context of principal-agent relationships, according to Arrow (1985), interlinking permits the principal (the lender) to exercise a greater degree of control and monitoring over the activities of the agent (the borrower).

Alternatively, interlinkage may serve to reduce moral hazard or adverse selection of risk problems by permitting the use of contractual forms in one transaction to alter an agent's behaviour in another (Stiglitz, 1986). Braverman and Srinivasan (1982) and Braverman and Stiglitz (1982) define control in terms of influence over the performance of the tenant-borrower as a cultivator. Lenders who are landlords or merchants may use the contractual terms in these other exchanges to affect the probability of default. A trader-lender, for example, may offer a farmer who borrows from him lower prices on fertilisers and pesticides because the probability of default is reduced when such inputs are used.

The use of interlinkages as a direct mechanism for solving information and enforcement problems is quickly established in the rural markets. Information gathering is a by-product of living near the borrower or being part of the kinship, clan, tribal group

or a party to some other market transaction with the borrower. Thus, village moneylenders also collect information and monitor at lower costs while the formal institutions, especially the banks, may find it virtually impossible to do so. The trade/credit interlinkage "makes information on the size of the borrower's operation available to the lender and to nobody else; thus restricting borrowers' access to other lenders" (Siamwalla et. al., 1990). Furthermore, the trader-lender can easily enforce his claim by deducting it from the value of the crops sold to, or through him. In towns with well organised commodity markets, there may sometimes be co-operation among trader-lenders in enforcing repayment. Bell (1990) reported that:

> "in Chitoor (in Thailand) a commission agent who dealt in *gur* (a sugar product) told me that agents frequently know one another's clients. If a farmer attempted to sell through an agent other that than one with whom he normally dealt, the new agent would deduct principal and interest on the loan, basing his calculations on the usual rule of thumb, relating the size of the loan to the quantity to be delivered, and hand over the said sum to the first agent".

Bell (1990) and Siamwalla et. al. (1991), argue that trade-credit interlinkage helps in resolving the information asymmetry between borrower and lender and the enforcement problem, while they create asymmetry of information across lenders. Lenders who do not serve as traders for a borrower will not know as much about the latter's productivity and will be in a less favourable position to enforce a loan. In our survey of moneylenders, only 35 per cent reported that were willing to share information about borrowers with other lenders (Table 4.1).

It is not uncommon for landlords to require their tenant to borrow from them alone. This is done to get tenants to behave in a way advantageous to the landlord, who could charge an interest rate that is above market rate with a view to limiting the tenants'

borrowing (Braverman and Guasch, 1986, p.1261). The landlord could at the same time provide a contract that is attractive in other ways such as rescheduling loans when default occurs. Braverman and Guasch (1986) concede, however, that such a situation could occur in both competitive and non-competitive markets. They added that interlinkage is a way of internalising externalities in the absence of a complete set of markets, and causes the utilities possibilities frontier to move outward; but the distribution effects remain ambiguous.

It should be noted, however, that linking credit and land as it obtains in parts of Asia is different to what happens in parts of West Africa. In Asia, a loan that is linked with land bestows upon the lender rights of occupancy and use of the borrower's land until the principal is repaid. Such loans by landlords have also been observed in Thailand who tend to increase their holdings when default occurs (Siamwalla et. al., 1990). In some parts of West Africa, the situation is different. In Ghana for example, the procurement of loans could be ensured by transferring only the rights to harvest the borrower's tree crops. The harvest provides the principal and interest on the lender's loan. Such a transactions is called *tree pledging* and is very common in English-speaking West Africa (Adegboye, 1983). The pledge is part of the contract and not necessarily the result of a default (op. cit.).

In Sierra Leone, as stated earlier, land in the rural areas is mainly communally owned and held in trust for the family or the community by the PC. Land cannot be transferred (sold) freely in the open market. All land transactions have to have the concurrence of the family elders and that of the PC. Therefore, any interlinkage between credit and land is usually limited only to usufructuary rights (Johnson, 1972; Knickel,

1988). The lender is allowed in cases of default to extract repayment from income derived from output of economic trees. Such extraction is supposed to be monitored by the PC to ensure that more than what is due is not extracted from the land. In cases where the land does not have economic trees, such as bananas, kola nuts, oranges, oil palm etc., the lender is allowed to cultivate the land for a certain period agreed between the lender and the borrower in the presence of the PC or his representative (Turay, 1980). In some areas of Sierra Leone, if the lender fails to cultivate the land during the agreed period, he runs the risk of forfeiting his debt, which is presumed to have been extracted from the land during the agreed period. The latter clause is one of the reasons, among others, why interlinkage of credit and land are not common in rural Sierra Leone. If, however, the original terms of the agreement was a land pledge, the lender is permitted to retain the land and benefit from the fruits thereof until the borrower or a member of his or her family settles the debt.

Such interlinkages could run for several years, even generations and can sometimes result in a land dispute (Kamara and Turay, 1981). The apparent lack of written records on such deals (especially those which have spanned considerable number of years) makes claims for the return of land to original owner-families difficult to adjudicate. To minimise such occurrences, the pledging or linking of land in loan contracts is usually a family affair in the sense that the elders of the extended family (brothers, sisters, uncles etc.) having some claim to the land should be consulted and involved in the initial deal. This is not an easy thing to achieve because people do not want to be deprived of their claim to land and locating such relatives to conclude such a deal could be costly and frustrating. Land is regarded as the link between the unborn, the

living and the dead and in most rural areas in Sierra Leone, it is the single most important factor of production and source of livelihood. Family members can harvest from economic trees and sell the output for necessities. Since litigation involving land can be a protracted and very costly affair (Kamara and Turay, 1981), lenders try as much as possible to avoid engaging themselves in interlinkages involving land.

The most popular form of interlinkage, and the least costly for the lender in Sierra Leone, is the one involving credit and the purchase of consumerables, inputs and/or the sale of output. In our survey over 40 per cent of moneylender reported that they were involved in this kind of interlinkage, receiving repayment in kind (see Table 4.4). None was involved in land/credit interlinkage among our sample, because the costs and social repercussions may be adverse to the moneylender in the long run.

Table 4.4 **Modes of Lending and Repayment by Moneylenders**

Loan/repayment loan	**How granted**		**How repaid**	
	Freq.	%	Freq.	%
All Cash	3	20	5	25
All produce (output/input)	9	45	12	60
Goods (consumer items)	6	35	-	-
Part cash/part goods/output	2	10	3	15
Total	20	100	20	100

Source:- The Survey, 1994.

Moneylenders informed us that such deals do not augur well for business. Apart from land disputes being protracted and costly affairs, land/credit interlinkage can convey a wrong message about a moneylender. He could be viewed as some 'greedy and evil' man who is seeking to expropriate land from families in the locality. Such a man risks being unpopular and untrustworthy in the rural set-up, leading to disrespect or even social

ostracism for him and his family. This could further impact adversely on any political ambitions he or a member of his family may have in the future.

In addition to the high costs involved in linking credit and land, another reason why such a deal is usually avoided by the moneylender is that fallow periods are still long in rural Sierra Leone. By 1975, fallow periods were estimated to have fallen from an average of 15-20 years to 10-15 years (Spencer and Brylee, 1977; Johnny, 1981; Knickel, 1988)). In a situation where agriculture still relies on rain-fed-shifting-cultivation technology, few borrowers would risk using their land in land-credit deals and thereby risking their source of income as well as incurring the wrath of the extended family. Consequently, lenders and borrowers prefer to use output instead of land in credit interlinkage in Sierra Leone.

The above analysis suggests a very strong case for credit interlinkage and the literature does not yet have any counter arguments. The questions that need to be answered, however, are; (1) why are FFMs not taking advantage of credit interlinkage to provide effective competition for IFMs in the RFMs ? (2) Are there any barriers to entry or exit?

4.274. Barriers to Entry and Exit.

From an outsider's point of view, the apparent dominance of the IFMs, especially moneylenders, in LICs tends to suggest that there are many and that there is competition among them (Aleem, 1990); and therefore an advantage to borrowers in terms of the reduction in interest rates that could result. But from the borrower's point of view, it is different. Most borrowers are unable to use multiple sources of informal loans or to switch easily from one lender to another. In our survey, about 80 per cent of both

samples (i.e. rural banks customers and the control samples combined) who reported that they had borrowed from a moneylender, had borrowed from only one source during the last three years (Table 4.5). The main reason given was that the moneylender has been their customer, which means in the Sierra Leone context, that he had been dealing with these borrowers in several markets. Many of them also borrowed from rural banks as well. Siamwalla et al. (1990), observed a similar situation in their survey of the Nakhon

Table 4.5 **Number of Moneylenders borrowed from in the last three years**

Number	Frequency	Percentage	Major reasons
One	241	80.3	He has been our trader
Two	32	10.7	Old customer died
Three	25	8.3	Still owe last moneylender
More than three	2	0.7	Moved from two villages
Total	**300**	**100**	

Source:- The Survey, 1994.

Ratchasima province in Thailand, where about five-sixths of those surveyed reported having borrowed from the same source in the last three years. In their national survey of Thailand (Siamwalla et al., 1990) it was observed that a total of 72 per cent of the informal sector borrowers did not attempt to borrow from more than one informal lender for the same period.

The trader-lender secures business in advance of the harvest through interlinked loans. By negotiating the terms of the loan, he can influence the borrower's action in a manner that will be advantageous to his expected profits from moneylending and market interlinkage. By providing a fairly high amount of debt, the trader-lender can influence the farmer-borrower to use inputs (fertilisers, pesticides etc.) more extensively, in order to increase expected volume of output. By acting as a marketing channel, the trader-

lender is in a position to exercise first claim on proceeds, thereby settling what is owed him. The above analysis suggests a strong hold by the moneylender who interlinks credit with output sales and further suggests some barrier to exit for the farmer-borrower. This is especially so where there are very few moneylenders such as in the rural areas of Sierra Leone. Barriers to exit are also likely to exist in a situation where the viscious circle of poverty is still strong and tends to make the farmer-borrower tied to one moneylender. The borrower goes in for a loan year-in and year-out, finding himself or herself in cycle of debt.

There is the tendency in the literature to view the lender as possessing a natural monopoly stemming from his intimate knowledge of his clients, their ignorance and poor communication with the rest of the economy, all of which isolate the area in which he operates (Udry, 1990a). This view is also embraced by Wharton (1961), Nisbet (1967) and Bottomley (1975) who draw in data from the Reserve Bank of India[39]. Of these writers, Nisbet provides the clearest evidence yet, in support of the contention that lenders have significant market power, controlling what is to be cultivated and dictating the price of the output through interlinkage arrangements. Moneylenders, who were all agriculturists, were active in 18 out of the 34 *Communas* that Nisbet (1967) studied in central Chile and they accounted for most of the private credit. Each had a well defined geographical area, with no instances in which such areas were adjacent to one another. This suggests that with rather limited access to institutional finance, conditions ranged from monopoly to oligopoly in the credit markets of central Chile. To clinch the argument, however, it is necessary to demonstrate that the barriers to entry were

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[39] Some of these references may seem old; but the literature has not yet produced any new or counter evidence in this regard

sufficiently formidable to deter potential lenders from going into business if expected profits were supernormal. Nisbet did not do this directly; but the general tone of his exposition suggests that this is what he had in mind.

In Sierra Leone, formidable barriers to entry seem to exist. To start a moneylending business, seed capital is required. The average rural resident including the farmer is poor as we have indicated earlier and per capita annual income has fallen to about US$167 (The Economist, 1995) due to falling output combined with an increase in population. In addition, shortage of inputs largely in consequence of falling exports and scarcity of foreign exchange, has compounded the problem further. Moreover, marginal propensity to save in rural areas is very low, estimated at about 0.02, compared to the national figure of 0.23 (CSO 1990). Furthermore, access to institutional credit is limited to rural banks which are few and far between, lend only for production purposes and have only reached a small percentage (about 7 per cent) of the target population in their service areas (see Chapter Six). In these circumstances, the rural trader-lender appears to hold and exercise various controls over borrowers. In our household survey, some of the respondents in the control sample gave a contradictory response when asked if they knew any moneylenders. They responded that they did not know any moneylender but admitted that they borrowed from some relatives or friends or neighbours. Our interpretation of this is that they may be afraid to reveal the names of moneylenders for fear of being denied a subsequent loan or not wanting to talk about debt obligations to 'strangers'. Nisbet (1967) reported a similar situation when, in one *commune* that he surveyed, farmers were afraid to discuss the activities of three moneylenders for fear of losing their only current source of credit. For some rural residents, the local moneylender

represents the only source of loans in cash and/or in kind. Any attempt to go outside for institutional or non-institutional credit could entail some cost and endanger their subsequent borrowing chances. Moreover, some lenders are important rural community leaders which strengthens their position and enables them to exert socio-economic sanctions on individuals who do not cooperate (Aleem, 1990). Landlords, traders, and rich farmers in LICs use credit interlinkage. Through these mechanisms, they can exert influence and control over borrowers. Furthermore, because the interlocker can reduce transaction and risk costs, he is in a position to force his competitors to also use interlinkages. But vertical integration and tie-in arrangements can also force borrowers not to deal with other lenders. The above discussion suggests that interlinked markets can be a way of limiting entry to the credit market (Lamberte and Lim, 1988). The analysis also suggests that barriers to entry for new moneylenders and exit for the farmer-borrowers tend to exist in Sierra Leone and indeed, in some other developing countries, especially in the midst of high levels of poverty and given the high degree of market control that the trader-lenders exercise. The barriers are not the result of collusion among moneylenders but a consequence of the underdeveloped nature of the rural economy. They are, however, not insurmountable. What is required is investment in market infrastructure and appropriate marketing and pricing policies that will provide the incentives for private investment and an effective competition in both credit and input/output marketing. Rural banks in Sierra Leone could provide this kind of competition if policies governing their operations are modified as suggested in Chapter Seven. Competition could also help to reduce the level of interest rate in the IFM.

4.275. **Interest Rates in the Informal Financial Markets**

The debate about interest rates in the IFMs is polarised into two distinct schools of thought - the neo-classical (competitive) school and the monopolistic school. It was in the 1960s that first attempts were made to provide an economic rationale for the relatively high interest rates observed in IFMs in the rural areas of LICs. Micro-economic tools used to carry out partial equilibrium analysis in goods markets were employed (Bottomley and Nudds, 1969). Thus the debate that emerged centred on whether the market was competitive or monopolistic and high interest rates were explained by either cost of lending (competitive) or due to the pressure of monopoly rent (monopolistic). What was ignored at the time was the impact of information and uncertainty. The neo-classical models underestimated the problems of rural financial markets, especially uncertainty and asymmetric information; and have become inadequate in analysing the functioning of RFMs, especially the IFMs.

4.276. **The Competition View Point**.

Many observers including Bottomley, (1963a, 1964a, 1975); and Ghatak (1972), have been of the opinion that interest rates in the rural areas of LICs are high because of (1) the high rate of default (partial or complete) and (2) the size and short term nature of the loans which push up administrative costs (an excuse commonly used by western-styled commercial banks for the low proportion of their loan portfolio devoted to small farmers in LICs). The analysis used then, was straightforward and based on the assumption that the demand for loans was given and the curve is downward sloping. It also centred around opportunity costs (Oc), administrative costs (Ac), premium risk (Pr) and monopoly rent (Mr). Thus, the interest rate under that analysis was,

Interest rate = Ac + Oc + Pr + Mr .....(1)

When the probability of default (P), loan size (L) and the nominal interest rate (r) are included in the analysis, a second equation emerges;

$L(1+r)(1-P) = (1 + Ac + Oc)L$ .....(2)

the interest rate r, becomes

Interest rate $= [1 + Ac + Oc/(1-P)] - 1$.....(3)

Equation (3) suggests that a relatively small default rate can increase costs of lending. For example, if Oc is 5 per cent, default is 15 per cent and Ac is 5 per cent, the lender would need to charge borrowers no less than 29 per cent to cover his operating costs. The probability of default also depends on the dishonesty of borrowers, the vagaries of the weather which could adversely affect output, and market price fluctuations for agricultural produce. All of these factors can in turn affect the income of the producer. The competitive model assumes, therefore, that if the interest rate covers costs, then the rate is competitive. It also assumes that default and the terms of the contract are independent of each other. Furthermore, equation (3) assumes that the interest rate reflects the average risk of default and the latter is the same for all borrowers.

With the degree of screening and information collection undertaken by moneylenders (Table 4.6), a farmer who has a reputation for dishonesty or laziness will not be treated observationally equivalent to an honest and hard-working farmer. The former is a high risk borrower and the terms of the loan contract, including the interest rate for such a borrower, could be treated differently from a less risky (honest and hard working) farmer/borrower. This non-inclusion of the risk factor and information

asymmetry, therefore, renders the neo-classical model inadequate in analysing present-day RFMs in LICs.

4.277. **The Monopolist View**

The monopoly argument is that a monopolist will lend up to that volume at which his marginal cost of lending equates the borrower's marginal product of the loan and he will charge an interest rate that is equal to the value of marginal product, where product markets are competitive (Lipton, 1976). But the true rate of borrowing in the IFMs in LICs is usually subsumed in the price at which a trader-lender sells his goods to a borrower in credit/market interlinkages. High interest rates in the IFM have been cited as an indication of credit shortage because of the demand pressure on a small pool of loanable funds in a highly inelastic supply situation. Thus interest rates for these funds are driven up (Bottomley, 1975). Other studies argue that high interest rates in the IFMs may be justified because loans are small, short term and mostly for consumption. In addition, lenders' administrative costs, opportunity costs of capital and risks are high under substantial rates of inflation (Bottomley, 1963a, 1964c). Yet other studies note that there is very little evidence to substantiate extensive monopoly profits in the IFM (Adams, 1971; Iqbal, 1987; Aleem, 1990).

From the monopolists' point of view, the major component of high interest rates is monopoly rent. Empirical evidence which tends to support this view came mainly from surveys carried out in India (Chandavarkar, 1965) and Chile (Nisbet, 1967) mentioned above (section 4.29). Chandavarkar suggests that monopoly exists because of the low density of moneylenders and formal financial institutions in the rural areas. It has, however, been generally recognised that the proliferation of bank branches and credit

institutions achieved very little in terms of influencing the terms offered by moneylenders in the rural areas of LICs (Virmani, 1982; Akaah, et al., 1987; Abbot, 1985; Okorie, 1991). It has also been argued that interest rates will tend to decline on their own accord as economic growth increases because higher productivity with its associated high incomes will lead to an increase in demand for loans thereby lowering unit administrative costs and interest rate (Bottomley, 1964c). Premium risk will also decline as marketable surplus increases (Bottomley and Nudd, 1969). One policy implication related to this view is that direct intervention such as creation of government credit institutions or directing commercial banks to establish branches in rural areas, will not provide the complete answer. The answer rather lies in policies that will raise productivity through high yielding technology - fertilisers, seeds etc. - and other appropriate economic policy instruments such as the removal of price subsidies and/or the creation of market infrastructure as incentives for increased production.

In Sierra Leone the debate about monopoly profits realised by moneylenders is still on-going mainly because the overall operation of the IFM is still not properly understood. To understand how the IFM works and to contribute to the debate, it has become necessary to analyse moneylenders' operations and why they charge relatively high nominal interest rates. We are of the view that interest rates in the IFM of Sierra Leone are high mainly because of high transactions costs, especially those faced by the moneylender.

Table 4.6 **Steps Taken by Moneylenders to Screen Borrowers**

Lender	A	B	C	D	E	F	G	H
1	1(2)		2	3	4	no	yes	
2	1(1)		2	3	4	no		yes
3	1(2)		2	3	4	no		yes
4	1(0)	2		3		yes	yes	
5	1(1)		2	3	4	no		yes
6	1(0)	2		3		yes		yes
7	1(1)		2	3	4	no		yes
8	1(1)		2	3	4	no		yes
9	1(1)		2	3	4	no		yes
10	1(0)	2		3		yes		yes
11	1(1)		2	3	4	no		yes
12	1(1)		2	3	4	no		yes
13	1(2)		2	3	4	no		yes
14	1(0)	2		3		yes		yes
15	1(2)		2	3	4	no		yes
16	1(1)		2	3	4	no		yes
17	1(0)	2		3		yes	yes	
18	1(2)		2	3	4	no		yes
19	1(1)		2	3	4	no		yes
20	1(1)		2	3	4	no		yes

Note:- Figures relate to the stages through which a borrower goes before being granted a loan. Figures in brackets are the number of seasons step 1 could take before a borrower is regarded as a regular customer.

Key to Columns

Column A:- assessment related to dealings in other markets.
Column B:- request for reference/surety.
Column C:- enquiries of other borrowers/farmers in the applicant's village.
Column D:- visiting the applicant's farm/enterprise.
Column E:- small initial loan.
Column F:- if lender would grant loan to applicant who has not gone through first step.
Column G:- borrowers residing outside lender's operational area.
Column H:- borrowers who reside inside the lender's operational area.

Source:- The Survey, 1994.

Table 4.7 **Cost of Obtaining Information about Applicants and Some Operational Characteristics**

Lender	A	B	C	D	E	F	G
1	1	60	yes	10	no	90	10
2	1	20	yes	8	yes	60	15
3	1	20	yes	15	no	80	12
4	0.5	20	no	20	yes	62	8
5	1	20	yes	15	yes	85	20
6	1	20	yes	10	no	95	15
7	1	40	yes	12	yes	100	24
8	0.5	15	yes	15	yes	75	23
9	1	30	yes	10	yes	93	10
10	1	20	yes	20	yes	86	10
11	1.5	45	yes	30	no	58	14
12	1	20	yes	20	yes	72	18
13	2	30	yes	10	no	84	20
14	.05	10	yes	15	yes	98	16
15	1	40	yes	5	yes	65	20
16	1	30	yes	5	yes	95	10
17	1	25	yes	10	yes	96	11
18	1	20	yes	15	yes	79	14
19	1	30	yes	20	no	67	15
20	2	20	yes	40	yes	81	9
Mean	1.03	26.75		15.25		81.05	14.7

Key to Columns:-

Column A:- average number of days used to collect information about applicants.
Column B:- average expenses incurred per day.
Column C:- are moneylender's costs decreasing?
Column D:- percentage of applicants rejected by moneylender.
Column E:- did moneylender grant additional loan to customers who suffered crop failure?
Column F:- percentage of repeat borrowers
Column G:- number of years in moneylending business.

Source:- The Survey, 1994.

4.30. Transactions Costs in the Informal Financial Market

Data for this section come from our sample of 20 moneylenders (five from each of the four service areas of the RBs). A majority of the moneylenders we interviewed (80 per cent) are located within their area of operation (defined as a five-mile radius) because, according to them, they want to keep abreast with issues and events involving their clients with a view to minimising risk (Table 4.6).

Tables 4.6 and 4.7 provide a synopsis of the steps moneylenders in Sierra Leone use to collect information and to screen borrowers. The moneylender expends considerable effort and resources to obtain information about applicants in order to reduce the risk of default and to solve the moral hazard and adverse selection of risk problems. Due to the lack of bankable collateral, the legal problems and high costs associated with the foreclosure of land, there are no practical alternatives open to the moneylender other than a careful screening of his applicants. An indication of the consequence of providing loans without adequate screening is the rate of default which is in excess of 30 per cent experienced by the rural banks and past government credit schemes in Sierra Leone (see Chapter Six).

Although there is considerable variation in the methods used by individual moneylenders, some flexibility is displayed. However, the moneylender does not normally lend to an applicant with whom he has not dealt with in another market, say in the sales market of harvested crops or in the moneylender's multi-purpose shop (Table 4.6). Notable exemptions are close relatives who are not usually charged any interest and from whom collateral is not usually demanded. It should also be noted, however, that the moneylender could entertain a first application from a borrower who can provide

adequate collateral or a surety[40]. Such cases are shown in Table 4.6. These applicants were not given a small loan as an initial test and a visit to their farm or enterprises was only made to cross check and collect more information about their activities. The screening period which, on average, lasts one cropping season (April to November) provides important information about the farmer/borrower, which includes the likely marketable surplus and the way the latter deals in other markets. Such information is not available to the rural banks and if the rural banks were to attempt to collect it the cost could well be prohibitive. Secondly, most of the moneylenders surveyed made enquiries of applicants in their village and even their farms/enterprises (Table 4.6). Such enquiries involved the applicant's indebtedness and reputation in the market. Thirdly, if the applicant satisfies the requirements in the three stages, a small loan is given as a test. If the borrower repays the initial loan, he or she can depend on the moneylender for subsequent credit.

Tables 4.8 and 4.10 show that the screening costs are substantial. On average, it takes one day of the moneylender's time to collect information about the applicant. Expected default, which is based on past experience, is high given the amount of money lent. There are costs implicit in this exercise. Firstly, there is an opportunity costs of time for the one day which is determined here using the agricultural daily wage rate[41] and which is uniform for the whole country. It is a better measure than, for example, returns which may vary with different types of enterprise and the entrepreneurial skills of the moneylenders.

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[40] A surety in this case means a village notary who has the means of repaying the loan if default occurs or a member of the borrower's family who is of good standing with the moneylender in the village.

[41] Agricultural daily wage rate was Le166.00 (FAO, 1992)

Table 4.8 **Risks Faced by Moneylenders**

Lender	A	B	C
1	3.0	8	1.5
2	2.6	0	1
3	2.7	0	2
4	3.1	10	1
5	3.0	0	3
6	2.1	10	2
7	2.0	0	1
8	2.6	0	1
9	2.7	5	2
10	2.8	20	1
11	2.5	0	1
12	2.3	0	1
13	2.6	0	2
14	1.7	20	2
15	3.2	0	1
16	2.6	0	2
17	2.3	10	1
18	2.6	0	1
19	2.8	0	1
20	2.6	0	2
Average	**2.59**	**-**	**1.45**

Key to Columns.
Column A:- percentage of expected default (based on past experience).
Column B:- percentage of loan against which collateral is taken.
Column C:- average delay of repayment after due date (months)
Source:- The Survey, 1994

Table 4.9 **Location of Moneylenders and their Clients**

Lender	Location of moneylender	Name of town or village*	Clients located within**	Clients located outside**
1	1	Mile 91***		yes
2	0	Mathoir	yes	
3	1	Yonibana		yes
4	1	Malal		yes
5	1	Masorie	yes	
6	1	Lunsar***	yes	
7	0	Portloko	yes	
8	1	Feredugu	yes	
9	1	Mabesseneh		yes
10	0	Mamusa	yes	
11	1	Mattru***	yes	
12	1	Mokanji	yes	
13	1	Mattru***	yes	
14	1	Luawa	yes	
15	1	Bonthe	yes	
16	0	Makali***	yes	
17	1	Masingbi		yes
18	1	Makali	yes	
19	1	Matotoka	yes	
20	1	Magburaka	yes	

Note:- 1 located inside operational area (defined as a 5-mile radius).
0 located outside operational area.
* Moneylenders location.
** clients located inside or outside operational area of moneylender.
*** Location of RB.

Source:- The Survey, 1994.

Table 4.10 **Moneylenders Loans Analysis (Previous year's Actuals)**

Lender	Number of borrowers	Amount loaned (Le000)	Average size of loan (Le000)	Number of actual defaulters	Amount actually defaulted (Le000)	Percentage of loans actually defaulted
1	16	24.00	1.50	2	1.20	5.0
2	11	30.00	2.70	3	0.51	1.7
3	4	20.00	2.50	1	0.60	6.0
4	3	20.00	6.60	1	0.40	2.0
5	6	20.00	3.33	1	0.42	2.1
6	9	30.00	3.33	2	0.33	1.1
7	8	15.00	1.88	2	0.77	5.1
8	5	20.00	4.00	3	0.68	3.4
9	3	15.00	5.00	2	0.90	6.0
10	4	10.00	2.50	1	0.62	6.2
11	3	30.00	10.0	2	1.56	5.2
12	7	35.00	5.00	3	2.10	6.0
13	10	30.00	3.00	1	0.30	1.0
14	8	40.00	5.00	2	0.40	1.0
15	15	30.00	2.00	1	2.40	8.0
16	12	20.00	1.67	1	0.42	2.1
17	13	10.00	0.77	3	0.16	1.6
18	5	15.00	3.00	2	0.62	4.1
19	14	20.00	1.43	1	1.40	7.0
20	10	30.00	1.80	1	1.20	6.7
Total	166	464	67.01	35	16.99	-
Mean	8.30	23.20	3.35	1.75	0.85	3.84

Source:- The Survey, 1994.

On average, the expected rate of default ranged between 1.7 to 3.1 per cent with a mean of 2.6 per cent (Table 4.8). The actual default for the previous year (Table 4.10) was higher, with fifteen (75 per cent) of the twenty moneylenders surveyed experiencing a default rate of over 2.0 per cent. The cumulative rate of default is a good approximation of the incidence of bad debt. Given that some of the overdue loans may eventually be recovered, due mainly to the closeness of the moneylender to his clients and the methods used to collect repayment, the cumulative rate of default, if anything, an over estimation

Table 4.11 **Factors Influencing Moneylenders' Loan Decisions**

lender	A	B	C	D	E	F	G	Ranking
1	yes		yes	yes	45	yes	yes	F, E, & C
2	yes	yes	yes	yes	60	yes		F, C, & A
3	yes	yes	yes		75	yes		F, E & C
4	yes		yes	yes	40	yes		C, D & F
5	yes	yes	yes		40	yes	yes	F, G & E
6	yes	yes		yes	50	yes		D, E & F
7	yes		yes	yes	60	yes		E, F & A
8	yes		yes		70	yes	yes	F, C & E
9	yes		yes	yes	30	yes	yes	A, F & E
10	yes	yes		yes	45	yes		E, F, & C
11	yes	yes	yes	yes	64	yes		F, D & E
12	yes	yes	yes	yes	80	yes		B, F & E
13	yes		yes		70	yes		F, D & C
14	yes		yes	yes	100	yes		E, F & A
15	yes			yes	55	yes		D, E & F
16	yes		yes		20	yes		A, C & F
17	yes	yes	yes	yes	30	yes		E, F & C
18	yes	yes	yes	yes	45	yes		C, F & E
19	yes	yes	yes	yes	50	yes	yes	D, B & F
20	yes		yes		70	yes		C, G & F

Key to Columns

Column A:- Acreage cultivated by customer.
Column B:- Availability of funds.
Column C:- good customer i.e. one previously dealt with, in another market.
Column D:- Duration of loan.
Column E:- Credit/market interlinkage.
Column F:- Fear of the 'rebel' war situation.
Column G:- Availability of collateral.
Ranking:- The three most important factors (in order of priority).
Source:-The Survey, 1994.

Table 4.12 **Actual Transaction Costs of Moneylenders for Previous Year (1993) (Summary of Data)**

Lender	A	B	C	D	E	F
1	24	.060	.332	.0296	.4216	1.757
2	30	.020	.166	.0084	.1944	0.648
3	20	.020	.166	.0197	.2057	1.029
4	20	.020	.083	.0066	.1096	0.548
5	20	.020	.166	.0207	.2067	1.034
6	30	.020	.332	.0109	.3629	1.209
7	15	.040	.332	.0013	.3733	2.489
8	20	.015	.083	.0112	.1092	0.546
9	15	.030	.332	.0297	.3917	2.611
10	10	.020	.166	.0102	.1962	1.962
11	30	.045	.332	.0257	.4077	1.359
12	35	.020	.166	.0346	.2206	0.630
13	30	.030	.332	.0099	.3719	1.239
14	40	.010	.083	.0132	.1062	0.266
15	30	.040	.166	.0396	.2456	0.819
16	20	.030	.166	.0139	.2099	1.049
17	10	.025	.166	.0264	.2124	2.124
18	15	.020	.166	.0102	.1962	1.308
19	20	.030	.166	.0231	.2191	1.096
20	30	.020	.332	.0396	.3916	1.305
Total	**464**	**0.535**	**4.233**	**0.3845**	**5.1525**	**25.028**
Mean	**23.2**	**.02675**	**0.2117**	**.0192**	**.2576**	**1.251**

Key to Columns:-

Column A:- Amount loaned (Le 000).

Column B:- Cost of collecting information about borrowers i.e. number of days used multiplied by the agricultural wage rate (in Le000).

Column C:- Opportunity cost of lender's time (in Le, calculated as number of days used to collect information multiplied by the agricultural wage rate i.e. Le 166.00/day[42] (in Le '000')

Column D:- Opportunity cost of lender's funds delayed after due date (the savings rate in the RBs is used as a proxy; i.e. 20 percent per annum (in Le '000')

Column E:- Total transaction costs (B+C+D).

Column F:- Total transaction costs as percentage of total amount loaned.

Source:- The Survey, 1994.

[42] FAO, 1992.

of the non-recoverable debt. It would, therefore, be fair to conclude that the screening actions of the moneylender tend to be more successful compared to rural banks and those of predecessor credit institutions in Sierra Leone. The screening process of moneylenders is, however, not perfect. Delinquent loans involving late repayment were a constant source of concern to moneylenders surveyed. As indicated in Table 4.12, the lender faces a significant risk of losses in terms of default and opportunity costs of time when repayment is delayed with the period of delay being, on average, 1.5 months with a range of 1-3 months (Table 4.8). The above discussion suggests that the moneylender faces high costs in his lending operation as Table 4.12 indicates. Total actual transaction costs for the previous year, 1993 are, on average, 1.25 per cent of total loans with a range of 0.2-2.5 per cent. This is high considering the average mean loan size of Le 23.2 thousand (US$ 41.13 at 1993 exchange rate). This level of transaction cost is, however, low compared to RBs (see Chapter Six). But to be able to explain the relationship between the interest rates observed and the factors influencing them, a linear regression model is used.

4.31. Model specification.

Several variables influence the interest rates charged by the moneylender. Some of them are easily quantifiable. The discussion that follows will indicate the various variables used to develop the model.

4.32. Monopoly variable.

The monopoly profit has been ascribed the difference between the observed interest rate and the total cost of lending. The existence of monopoly profit in IFMs is, however, still not clear. For example, Long (1975); Bottomley (1975) and Wells (1980),

using hypothetical cost curves strongly affected by administrative cost and risk premium conclude that monopoly profit is not an important feature of RFMs in LICs. Nisbet (1967) and Wai (1957) using different assumptions regarding default rates and returns on investment conclude that monopoly profit is important. In the Philippines, Floro and Yotopoulos (1991) found that the issue of monopoly profit is still inconclusive. For example, Gapud (1958) and TBAC (1985) found evidence of monopoly profit. But Quinones (1982) and Serrano (1983) distinguishing between premium risk, administrative cost and opportunity cost of capital among transactions costs, found little incidence of monopoly profit. Since many aspects of transaction costs are not directly observable and quantifiable, measurement of these leaves room for much speculation. As Floro and Yotopoulos (1991) have stated, the deductions about the evidence of monopoly profit must be viewed as an analyst's construct.

The above notwithstanding, other approaches have been used to assess the evidence of monopoly surcharge in the IFM. In Sierra Leone, the theory of the firm offers a satisfactory compromise in explaining the presence or non-presence of monopoly profit in the lending activity of moneylenders. One of the best known outcomes of competitive pricing is that no firm can make abnormal profits; and firms operate at the minimum point of their long-run average cost curve (Lipsey, 1990). Using that as a basis, let us consider the entry of a non-profit maximising government lending agency with subsidised interest rates into the credit market. If it charges a lower nominal interest rate than moneylenders (as the RBs do in Sierra Leone), the tendency will be for borrowers to flock to it for the cheap loans. A moneylender will, therefore, be forced to close down if this government agency can satisfy the demand for credit. From what we know,

however, such agencies can rarely satisfy the total demand. Government agencies are usually forced to allocate credit through non-price means (rationing). They tend to lend to borrowers whom they consider low risk, leaving the high risk borrowers to be catered for by the moneylenders. In this scenario, which is typical of RFMs in LICs, the presumption is that interest rates in the IFMs will not fall. It should be noted, however, that the opportunity cost borne by a moneylender can be reduced by the presence of a RBs causing moneylenders to reduce their interest rates. This could happen if moneylenders are able to borrow from RBs to on-lend to their clients. It could also occur if moneylenders face an increasing cost of funds schedule (i.e. in securing loanable funds) and competition from the RB pushes them down to a lower cost of funds schedule.

In this model it is assumed that the IFM in Sierra Leone operates under competitive market conditions and there are numerous moneylenders. By implication, therefore, if a rural bank (with its subsidised interest rate) enters such a market, we would expect rural residents to take advantage of the lower interest rate it offers. It is expected that this would reduce moneylenders' clients and those moneylenders who lose enough clients to the extent that their credit operations become unprofitable, would close down. If the situation remains competitive and no rationing occurs, the long run consequence is a reduction in interest rates charged by moneylenders. The caveat, however, is that the interest rate in the IFM will remain constant or rise. The reason being that RBs have limited funds and the huge demand will force them to ration or select borrowers using non-price means. It will be shown in Chapter Six that RBs in Sierra Leone tend to be rationing credit.

In this model, the presence of an RB is introduced to assess the effect on the interest rate charged by moneylenders. To assess this effect, a dummy variable which takes the value of 1, for the presence of a RB where a moneylender operates and 0, where no RB is present. If the coefficient is large enough and negative, we can reasonably argue that a monopoly surcharge is an important component of the interest rates charged by moneylenders. The rate will however be measured against the level of interest rate charged by RBs. Iqbal (1987), used this technique to measure the incidence of monopoly surcharge in Bangladesh; but found the incidence to be negligible.

4.33. Credit-Marketing Interlinkage (Tie-ins) variable.

Tie-in sales is one of the variables whose effect is difficult to measure in credit-market interlinkage deals in the IFMs of LICs. Moneylenders combine various services - trade, farming, marketing - in the rural areas (lack of specialisation). They trade in a variety of goods ranging from consumer to production items. The linking of these activities with credit deals makes the separation of the returns from tie-in sales difficult. Since prices at the time of harvest could be higher or lower than the price agreed at the time the tie-in sales contract was drawn up, the true interest rate from interlinkage is subsumed and could only be considered as implicit (Aleem, 1990; Floro and Yotopoulos, 1991). Thus we have used a dummy variable as a proxy for tie-in sales. A value of 1 is used where the moneylender reported that more than 10 per cent of his lending operation involved tie-in sales and 0 if tie-ins are less than 10 per cent of his lending transactions.

4.34. Risk of default variable.

The risk of default is one of the variables that has been investigated by many researchers including Bottomley (1975); Aleem (1990) and Yotopolous (1991). All of

them found it to be significant in its influence on the level of interest rates charged in the informal sector. Discussions with our sample of moneylenders indicates that risk of default is one of the worrying aspects in credit operations. To reduce its effects on lending, moneylenders often engage in credit-marketing interlinkage. In this model expected default is expressed as a percentage of loans extended. A positive sign is expected because an increase in the probability of default will tend to increase the interest rate charged.

4.35. **Number of years in business variable.**

The longer a moneylender has been in business the more insight he has into the character of his clients and potential borrowers. In other words, he is high up the learning curve. This increases his chances of reducing the adverse selection of risk and the moral hazard problems. He is also in a better position, compared to newly established moneylenders and formal lenders, when it comes to the use of social and cultural measures of loan enforcement because of his familiarity with the socio-cultural milieu. The length of time a moneylender has been in business has been recognised in the literature as an important factor (Besley, 1993; Aleem, 1990; Floro and Yotopoulos, 1991). Our model has thus included it as one of the variables to explain the level of interest rate observed. In our sample about 60 percent have been in business for 10 years and above (Table 4.6).

4.36. **Information costs variable.**

The study was unable to separate administrative from information costs because moneylenders did not keep records of administrative costs. They regard administrative costs as part of the costs incurred in the collection of information and repayment when

loans are due and none of them reported of having agents to collect repayment. Their areas of operation tend to be small and the volume of business (granting loans) at the time of the survey, was on a small-scale probably on account of the on-going 'rebel' war. In the Sierra Leone context then moneylenders do not incur significant costs on loan administration. Given that initial runs of the model produced serial correlation between information cost and administrative cost. The two variables were combined to form a variable called INFO, which was expressed as a proportion of total loans granted. The indication from the survey was that the collection of information is very vital and it is a continuous process given the moneylender's desire to reduce adverse selection of risk.

4.37. **Acreage variable.**

Different types of variables have been used to measure risk of default. The one commonly used is the income of the borrower (Iqbal, 1987). But this variable is not directly measurable in the Sierra Leone context. People's wealth and income are treated as confidential matters, and businesses in the informal sector do not disclose quarterly, half-yearly or yearly accounts. Farmers are mostly illiterate and do not keep records of operations. The lender is therefore unlikely to base his decision to lend on the borrower's income. One factor which could be used as a proxy for income is the average acreage cultivated by the borrower. It should be recalled that one of the activities in the collection of information about the borrower is a visit to the latter's farm or business location (Table 4.6). This is done to assess the probability of default in relation to the size of the applicant's business. Iqbal (1987) used this variable in Bangladesh and found it to be a good proxy for income and significant in explaining differential interest rates charged by moneylenders. In our survey, moneylenders informed us that the size of a

man's farm tells a lot about him. It conveys how serious he is with his work and how hard working he is. As one of the moneylenders put it, "it would be foolish to lend a huge sum of money to a farmer who you know is lazy (i.e. cultivates a small farm)". Spencer (1977), calculated that the minimum acreage for subsistence for a family of three in Sierra Leone is 1.5 acres. Experience has taught moneylenders in Sierra Leone that lending to farmers who cultivate small acreages increases the risk of default. Table 4.11 gives an indication of the factors influencing moneylenders' decision to extend credit. The size of farm (acreage) is one of the important ones. But the most important are the 'rebel' war, followed by interlinkage and 'good customer' defined as one with whom the lender had dealt with in another market. The borrower's family size could also be a proxy for the size of farm; but most farmers now send their children away to schools in urban areas. In the rural areas of Sierra Leone, the size of a farmer's family used to influence the size of his farm (Spencer, 1977); but in present-day Sierra Leone, the desire to educate children as an insurance against old age and illness tends to reduce farm family labour. Therefore, family size was not used in our analysis. Instead, the acreage a farmer can cultivate on his own with the available labour, gives a close approximation of output and hence income.

4.38. **Duration of loan variable.**

Duration of loans is also likely to be affected by the instability and uncertainty in the country. Lenders informed us that they were afraid to lend for periods longer than 9 months for the same reasons discussed earlier. It is expected that the longer the period of loan, the higher will be the interest rate charged.

On the whole, the results of the analysis should be treated with caution as the true picture could have been influenced by the on-going 'rebel' war. This notwithstanding, the results of the analysis provide a fair assessment of the costs facing the moneylender and the factors affecting the level of interest rates they charge at this point in time.

To understand these factors, a simple multiple regression model (MRM) has been fitted for parameter estimates. The MRM is based on the simple equation approach where the independent variables are assumed to have a relationship with the dependent variable. The indicative interest rate is thus assumed not to be influenced by any other relationships within the economic process. Parameter estimate of the multiple regression are derived through Ordinary Least Squares (OLS). In addition to the conventional assumptions underlying the multiple regression model the selected variables, average acreage cultivated, cost of collecting information about borrowers, default risk, average duration of loan, the presence of a rural bank and tie-in contracts are assumed to be important factors influencing the level of interest rates charged by the moneylender.

The equation can, therefore, be implicitly expressed as;

$$Y = f(X_1, X_2, X_3, X_4, X_5, X_6, X_7, \varepsilon)$$

Where,

Y = Indicative interest rate charged by the moneylender.

X_1 = Administrative costs and resources allocated to the collection of information about borrowers.

X_2 = Presence of an RB in the operational area of the moneylender. (Dummy variable which takes the value 1, for the presence of a RB and 0, where no bank is present).

X_3 = Tie-in sales (Dummy variable which takes the value of 1, where moneylender's lending operation involves over 10 per cent of tie-ins and 0, where tie-in transactions are less that 10 per cent of transactions).

X_4 = Expected default risk as a proportion of loans granted.

X_5 = Number of years the moneylender has been in business.

X_6 = Duration of the loan (in months).

X_7 = Average acreage cultivated by borrowers.

ε = Error term for unquantifiable factors influencing level of interest rates.

The list of variables is;

Dependent Variable

1. INDRT (Indicative interest rates observed).

Independent Variables	Expected Sign
2. BNKPR (Presence of a RB, Dummy variable).	-
3. TIEIN (Tie-in sales, Dummy variable).	+
4. DFRK (Default risk).	+
5. YRBU (Number of years in business).	
6. INFO (Administrative cost and resources allocated to the collection of information about borrowers).	+
7. DURA (Average duration of the loans in months).	+
8. ACRG (average acreage cultivated by borrowers).	_

The equation for the model stands as:-

$$INDRT=b_0+b_1(BNKPR)+b_2(TIEIN)+b_3(DFRK)+b_4(YRBU)+$$

$$b_5(INFO)+b_6(DURA)+b_7(ACRG)+\varepsilon$$

The first step towards the development of the model was the construction of a correlation matrix of all the variables used to explain the dependent variable. This is given in Table 4.13. It is implicit in the above relationship that variations in the dependent variable (indicative interest rate charged) can be explained by the variations in the independent variables

4.40. Results of the Regression Analysis

The regression was run using the stepwise method to eliminate the variables that were not significant in explaining the level of interest rates observed.

Notwithstanding the limitations imposed by the small size of the sample, the model's correlation coefficient (Multiple R) is high at 0.89, suggesting that the model go a considerable way in explaining the situation as observed. The adjusted coefficient of determination (R^2), 0.80, indicates that 80 per cent of the variation in the interest rates observed can be explained by variance in the variables used in the model. The variables had the expected signs.

On the basis of the correlation matrix (Table 4.13) it can be suggested that the most important variables for the data set and the model are the duration of the loan, the default risk and tie-in sales. All three variables were significant at the 99% level. The positive sign on the coefficient of the duration variable (Table 4.13), suggests that interest rate would increase with increase in the length of time the borrower wants the

loan for. Iqbal (1987) and Aleem (1990) came to the same conclusion when they studied factors influencing the level of interest rates observed in India and Pakistan respectively.

Table 4.13 **Correlation Matrix**

	INDRT	ACRG	BKPR	DFRK	DURA	INFO	TIEIN	YRBU
INDRT	1.0000							
ACRG	.0337	1.0000						
BKPR	-.2160	.0101	1.0000					
DFRK	.8390	.1858	-.0867	1.0000				
DURA	.8261	.1047	-.1100	.7144	1.0000			
INFO	.2157	.1739	.1238	.2870	.0627	1.0000		
TIEIN	.7074	.0788	.0000	.8518	.5185	.2444	1.0000	
YRBU	-.1927	.1277	-.2262	-.2080	-.1952	-.3110	-.2584	1.0000

Table 4.14 **Summary of Regression Analysis**

Coefficient of multiple regression .899

Coefficient of Determination (R Square) .808

Adjusted R Square .786

Standard Error 1.335

Analysis of Variance

	DF	Sum of Squares	Mean Square
Regression	2	128.248	64.122
Residual	17	30.301	1.782

F Ratio = 35.975 Sig. F = .000

Variables in the Equation

Variable	B	SE B	Beta	T	Sig. T
DFRK	3.377	1.006	.051	3.354	.004
DURA	.780	.255	.463	3.056	.007

Default risk also had the expected sign suggesting that an increase in default risk would lead to an increase in the interest rate that will be charged. Bottomley (1975), Iqbal (1987), Aleem (1990) and many others have all observed that default risk had a positive correlation with interest rate in the IFMs of LICs. The actual default risk of from 1 to 8.0 per cent (with a mean of 3.8 per cent) is high relative to the average size of total loans of Le 23.2 thousand granted (Tables 4.10 and 4.12). Aleem (1990) observed a default risk of around 6 per cent in the IFM in the area he studied in Pakistan. As with the duration of the loan, the anticipated default risk was high due to the instability in the country, underlying the fear of moneylenders about default risk.

Tie-in sales are a common feature of IFMs in LICs. In Sierra Leone over 60 per cent of the moneylenders we interviewed reported having linked their loan operations to other transactions such as input/output sale and repayment in kind (Table 4.4). The interest rate in this kind of credit/trade interlinkage is subsumed in the prices ruling at the time the contract is concluded and the prices at harvest for the commodity used in the in-kind payment. The matrix shows that tie-ins are significant with a high and positive correlation with interest rate charged, at the 99 per cent level and the result is consistent with conclusions reached by others (Iqbal 1987; Aleem, 1990), who have studied the IFMs in LICs. However, the final model did not include tie-in sales probably because interest rates charged by moneylenders are subsumed in the credit/market interlinkage.

Although the other variables are not significant at this point in time, some comment about their magnitudes is warranted. The information cost (i.e. administrative cost and resources allocated to the collection of information about borrowers) is low and

varies from between 1.0 to 1.6 per cent of average loan size of Le 23.2 thousand, mainly because of the experience of lenders, a majority of whom had operated for over 10 years (Table 4.15). Table 4.12 provides a breakdown of these costs. Total transaction costs (administrative cost, information cost and opportunity costs of time and outstanding

Table 4.15 **Variables Information**

	INDRT	ACRG	BKPR	DFRK	DURA	INFO	TIEIN	YRBU
1	49	2.0	1	3.0	9	120	1	10
2	45	1.5	1	2.6	6	20	0	15
3	48	2.6	1	2.7	9	20	1	12
4	51	2.1	0	3.1	9	25	1	8
5	47	2.3	0	3.0	6	40	1	20
6	42	1.9	1	2.1	6	40	0	15
7	43	2.5	1	2.0	6	40	1	24
8	45	2.5	0	2.6	6	20	1	23
9	46	2.3	1	2.7	6	60	1	10
10	48	1.2	1	2.8	9	20	1	10
11	45	1.6	1	2.5	6	60	0	14
12	44	1.8	0	2.3	6	20	1	18
13	45	1.6	1	2.6	6	30	0	20
14	43	1.5	0	1.7	6	10	0	16
15	52	1.4	0	3.2	9	40	1	20
16	45	1.8	1	2.6	6	30	0	10
17	40	1.8	1	1.3	3	25	0	11
18	46	2.0	0	2.6	9	20	1	14
19	46	2.5	1	2.8	9	30	1	15
20	47	2.0	0	2.6	6	100	1	9
Total	--	38.9	--	50.8	138	770	--	294
Mean	45.85	1.945	--	2.54	6.9	38.5	--	14.7

Notes:-INDRT = Indicative interest rate charged by moneylender (%).
ACRG = Average acreage cultivated by clients of moneylender.
BKPR = Presence of RB (Dummy variable - 0 for no bank, 1 for bank presence).
DFRK = Expected default risk (percentage of amount loaned).
DURA = Average duration of loans (months).
INFO = Average administrative and cost of information collection about clients.
TIEIN = Tie-in sales (Dummy variable - 0 for no tie-in sales, 1 for tie-in sales).
YRBU = Number of years in business of lending.

Source:- The Survey, 1994.

loans) are on average 1.25 per cent of average loan granted. It suggests that moneylenders face high costs, especially in view of the smallness of the amounts loaned. Aleem (1990) also reported an average transactions costs of around 1-6 per cent in his study of the IFM in Pakistan; but he considers it to be low when compared to formal credit institutions in the same country.

The model also suggests that interest rates observed were not influenced by monopoly surcharge. The presence of a RBs in the area of operation of moneylenders did not influence the rate charged by moneylenders. This may be due to the ineffective competition posed by RBs. It is therefore not surprising to see that BNKPR is not significant in explaining the level of interest rates observed, although it had the expected sign.

It must be emphasised that the result of the regression, though important, may have been influenced by the unstable situation in the country. In addition, although the sample of moneylenders was chosen on availability of respondents as against representativeness, the results give a fair idea of their mode of operation and lessons can be learnt from it by RBs and policy makers who are interested in creating viable RBs. The variables which are not significant at this point in time, may be important when a relatively stable enabling environment returns in Sierra Leone. It would, therefore, be necessary to test the model when the situation returns to normality.

4.41. Conclusion.

Over thirty years of government intervention in rural credit markets suggests that the creation of institutional alternatives has failed to replace the traditional moneylender in the credit markets of rural areas in Sierra Leone. Whatever competition government

institutions have provided, interest rates charged by traditional moneylenders remain high in nominal terms when compared to those charged by RBs.

Their flexible mode of operation, nearness to their clients, little or no delay in granting loans and the use of socio-cultural means to extract repayment put moneylenders in a more advantageous position when compared to other formal credit institutions. In addition, moneylenders perform useful services which RBs have been unable to undertake and for which they were not designed. Moneylenders provide a market through credit interlinkages and lend without being too fussy about collateral or too worried about the end-use of the loan.

Their transaction costs are typically low compared to RBs (Chapter Six) and costs incurred by clients when borrowing from them is next to zero mainly because they are part of the village set-up. Moneylenders seem to be exercising a high degree of control in rural credit and marketing of inputs and output. Mechanisms they employ involve the expending of resources on screening applicants and enforcing loans repayment. It follows that the relatively high nominal interest rates they charge reflect the high cost of these activities. More importantly, these mechanisms may suggest a monopolistic competitive structure with interest rates spread between different segments of the rural credit market; it further suggests that the moneylender's power is unlikely to be broken by entry of formal credit institutions unless such institutions (including RBs) find substitutes for or integrate the kinds of mechanisms used by moneylenders into their operating policies in order to overcome the problems of screening, incentives and enforcement.

Although our discussion suggests barriers to entry and exit in the IFM in Sierra Leone, these barriers are not insurmountable. What is needed is more effective competition to reduce the profit of the moneylender, thereby forcing a reduction of interest rates and provision of a wider choice of lenders for borrowers.

Chapter V Analysis of the Operation of the *Osusu* in Sierra Leone.

5.0. Introduction

This chapter provides a continuation of the discussion on the informal financial sector through focusing on the *Osusu*, the local version of the Rotating Savings and Credit Association (ROSCA) in Sierra Leone. Because of the *osusu's* pervasiveness in both the urban and rural areas, its different mode of operation compared to a moneylender's and the variety of services it performs for its members, it warrants a chapter of its own. The objective is to highlight its importance for savings mobilisation and as a source of credit, to outline the variety of needs it meets and to examine its linkage with FFIs. The chapter is organised into five sections. The first provides a theoretical perspective for analysing the ROSCA. The second discusses the operations of the *osusu*, highlighting the various types which can be found in Sierra Leone. The third discusses the rationale for membership and the uses to which funds are put. The fourth examines some efforts to link ROSCAs with FFIs in some African countries and the fifth concludes the chapter with a discussion on a new perspective for providing assistance to these self-help groups by Non-governmental Organisations (NGOs) and International Donor Agencies (IDAs) in LICs.

5.10 Theoretical Perspective

Rotating Savings and Credit Associations (ROSCAs) have been reported in most LICs including more than half of the countries in Africa (Miracle et al., 1980). They have also been reported to operate among immigrant groups in the United States of America (Light, 1972; Bonnet, 1981). The basic form of the ROSCA is "an association formed

upon a core of participants who agree to make contributions to a fund which is given, in whole or in part, to each contributor in turn" (Ardener, 1964, p. 201). The modes of operation of this basic form can vary from one country to another and from one locality to another within the same country (Bouman, 1995; Ardener, 1995; Burman and Lembete, 1995). In many countries ROSCAs are popular among the poor who have been rationed out of banking services (Von Pischke, 1994). They are also often popular among the intellectuals and the political elite even though they may have easy access to formal banking systems (Adams, 1993; Ardener, 1995; Bouman, 1995). ROSCAs have been reported to be operated by workers of FFIs in both high-income and low-income countries. Adams (1993) gives examples of some FFIs in Bolivia, Belize, Papua New Guinea, the Philippines and Egypt[43] where worker have been engaged in the practice. ROSCAs have also been reported among Somali and Asian Women in the United Kingdom (Summerfield, 1995) and Koreans in Los Angeles (Deng, 1995). A ROSCA is even known to have been operated by employees of the International Monetary Fund (Adams, 1983, p. 13-14).

The names by which ROSCAs are known in various countries are numerous. Miracle et al. (1980, p. 704) gives a list of local names applying in some African countries. In Nigeria, for example, they are known by a variety of names including *esusu, isusu, dashi, adashi, oha, bam.* In Liberia, they are called *Asusu.* In the Cameroon, *djanggi* in Ghana, *susu* and in The Gambia and Sierra Leone they are called *osusu.* In Francophone west Africa, they are generally known as *tontines.* In Egypt they are called *Gam'iya* (Baydas, et al., 1995).

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[43] Baydas, et al (1995) reports that a high proportion of employees of the Principal Bank for Development and Agricultural Credit (PBDAC) have been participating in Gam'iyas in Egypt.

ROSCAs are of two basic forms: those with rotating funds and those with non-rotating funds. According to Bouman (1995, p. 371), "the scope of the ROSCAs extends beyond the frontiers of the financial landscape, revealing the gradual changes taking place in the tribal and political arenas and in the economic, cultural and normative systems of society at large". In many places ROSCAs have spread in financial climates and cultural contexts where FFIs have floundered, due to the inability or unwillingness of creditors to meet their obligations (Ardener, 1995, p. 2). ROSCAs are sometimes also initiated in response to sudden needs of liquidity, to take advantage of unpredictable income flows or to acquire desired durables (Bortei-Doku and Aryeetey, 1995; Bouman, 1995). The discipline of regular contribution and payment in the ROSCAs is thought to have influenced new forms of financial arrangements. The *Chit*[44] funds in India are believed to have influenced the establishment of credit unions and the Grameen Bank in Bangladesh (Ardener, 1995, p. 3). In South Africa, FFIs have introduced new arrangements to attract ROSCA savings and have even used them to provide security and insurance for housing loans (Burman and Lembete, 1995). These developments suggest that the notion of FFIs and IFIs operating independently is no longer tenable.

Participants can belong to more than one ROSCA (Niger-Thomas, 1995; Bortei-Doku and Aryeetey, 1995; Bouman, 1995), paying into one fund while contributing to another fund, which can be called on in an emergency. As Ardener (1995, p. 3) notes, "the speed with which ROSCAs can usually react to their members' needs can rarely be matched by distant, impersonal, banking systems". Other uses of the ROSCAs which go beyond the group dynamics are also emerging. For example, family planning in Indonesia

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[44] See Radhakrishnan (1975) for more details.

directed at providing contraceptives for women has taken advantage of the discipline and moral imperatives of the ROSCA by setting up one to ensure that women present themselves regularly for treatment (Hospes, 1995). Members of a ROSCA can receive valuable services and economic information on a wide variety of topics. Nelson (1995) reports that a successful ROSCA organised by women beer-brewers in Kenya acquired the initial capital, organisational skills and confidence to deal with formal authorities and thereby acquire land, loans and ultimately substantial property assets. A similar success story is reported by Light and Deng (1995) about Korean clothing manufacturers in California having been aided by their use of ROSCA membership. Hospes (1995) also describes the accumulation of capital in Indonesian ROSCAs by all sections of the population - from police officers to traders to relatively impoverished housewives. Rowland (1995) reports on how the Bamileke businessmen in Cameroon establish networks of trust built up by membership of ROSCAs to share news and arrange business deals on a large scale. Almedon (1995) describes how Ethiopian women in war-torn Addis Ababa exchanged information at ROSCA meetings, while Burman and Lembete (1995) show how the rising middle-class women belonging to one ROSCA in Cape Town (South Africa) draw on each other's professional advice without financial payment. Ardener (1995, p. 8-9) notes that "in all these situations, friendship networks are a resource, because 'social collateral' is a prerequisite for social and economic survival". Financial and mutual aid ROSCAs are also reported to provide widespread, comprehensive welfare and insurance networks (Burman and Lembete, 1995). Their role is in guarding against expenses on illness and other forms of misfortunes. Such a vast array of services would definitely form a compelling motive for participation especially

among marginal populations (Bouman, 1995). Against such a background, it would not be wrong to suggest that evidence is strongly refuting claims that ROSCAs do not provide productive credit and that they are merely social gatherings rather than organisations performing indubitable economic functions.

Membership of ROSCAs can be single-sex or mixed. In countries such as Cameroon where Bamileke married couples tend to lead almost independent and parallel lives, membership tends to be single-sex (Ardener, 1995). Generally, however, ROSCAs

Table 5.1 **Sex Composition of Rotating Susu Clubs in Accra and Kadjebi District (Ghana), 1991**

Susu Club	Male	Female
Accra District (Public Departments.)		
1	44	1
2	7	3
3	3	7
4	24	1
Nungua Ladies' Club	0	35
Nungua Savings Club	15	15
Nungua Victory Bar Fan Club	10	70
Makola Market (Enam Obi so Na Ye Yie)	0	10
Kadjebi District		
(Dodo Amanfrom Market)		
- Vegetable Sellers' Club	0	10
- Kofinyor Club	0	10
- Fish Sellers' Club	4	16
- Agbesino's Club	0	16
- Aboboitor's Club	0	10
- Akpletor's Club	1	9
Kadjebi Market	1	21

Source:- Bortei-Doku and Aryeetey, (1995, p. 81).

membership takes into consideration similar circumstances such as the same neighbourhood, same workplace, occupation or profession, tribal affiliation etc. Eldijk (1992) however, argues that trading activities, in particular, stimulate the emergence of new savings and credit groups which allow multiple speculation, bulk purchases, price fixing, the allocation of buying and selling territories and exercising market power. No single individual acting alone can possibly exercise such influence in the market place.

Membership of ROSCAS varies considerably. In the Cameroon, for example, it is estimated that up to 80 per cent of the population and nearly all households (both men and women) participate in one form of ROSCA or another (Bouman, 1995). According to Bortei-Doku and Aryeetey (1995) membership of *susu* groups in Ghana is also high (about 73 per cent); but they note that these are predominantly women (market women). In offices, the composition tends to be predominantly men mainly because they are the majority office workers. But their research did not extend beyond the Accra and Kadjebi District and generalisations based on it cannot apply to the country as a whole. Table 5.1, however, support their statement that women predominate the *susu* groups in Accra (op. cit., p. 81).

Research findings in LICs by economists on resource mobilisation and allocation services performed by ROSCAs have generated interest and a tremendous amount of literature. It was reported that in several countries, amounts mobilised by informal financial sources including ROSCAs, have been as high as those mobilised by FFIs, especially banks (Callier, 1990). For example, Begashaw (1978, p. 249) reported that in Ethiopia, aggregate annual ROSCA savings were 8 - 10 per cent of GDP. Schreider and Cuevas (1992, p. 54), reported that on the basis of a mean of US$ 777 for respondents,

the total national savings handled by IFIs in Cameroon was US$ 1.9 billion, amounting to 54 per cent of total savings in the Cameroon in 1988. Another reason why economists have been interested in informal financial sources is the ability these informal sources have to solve problems that FFIs have either failed to handle properly or ignored (Adams, 1989).

ROSCAs have been analysed in terms of financial intermediation, where members who have received the *pot* are seen as borrowers who borrow sums equivalent to their future contributions. These contributions are in turn regarded as future debt service payments. Members who have not received the *pot* are regarded as net savers as opposed to its recipients who have been regarded as net borrowers. Except for the first and the last members to collect the *pot*, all members switch from net savers to net debtors at some point in the cycle. The first is a net borrower and the last is a net saver throughout the entire cycle (Miracle et. al. 1980, p. 709-710).

Besley et al. (1993, 1994) used a model to examine the operations of two types of ROSCAs (the rotating and the random types) and showed that they do not in general produce efficient resource allocation. While these findings may be valid, their model fails to take into consideration the effects ROSCAs have on poor people's lives in LICs and the range of services performed. The benefits of collective action cannot easily be quantified. For example, Callier (1990, p. 274), with the use of a simple formula[45] showed that by collective action the average waiting time that would be taken to accumulate savings for the purchase of a bulky item if a member were saving in solitary fashion, could almost be halved. For instance, if the length of the cycle is 10 months and

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[45] If the amount of the pot is equal to the planned expenditure, the average waiting time W (expressed as a fraction of the entire circle of the osusu) for each of the n members is: $W = [n + 1]/ 2n$.

the number of members is 10, the average waiting time, using Callier's formula could be a little over 5 months. The assumption is that the amount of the expenditure is equal to the total fund. The waiting time could be crucial for a poor farmer who does not have access to other forms of credit facilities. Bouman (1976), noted that the opportunity cost of time spent travelling to contract a loan from an FFI, the restrictions on deposits, rural residents' unfamiliarity with banking practices and the fear of rejection, contribute to making the ROSCA a favourable and easier option. The low transaction costs in saving and in contracting a loan are an added attraction of the ROSCA in LICs.

Ardener (1995) notes a fundamental issue raised by Chapman (1992) that analysing the ROSCA using economic, political, social, ethnic, religious or gender terms separately, tends to ignore the 'imagery of the system' and can lead to spurious conclusions. Ardener adds that:

> "the social and economic benefits commingle and are indissociable. The economic underpins the social, while simultaneously, the social supports the economic. The economic is the social and the social is the economic" (Arderner, 1995: pp. 17-18).

The discussion that follows, therefore, takes into consideration this fundamental issue in analysing the economic and social aspects of the *osusu* in Sierra Leone.

5.20. The *OSUSU* in Sierra Leone

The data and information in this section were obtained mainly from the three *osusu* organisers who fell within our sample of rural banks customers interviewed, from discussions with other respondents (non-customers) and commercial bank managers. While we note the limitations inherent in this we believe, however, that the information

on the *osusu* in Sierra Leone is fairly accurate and provides us with a basis for comparing with other financial intermediaries in the rural areas of Sierra Leone.

In Sierra Leone, the *osusu* is practised within every stratum of society, from the rural to the urban areas and from the farming to the civil service sectors. It is also found among employees of most FFIs, such as commercial banks, the development bank, the rural banks, the central bank and Government departments. Our survey did not focus on *osusu* groups per se, because of cost and time limitations; but we spoke to 5 *osusu* members who were also RB customers. Three of them were *osusu* organisers. The discussion that follows is, therefore, a mixture of what has already been found in other parts of the world and the information we obtained from the *osusu* members we interviewed. It should be noted that the only documented evidence of the *osusu* in Sierra Leone is from Banton (1957), who wrote about the practice during the 1950s among residents in Freetown, the capital of Sierra Leone. Very little has been documented on the *osusu* since then.

From descriptions of the operation of ROSCAs by different authors including Ardener (1964), Lewis (1976), Okorie and Miller (1976), Begashaw (1977), Bouman (1977), Delancy (1978), Miracle (1980), Bortei-Doku and Aryeetey (1995) to name but a few, ROSCAs, especially in Anglophone West Africa, are fairly uniform in their characteristics and in the ways in which they operate. In Sierra Leone, the basic form is still predominantly practised. It is, however, slowly evolving and developing in several different ways

5.21 Types of *Osusu* in Sierra Leone

There are two main types of *osusu* operating in Sierra Leone namely, the Fixed Fund (FF) *osusu* and the Rotating Fund (RF) *osusu*. The differences between these two are significant in both operational terms and in the services they offer their members. The FF type was the earlier version introduced by Nigerian traders. The date of its introduction in Sierra Leone is still doubtful and a matter for research (Banton, 1957). In the FF *osusu*, the number of members can range from five to hundreds, whereas in the RF, membership rarely exceeds fifteen. The FF type can run for several years but the RF *osusu* mostly operates on short-term basis and can disband after one cycle, although it can be reconstituted if the members so decide. Another difference is that, in the FF *osusu*, not all members know each other because of the wide membership and the area covered by the *Master osusu* (see below). In the RF type, members may be co-workers, or living in the same neighbourhood or in the same occupation or profession. In other words the membership of the RF type is relatively homogeneous. Because of this homogeneity and acquaintance, members seem to be familiar with each other's circumstances, background and integrity. In the RF type very little records are kept. The contributions are collected and handed over to the recipient whose turn it is in the cycle. In the FF type, however, each transaction is recorded in duplicate. In the FF type, an individual can become a member at any time even after the commencement of operation; but in the RF type individuals are rarely, if at all, admitted after it commences operation.

5.22. The Fixed Fund (FF) *Osusu*.

The FF *osusu* in Sierra Leone is mostly popular among traders, particularly women. No figures are available, but the heads of *osusu* groups we interviewed,

commonly referred to as *Master osusu* (usually pronounced as *Master susu*),[46] informed us that about three out of every five members of their FF *osusu* group are women. The *Master osusu* is more often than not a man of good standing in the society, though not necessarily the PC or Chiefdom councillor. When asked why not these local dignitaries, the reply was that, one would have no one to go to seek redress if your *Master osusu* were the PC. This underscores the issue of the lack of a strong legal code relating to these kinds of operations in the rural areas. The *osusu's* operation, like that of the moneylender's, is based mainly on trust and information about prospective members. The members trust not only each other, but the *Master osusu* as well. He is equally vetted along with other members. His background is usually researched by members even before the *osusu* commences. Similarly, before a new individual joins, his or her integrity has to be verified. The *Master osusu* should preferably be married. If neither the *Master osusu* nor his wife is indigenous to the community, members will rigorously investigate their family backgrounds and their past social and economic activities. This screening process reduces the risk of the *Master osusu* absconding or behaving inappropriately with members' funds. Often, the *Master osusu's* credibility is further enhanced if he is an active member of a secret society or a religious group. The screening process is, however, not foolproof. The risk is always there and members are aware of it. This is why the news of the *Master osusu's* failure to collect a member's contribution even for a single day, is quickly circulated amongst the members. Consequently, his home is visited to establish his whereabouts. Two of those we spoke to informed us of a case of one

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[46] In the literature they have been identified as ambulatory bankers (Okorie and Miller, 1976, Timberg 1984 , p 43) and 'private deposit collectors' (Seibel and Marx, 1987, p. 21)

Master osusu absconding and tremendous pressure having been put on his family. The usual practice is that his family is expected to shoulder the responsibility of such liability.

Basically, the FF requires each member to contribute an agreed sum of money either daily, weekly or monthly. The mode of contribution depends on the individual member's income flow. The *Master osusu* often travels to his members to collect contributions. Petty traders, especially market women, usually contribute on a daily basis because it offers them the opportunity to save the day's taking. Depositing the amount in an *osusu* prevents it from being utilised on less important matters. The transaction cost in saving funds this way, is low and close to zero compared to what it would have been if the individual had had to travel to a bank to save.

It is not uncommon for one individual to belong to more than one FF *osusu* with different *Master osusus.* A person can also make more than one contribution in the same FF *osusu* with the same *Master osusu*. A single contribution is referred to as *one hand* and a member can make several *hand* contributions within the same FF *osusu*, depending on his or her needs and income flow. Although there is no restriction on the number of *hand* contributions one individual can make in an *osusu*, concern will be expressed by the *Master osusu* through explaining the penalties if a member disrupts the contribution rhythm.

Contributions to the FF *osusu* vary from Le 20.00 per day to Le 2000.00 per month. An *osusu* member is issued with a membership card (passbook) on which his or her daily, weekly or monthly contributions are recorded, with the duplicate kept by the *Master osusu*. Transaction details are recorded on both cards in the presence of the member. A member may decide to contribute with the understanding of collecting

monthly, quarterly or yearly. Most market women collect on monthly basis. At the end of the period, i.e. on the day payment of the bulk sum is made to an individual member, the *Master osusu* deducts *one hand* (i.e. the amount that is equivalent to a member's single daily, weekly or monthly contribution). The rest of the money that is paid to the member is called the *pot*. The deducted sum is called the *bode*. The member is then free to continue or discontinue his or her membership. The *bode* from every individual member is the total income of the *Master osusu*. Thus his income depends on the number of members he has on his *osusu* list and the magnitude of the periodic contributions members make. There is, therefore, some competition among *Master osusus* to attract members. But the terms of payment to the head of a ROSCA in other countries varies considerably. In the Cameroon, according to Bouman and Harteveld (1976), the head of the *djanggi,* who is called the president, is not paid. But the secretary and the treasurer both receive a total of 5 per cent of the fund. Delancy (1978) found in one of the associations he studied in Western Cameroon in 1960 that officers were paid 2.2 per cent of the fund. In parts of Eastern Nigeria, Okorie and Miller (1976) observed that 64 per cent of associations they studied did not pay officers, and for those which did, the rate was below 1 per cent of the total fund. Adeyemo and Osuntogun (1981, p. 248), found that officers of ROSCAs in Liberia are typically paid 1-2 per cent of the fund.

There are rules governing the FF *osusu* in Sierra Leone. For example, if a member decides to withdraw before the end of the period of contribution, two *hand* contributions are deducted by the *Master osusu*. Where only one *hand* contribution has been made, the member forfeits that *hand* contribution. This is to ensure that members abide by the rules governing the *osusu*. If a member needs funds urgently, he or she is

allowed to ask for a loan, which is to be repaid with interest. The *Master osusus* we interviewed informed us that the interest rate charged for loans depends on three main factors namely, the amount of the loan, its duration and the length of time the borrower has been with the *osusu*. The interest rate varies from 10 to 25 per cent. They also informed us that it is illegal for the *Master osusu* to lend to an individual who does not belong to his *osusu* group. If he did, it could cost him members, confidence in him could wane and it might eventually drive him out of the business altogether, because he would be regarded as dishonest and word about this could spread quickly, and as far as possible. This tends to confirms the seriousness with which *osusu* membership is regarded and it also underscores the point that the *Master osusu* and even ordinary members need to have a clean slate of honesty and reliability.

The FF *osusu* members meet, if the need arises, to discuss social, cultural or even economic issues affecting the group. Although these meetings are usually brief and informal, market intelligence (supply and demand situations) are often exchanged, and old members are able to meet new ones and make friends. The possibility of meeting and exchanging economic information is a benefit to members. Such information is unlikely to be available from rural bankers who may be unfamiliar with the problems and constraints facing people operating in the informal market. Ottenberg (1968), Delancy (1978) and Miracle et. al. (1980) added that such information is usually not available from radio, newspaper or television sources in LICs. Miracle (op. cit.) also observed that the FF *osusu* serves as a social club. Members often make financial and moral contributions towards helping a fellow member who, for example, has been bereaved or has experienced some kind of misfortune or who is celebrating a rite of passage.

Participants in this informal banking arrangement seem to believe that they save more than they would, if they saved in solitary fashion. The sense of discipline arising from regularly meeting their 'banker' or the rest of the group helps the members to keep up with the act of saving (Okorie and Miller, 1976, p. 27; Bouman, 1977, p. 3 and 5; Delancy, 1978, p. 222).

It should be noted that the loans are usually small and short-term - seldom above six months. Against this background, the interest rate could be doubled or trebled depending on the number of times a member borrows from the fund in a year. According to our respondents, the interest rate is not the issue; the crucial factors are accessibility and dependability. The conditions governing the *osusu* ensure that members can get a loan as and when the need arises. An experienced *Master osusu* always keeps adequate funds at home to meet unexpected demands for withdrawals and loans. Such demands can be made anytime during the day or night. Depending on the amount in the *osusu* fund, *Master osusus* are known to have fostered links with banks. Those we interviewed declined to tell us the quantum of funds they managed and have with banks; but a rough estimate based on the number of members and the individual contributions in a particular *osusu,* suggests that the *Master osusu* could be managing funds ranging from Le 50,000 - Le 500,000 (i.e. US$ 86 - US$ 862 at 1993 prices). The interest that accrues to funds which have been deposited in a bank, goes to the *Master osusu*.

5.23. The Rotating Fund *Osusu*

The Rotating Fund (RF) *osusu* is basically a cycle. The members numbering between three and ten, on average, contribute a fixed sum on a weekly or monthly basis. The amount contributed by a member varies from Le 50 per day - Le 2,000 per month or

more. ROSCAs which require as low as a penny per day and as much as US$1,600 per month have been reported in other parts of Africa (Haggblade, 1978, p. 49). At the end of the period, the *pot* (total fund) is allocated to one member whose turn it is to receive payment. This procedure is repeated until every member has had his or her turn. When the cycle is completed, members may decide to disband the *osusu* or reconstitute a new cycle.

The RF type can be subdivided into two versions - the Bidding and the Random versions (Besley et. al., 1994). In the bidding version, members are allocated the *pot* by a bidding procedure as in the *chit* fund in India (Radhakrishnan, 1975). The member who receives the first *pot* in the present period does so by bidding the most in the form of a higher contribution in future cycles. Individuals still receive the *pot* once in the cycle. Thus the bidding merely establishes priority (Besley et. al. 1994). In another variant of the bidding version, the individual who bids to forego the highest sum from the *pot* wins the bid. In the random version, as the name implies, members are randomly allocated the *pot*. For each period, lots are drawn and the *pot* is allocated to one member. The process is repeated but with the previous winner(s) excluded from the draw. These variants are not yet practised in Sierra Leone as far as is known.

5.24. The Fixed Rotating Circle (FRC) *Osusu*

In Sierra Leone the RF type that is most common is the Fixed Rotating Circle (FRC) *osusu*. The order of rotation, the duration, the number and calibre of members are all agreed upon before the *osusu* commences. These are financial decisions that require information about the character, motives, financial probity and leadership skills of the *Master osusu* as well as prospective members. After it commences operations, new

member(s) are rarely admitted, hence the idea of fixity and the circle as opposed to the cycle. However, members can swap turns with each other and with the knowledge and approval of the *Master osusu*. Membership is usually mixed with women usually in the majority. The screening of potential participants helps in minimising adverse selection of risk since uncreditworthy and dishonest applicants are prevented from becoming members. The screening process is still not perfect. The risk of default is still there. Apart from the last person in the circle, any of the other members could disrupt its smooth operation by absconding after receiving the *pot*. To minimise such a risk, several measures are usually taken. First, participants in FRC *osusu* usually have intimate knowledge of each other either as co-workers, members of the same religious group, neighbourhood, secret society, occupation, tribe or village. Participants recognise that such cordial and friendly relationships with each other are the basis for successful transactions and that a person's worth in the eyes of others depends significantly upon his or her performance under their shared ties ('social collateral'). This promise and knowledge enable members to deselect potential defaulters. Second, in some white-collar job situations, the personnel department is usually informed about the *osusu's* existence. Rules governing the group's conduct are usually printed and circulated to members. Third, in the event of a default, a member loses the equivalent of a *hand* contribution, usually deducted from his/her salary and handed to the *Master osusu*. This should not be interpreted as an official recognition of the practice by employers. But because of the widespread nature of *osusus*, it is tacitly condoned.

Ardener (1964, p. 220), argued that members are unlikely to default because they find it easier to offset a debt gradually, by paying in instalments, rather than a lump sum.

She did not, however, provide any data to support this hypothesis. Illy (1973, p. 305) and Bouman and Harteveld (1976, p. 112) have noted that there is very little defaulting in some areas because the defaulter runs the risk of never being accepted in another ROSCA. Okorie and Miller (1974) provided some evidence to support this hypothesis. They found that the default rate is less than 1 per cent (0.64 per cent) in the 18 *esusu* clubs they studied, although they did not make any distinction between the FF and the RF types. Our discussion with *osusu* members revealed that in Sierra Leone, default in the *osusu* is low and rare because of the need to establish credibility in the community and the prospects of becoming a member in another *osusu* in the future.

The duration of the FRC *osusu* depends on the number of members and the period between contributions (i.e. weekly or monthly). The order of rotation, as already pointed out, is determined by negotiation among members. Many researchers have reported that it is not uncommon for the *Master osusu* to be allocated the first *pot* (Ardener, 1964; Haggblade, 1978; Bortei-Doku and Aryeetey, 1995; Bouman, 1995).

5.30. Rationale for *Osusu* membership

The *osusu* members we interviewed informed us that the reasons why people join an *osusu* are many. Individuals often come together to form an *osusu* in order to raise money individually, to purchase bulky and expensive household items such as furniture, planting materials, fertiliser, and sometimes to pay fees and to meet other school expenditure. Most often *osusu* funds are used for procurement of food and other consumption items. In a situation where incomes are inadequate to meet basic needs, and credit facilities from the banking system are not easily accessible, the funds from *osusu* clubs serve as 'supplementary' income. In the rural areas *osusu* groups have helped

members who suffer misfortune such as bereavement, accidents and illness by quickly switching turns in the circle or by contributing a purse which is given to the member. It should be noted that because of the closeness of the rural society and members acquaintance with each other's circumstances, it is difficult for an individual to fake a misfortune or engage in rent seeking behaviour.

The *Osusu*, in general, is highly dependable. Although risk of default is always present, it has typically been found to be low. But even in FFIs in developed countries, the risk of default is also always present. In the ROSCAs, those who default run the risk of being excluded from future participation and of being discredited for a long time. In a situation where alternatives for saving and access to credit are few and far between, the ROSCA often represent the best option.

Geertz (1962, pp. 260-261) noted that ROSCAs help communities to adapt to economic modernisation while maintaining ties of reciprocity and solidarity. Bonnet (1981) pointed out that the ROSCAs have helped to cushion people from severe socio-economic shocks resulting from their movement from rural to urban locations. For example, immigrant groups in the USA have used the ROSCA mechanism to overcome these kinds of shock (Light, 1972, Bonnet, op. cit.). Banton (1957), also made a similar observation about rural migrants in Freetown, Sierra Leone.

Von Pischke (1991), observed that ROSCAs have six major characteristics that recommend them. First, they are known across different localities, a feature which suggests adaptability and applicability. Second, they intermediate between savers and borrowers without any bias. Third, they signify collective action suggesting acceptability and congruity with the norms of the diverse cultures in which they have been identified.

It is hard to attribute such features to any FFI anywhere in the world. Fourth, ROSCAs are private and voluntary, enjoying high levels of immunity from rent-seeking behaviour by their members. Fifth, they manage risk effectively and sixth, they create incentives for responsible behaviour and performance which accounts for their continued popularity in many places around the globe.

5.31. Uses of *osusu* funds

Funds acquired from the *osusu* are put into various uses, some of which have been listed by Miracle et. al. (1980, p. 715). Table 5.2 from Okorie and Miller (1976, p. 22), gives the uses to which ROSCA funds have been put in two West African countries - Nigeria and Cameroon - where they have been studied in detail. The uses range from production to consumption, financing trading activities, buying planting material (seeds etc.) and financing rites of passage. Fragmentary evidence from other countries tends to support the hypothesis in this table. In Ghana, for example, a ROSCA of high school teachers was reported to have bought refrigerators for its members (Massing and Seibel, 1974, p. 64). These same authors also reported that a Fixed Fund ROSCA among the Mano and Loma tribes of Liberia loaned US$ 1,000 to each of its members in order to purchase a taxi in 1967. This same ROSCA paid US$ 700 the year before to a German construction company to build an access road to their village. The purchase of production items such as seeds for planting has also been reported in Ethiopia (Hamer, 1970, p. 295). Cameroonian women are also reported to have pooled their savings to purchase a grain mill (Bouman, 1977, p. 11). The above evidence suggests that ROSCA funds have been utilised for both consumption and production needs is some African countries. Although our *osusu* interviewees confirmed uses of funds for purposes similar

Table 5.2 **Uses of ROSCA Funds - Quantitative Data (%)**

Use	Nigeria[1] 1976	Cameroon[2]	Cameroon[3]
Buy land	1.9	...	...
Buy livestock	.1	...	...
"Trade expansion"	9.3	...	...
"Trade investment	...	7.0	...
"To open business"	...	...	3.6
Payment of taxes	3.2	14.0	...
Hiring labour	16.2	...	...
House construction	12.7	...	10.9
"Housing improvement"	...	4.0	...
Financing education	13.4	17.0	18.2
As funds for loans	.4	...	...
As funds deposited in banks	6.0	...	...
As saving for participating in rotating funds	...	7.0	...
As funds given to relatives to invest	2.8	...	...
As savings	...	...	12.7
Purchase of durable goods	8.4	...	...
Payment of debt	...	6.0	...
Purchase of clothing	7.4	...	...
"To buy things"	...	...	23.6
"To meet normal expenses"	...	...	14.5
Christmas expenses	...	...	12.7
"Medical care"	...	8.0	...
"Dowries, obligations to in-laws"	...	8.0	...
"To marry"	...	...	3.6
"As pocket money"	.2	...	...
Purchase of food	10.8	...	...
Total	**100**	**100**	**99.8**

Sources:- Okorie and Miller (1976, p. 22); Harteveld cited in Bouman (1977, p.17); Delancy, (1977).

Notes:-

[1] From 100 members of savings and loan associations interviewed on Ohaozara subdivision in East Central State, December, 1974.

[2] From 69 members surveyed in Cameroon. Information is not available on where survey was done but none of these uses is more than 3 percentage points different from those reported by Harteveld for 54 members he interviewed in Babanki, West Cameroon in 1971 (see Bouman and Harteveld, 1976, p. 113)

[3] From 56 members of three fixed-fund associations, West Cameroon, 1968.

to those listed in the Table 5.2, they informed us that consumption is the major use of *osusu* funds in Sierra Leone. Further research is, however, required to provide quantitative data on membership, operations and quantum of savings, uses of funds, credit extended and services provided by this financial self-help organisation in Sierra Leone.

5.40 Linking the Formal and Informal Financial Markets in LICs

The link between the IFMs and the FFMs in LICs has recently caught the attention of researchers. Linkages have been observed in several countries including Cameroon, Togo, Nigeria, Ghana, Bolivia, Indonesia (Seibel and Marx, 1987).

Three general strategies have been used to link IFMs and FFMs. One of them is the 'upgrading' or the 'bottom-up' approach involving the evolution of an informal financial institution into a formal one. This has occurred in the Cameroon and has culminated in the establishment of an FFI (a bank) by a group of ROSCAs. In another example, the *Kou* (a ROSCA in Japan), described as a precursor of modern finance, has evolved into co-operatives in the rural areas and into Mujin-companies in the urban areas. The Mujin-companies have further evolved into modern financial institutions (Izumida, 1992, p. 175).

The second strategy is the 'down-grading' or 'top-bottom' approach. The main objective of this approach is to create an environment for an FFI to reach out and develop financial arrangements with self-help groups and individuals. Several countries have used this strategy. In Indonesia, several small banks have been engaged in domestic resource mobilisation at the doorsteps of rural and low income people (Seibel and Paruhsip, 1992, p. 240). A 'pigmy deposit' scheme is operated by the Bank of India, in

which outsiders i.e. non-employees of the Bank of India are hired as agents to collect deposits at the homes of small savers on a regular periodic basis. Access to credit is used as a reward for the maintenance of scheduled deposits over a period of time. It has been reported that unit cost of 'pigmy deposits' varied between 3 and 5 per cent per annum. This is significantly lower than the cost of a three to five year fixed deposits (Bhatt, 1988, p. 289; Vogel and Burkett, 1986). Significant linkage between ROSCAs and FFIs has also occurred in South Africa (Burman and Lembete, 1995).

The third approach used is the direct linking of IFMs to FFMs. For example, in Ghana the *anago* (ambulatory bankers) are registered as tax-paying enterprises. Three hundred of these deposit collectors have formed The Greater Accra *Susu* Collectors Association (GASCA) which in turn is registered. They have their accounts with the National Savings and Credit Bank of Ghana. Other banks in Ghana are tentatively attempting direct involvement in this field (Seibel and Marx, 1987; Bortei-Doku and Aryeetey, 1995). In Sierra Leone, *osusu* funds are sometimes deposited into banks by *Master osusus*. But the *osusu* members are yet to benefit from the interest accruing to these funds. The evolution of the *osusu* in Sierra Leone has not yet reached the level of similar ROSCAs in the Cameroon, Ghana, Nigeria or Indonesia. However, some of the *osusu* members we interviewed have begun to think of some form of sharing of the interest accruing to the *Master osusu* from funds deposited in the bank. They expressed the feeling that the *Master osusu* is already getting enough compensation for his services with the *hand* deductions (the *bode*) that he makes from the *pot*. When asked why they want to change this arrangement, they replied that from news of what is happening in other countries such as Ghana and the Cameroon, they think that the *osusu* arrangements

should be re-examined to create a basis for deployment of funds in the community and for equitable distribution of benefits.

As stated by Seibel and Marx (1987, p. 91), linking IFIs and FFs in LICs can be a complex affair. A change or modification to the existing mode of operations of both the IFM and the FFM are required if success is to be achieved. For IFMs, a high level of organisation will be required, which will entail introduction of paperwork, coding, and other administrative techniques characteristic of FFMs. These kinds of changes require some research to establish the *modus operandi* that will suit the socio-cultural context within which the new institution will operate. This would in turn determine the appropriate linkage to be adopted. For example, within a ROSCA, considerable amount of trust is exercised. Members carefully choose each other and the success or failure of the association depends on a variety of rules, regulations and the conduct of members secured by sanctions and reciprocity. Social control also depends on numerous social relationships which hold members together. Seibel and Marx (1987), however, warn that these ROSCAs are one hundred per cent self-help ventures. When this aspect is disturbed by their internal affairs being determined from outside or where participants are not allowed to benefit from their own effort, the self-help spirit may be destroyed. One major ingredient of change, however, might be to allow participants to decide on the utilisation of resources.

One other issue that needs to be taken into account in interlinking IFIs and FFIs is secrecy. Niger-Thomas (1995) notes that ROSCA savings may be preserved by elaborate ruses that prevent a husband, for example, from knowing when his wife receives money, lest she be subjected to unwelcome persuasion or pressure to meet his

needs. A ROSCA may be operating in a situation where such a group is considered illegal, or charging interest rates considered too high and therefore illegal or where registration of such an activity is required for tax purposes etc.. In such circumstances, secrecy would be a paramount concern of members and any attempt to link it with an FFI may drive it underground or may destroy it altogether. But such antagonism to these financial self-help groups is now fading away. The debate on the operations and the impact these organisations have in rural communities or even urban settings, has created informed opinion about them. The evidence of the economic and socio-cultural functions they provide has captured the imagination of academics and politicians alike. Non-Governmental Organisations (NGOs) and International Donor Agencies (IDAs) have also been captivated by the array of support these self-help groups provide for their members; thus funding and assistance is now being directed at them.

5.50. The Non-Governmental Organisations - A new perspective for financing the Informal Sector in LICs

A significant proportion of the economic activity in LICs is conducted by self-employed persons, in small economic units or micro-enterprises using funds mostly derived from the informal sector (Mosley, 1993). For increasing numbers of poor people, including farmers in LICs, there are very few alternative sources of credit, income and employment opportunities. In order for business to prosper, micro-enterprises must have sufficient supply of working capital to purchase inputs. Lacking access to formal credit, they must find ways of providing this finance themselves either from their profits (which are usually very low) or they must turn to moneylenders, pawnbrokers, money collectors or ROSCAs. Most traditional self-help groups such as ROSCAs tend to have restricted capital in accordance with the resources of its members. In consequence, micro-

enterprises have often failed to secure the capital they need and have missed the opportunity for increased growth in both their business and incomes (Mosley, 1993, p. 1).

To attempt to solve this problem, foreign donors (both government and non-governmental) have tried to reach this substantial market; although their success has been limited in the past. In the 1970s and 1980s, a number of financial institutions began experimenting with new ways of providing formal credit, with interest rates that are close to market rates to these groups. Some of them have reached more people than previous credit programmes. Repayment rates have been very high and they are approaching financial self-sufficiency (Mosley, 1993; Campero, 1995).

This new dimension has involved the evolution of self-help groups (ROSCAs included) and non-governmental organisations (NGOs) into full-fledged FFIs, mainly banks. The major objective of these new institutions is to provide support, mainly credit, training and technical assistance to individuals and groups to establish and or expand small enterprises in the informal sector (Mutua, 1995, p.1). Such ventures are supported by funds from USAID and the World Bank (Bosley, 1994). In a conference on *'Finance Against Poverty'*, held at Reading University in March, 1995, it was revealed that some of these programmes have produced encouraging results (Mosley, 1993).

The first fully private bank in the world specifically devoted to micro-enterprise financing in Bolivia, is *Banco Solidario S. A.* (BancoSol), which is an outgrowth of the *Fundacion para la Promocion y Desarrollo de la Micro Empresa* (PRODEM), a successful NGO providing credit and training to micro-entrepreneurs in Bolivia[47]

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[47] For a full discussion of the evolution of PRODEM into BancoSol, see (Mosley, 1993).

PRODEM has been funded since 1985 by USAID through an American NGO, ACCION International[48]. Using conventional financial indicators, BancoSol has performed impressively. Repayment rates for the first six years have been 99 per cent, although there was a slight decline in 1992. Loan impact on beneficiaries has been significant; and some 27 per cent of sampled households were able to move above the poverty line in 1992. It should be noted that the loans are made at the market rate of interest, of 60 per cent. BancoSol's case has helped to refute the traditional view that the poor cannot save and afford market rates of interest. A total of about US$ 3.05 million savings have been mobilised. In terms of outreach, BancoSol has granted loans worth US$ 27 million to 61,255 borrowers as at end 1992 (Mosley, 1993).

Another success story in micro-enterprise lending is the Kenya Rural Enterprise Programme (K-REP), established in 1984 as an USAID funded project and incorporated as a Kenyan NGO in 1987. There were initial problems. The strategy adopted involved the development of micro-enterprises through promotion of Kenyan NGOs credit programmes with the objective of building institutional capability in as many Kenyan NGOs as possible. It became apparent that the integrated method of developing micro-enterprises, largely through grants and subsidised loans, had limited impact on beneficiaries (i.e. the local NGOs). It was costly and could only be sustained or expanded through grant funding. A new strategy was therefore adopted in 1989. Four of the most promising NGOs were selected and the focus of lending and method of credit delivery was changed from the integrated approach to the 'minimalist' approach, adopting the Grameen Bank system (Mutua, 1995). The financial assistance to K-REP-assisted NGOs

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[48] See Campero (1995) and Mosley (1993) for more details.

which took the form of 100 per cent grants and no loans was changed to a ratio of 70 per cent loans and 30 per cent grants.

The K-REP programme was broadened to include direct lending to rural residents (farmer, blacksmiths, tailors, etc.). Over a period of three years, performance under the new strategy has been described as encouraging (Mutua, 1995). Five K-REP assisted NGOs made over 9,000 loans amounting to 70 million Kenyan Shillings at market rates of interest of 14 per cent. The cost per shilling lent declined from 96 cents to 25 cents. Repayment rates improved from 78 per cent to 98 per cent. Deposit mobilisation is over 12 million Kenyan Shillings. All programmes are servicing their loans from K-REP with 100 per cent repayment.

The cases discussed above have used the 'financial intermediation' or 'financial systems' approach to micro-enterprise development which emphasises institutional sustainability as a crucial element in providing credit services. There are, however, some questions to be resolved in relation to the use of NGOs as agents of change. Can existing welfare programmes (granting food, seeds etc.) run by some NGOs, such as the Catholic Assistance and Relief Everywhere (CARE) implement effective credit programmes? Who should benefit from NGO credit programmes? Should NGOs pursue financial self-sufficiency goals?. The answers to these questions are legion. Some objectives and activities of welfare programmes conflict with the principles of good credit management. This is evident in cases where both welfare and credit services are provided in the same community by the same organisation. The CARE services in Sierra Leone are a case in point. In other cases, credit policies are based more on humanitarian grounds than workable financial models. For example, some NGOs argue for below-market rates of

interest using the traditional assumption of the poor being unable to afford market rates. Others consider expelling defaulters from schemes as being too harsh and incompatible with their humanitarian mission.

Credit for micro-enterprise development is becoming a very specialised operation as demonstrated by the two success stories cited above, and relies on sound credit management principles. If these principles are compromised, efficiency could be sacrificed to the disadvantage of the beneficiaries. In our view NGOs and IDAs in whatever country or locality they concentrate their support, should study the socio-cultural and economic environment before deploying funds. We will argue in chapter seven that the role of the NGOs and IDAs should be limited to institution building and creating a conducive environment for indigenous institutions to develop expand and become self-sustainable. Wholesale adoption of models that have been successful in one particular environment could be counterproductive if deployed in another setting without prior research and testing (Bouman, 1995). This new dimension should, therefore, be carefully and thoroughly tested before it is replicated on a large scale throughout the world. Africa is replete with examples of credit programmes that have been implemented using traditional assumptions and which have failed. Thus the above caution should be seriously considered to avoid what we are attempted to label 'financial joy-riding'[49] on the issue of credit supply in LICs.

5.51. **Conclusion**

The discussion on the ROSCAs' mode of operation shows that these self-help financial organisations are indigenous, one hundred percent self-help. They have

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[49] Financial joy-riding is defined here to mean the use of a credit supply model without testing its efficacy and fails leaving the target population worse-off than before the credit programme.

provided services which are appreciated by their members and they have proved to be adaptable and acceptable in whatever setting they operate. They are providing social security to marginalised populations in a variety of places all over the world (Bouman, 1995). This record of adaptation tends to be superior to that of FFIs because of their lack of bureaucratic red-tape and less cumbersome procedures. The linkage between them and FFIs in many countries shows that their mode of operation are flexible and can be linked successfully if the mode of linkage is carefully researched and judiciously executed. In the Sierra Leone context, therefore, we will argue in chapter seven that their positive effects could be used by RBs to improve credit supply and financial intermediation for the benefit of not only the target population but the rural banking scheme as well.

The major limitation of the ROSCAs, in a majority of cases, is the limited resources it mobilises and may be inadequate to satisfy the varying demands of farmers who have specific seasonal requirements for capital.

Chapter VI Analysis of the Performance of Rural Banks in Sierra Leone

6.10 Introduction

The purpose of this chapter is to analyse the operations of rural banks (RBs) in Sierra Leone. The focus will be on the four RBs surveyed (see Chapter One), Yoni Rural Bank (YRB), Marampa/Masimera Rural Bank (MMRB), Kunike Rural Bank (KRB) and Mattru Rural Bank (MRB). They have all been in operation for over six years (Table 6.1) and have generated enough data to allow some meaningful analysis. Of the remaining four (i.e. DRB, MOARB, SRB, and BRB), two (DRB and MOARB), ceased operations in 1991 due to the 'rebel war' while the other two only commenced operations in the second half of 1992. The analysis will, however, include DRB, MOARB, SRB and BRB where data are available.

The chapter is divided into four sections. The first provides a theoretical perspective on finance and development and describes the organisation and structure of RBs in Sierra Leone. The second section analyses the operations of the four RBs surveyed using Outreach Analysis. Section three analyses the lending operations, and cost of administration and gives the reasons for existing levels of default. The fourth section carries out viability analysis using the Subsidy Dependence Index and, the fifth interprets the results.

There is no universal or widespread methodology for analysing the performance of rural financial institutions (RFI) (Yaron, 1992a). Conceptually, however, several performance indicators have been used to determine the level of achievement. This study uses two performance criteria namely, Outreach and the Subsidy Dependence Index

(SDI)[50] because of their robustness and their ability to allow for some international comparison. This type of analysis has been used in assessing RFIs in countries including the Philippines, India and Bangladesh, as well as some countries in sub-Saharan Africa such as Togo, Cameroon and Rwanda. This study is the first to use this type of analysis on RBs in Sierra Leone and is the first critical analysis of their performance.

The data used in this chapter comes from the survey, the audited statements of accounts, financial statements and other returns sent by RBs to BSL. There are some limitations in these data, especially the financial statements and audited statements of accounts. The conventional accounting practice followed measures cost of funds priced at their actual cost. The opportunity costs of borrowed funds, that is the price the RB would have paid for its funds if access to concessional funds were eliminated, is ignored partly as a way of concealing operating costs. Therefore profits in the profit and loss accounts do not convey the true picture. In addition, subsidies are not disaggregated in the accounts. Data from these sources have, therefore, been computed using the SDI model (Section 6.40) developed by Yaron (1992a) of the World Bank, which takes these shortcomings into account and produces an index that can be used for international comparison with institutions providing similar services in other LICs. The above notwithstanding, results should be interpreted with caution for two main reasons. Firstly, the SDI is a lower bound measure of the level of subsidy dependence; but even so, generates valuable information on the subsidy dependence of the RBs. Secondly, the calculation of loan default/repayment rates varies from one institution to another even within the same country. Thus making comparison difficult.

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[50] The SDI was developed by the World Bank, in particular Jacob Yaron (1992b)

6.10 Theoretical Perspective on Finance and Development

There is a subtle debate between development experts and experts in development aid about whether finance is important for development and whether it has been given recognition in development aid. On one side of the debate, traditionalists claim that because of the long tradition of providing financial assistance to developing countries sufficient evidence exists that due regard has been given to finance. The other side argues that finance has only been recognised in the past few years as exemplified by the World Bank Development Report (1989). The difference between the two camps is due mainly to the different meanings attached to finance. The term is ambiguous and has two visible aspects. The first is the provision of investible funds, in accord with which finance is seen as capital provided for development. The other involves the means of providing the funds i.e. the financial system or the institutions involved in the process. It therefore appears that the issue of whether due recognition is given to finance may refer to the aspect of capital or to the financial system or to both or their relative weights. In this debate, four views emerge on finance for development, which are distinguished mainly by the importance each gives to capital and the financial system providing it.

After the second World War, development was largely seen as equivalent to macro-economic growth. Consequently, development theory was treated as an applied growth theory (Lewis, 1954 and 1955), according to which growth in real output and income were regarded as consequences of growth in factor inputs. With a simple macro-economic production function, assuming that aggregate supply of labour is exogenous, the growth in input factor i.e. capital, is regarded as the most important determinant of output and income growth. Growth of capital is the result of savings (foregoing

consumption out of current income). Marginal productivity of capital measured in terms of output is treated as a technological issue (Khranen and Schmidt, 1995). In this view the viscious circle of poverty (low income ⇒ low savings ⇒ low investment ⇒ low productivity ⇒ low income) underlies underdevelopment. It presupposes that for development, savings should be present either internally or supplied from external sources.

The main criticism of this view is that growth as the accumulation of capital is too narrow an understanding because development is a multi-dimensional process. Another criticism is that the distributional aspect is ignored. The traditional view emphasised finance in the sense of capital and ignored finance in the sense of the financial system by implicitly assuming that some invisible hand or mechanism would transform savings into investment. The transformation was also assumed to be perfect i.e. it was held that the marginal productivity of capital was not influenced by any working mechanism which mobilised and allocated these savings. This implicit assumption led to development aid policy which emphasised that if capital leads to growth and if local incomes are low and cannot lead to local savings, foreign savings (aid) are required to close the savings gap (Lewis, 1955). But aid is a flow of real resources and has been used to pay for the foreign exchange component of development projects. Projects were believed to have positive linkage effects such as increased employment and equitable distribution of wealth. It was convenient to believe that 'trickle-down' process would save developed countries from incurring extra costs in monitoring projects (Lewis, 1955). But institutions that were most suited to distribute the foreign funds were absent or if present were not well equipped to do the job. Consequently, Development Finance

Corporations (DFCs) were established to fill this gap. But these institutions were not banks. They were merely administrative entities. They did not take deposits, nor provide liquidity nor transform terms to maturity or take risks. A further criticism of the traditional view is that it is not clearly supported by empirical facts. The relationship between capital input, as measured by savings and or real investment and economic growth remains unclear (World Bank, 1989). According to the World Bank, there are many low growth countries with high savings or investment rates as well as countries with moderate savings/investment which grow at very high rates. Thus, there was still something missing in explaining the development process.

The missing link in explaining growth was provided by the second view which was put forward in the 1970s (Penny, 1968 and Adams, 1971). This view maintained that the infusion of foreign capital into development projects in LICs did not contribute significantly to Gross National Product (GNP). According to Penny (1968) and Adams (1971), it led rather to a deterioration in the economic and social situation in most LICs. Instead of the trickle-down or linkage effects that had been expected, the policy was counterproductive. Dualism was induced, poverty was reinforced, unemployment increased and migration became a problem. The reaction to this critique was to regard development aid policy as a world-wide social policy, focusing on income generation, poverty alleviation, employment creation (Levitsky, 1986). The poorer strata comprising farmers, small businesses and small entrepreneurs were regarded as target groups. However, the basic understanding of finance remained the same as under the traditional view and credit was still identified as an important bottleneck. Development experts did not care to find out whether demand for credit existed on the part of the intended

recipients. Instead they used the "supply-leading" approach (Patrick, 1966) as the guiding philosophy and emphasised need. Credit was said to be needed because it was assumed to have a positive development impact.

Thus the provision of credit (capital) to specific target groups became a public policy issue (Farbman, 1981; Ashe, 1985). It was felt that farmers and business people should be induced to use capital and other inputs in order to produce employment, income, and increased food supply. How was credit to be channelled to this target groups? Existing banks were unwilling and unsuited to act as purveyors of these funds mainly because of the high costs of administering numerous small loans to a widely dispersed clientele and the lack of skilled personnel to appraise and monitor such projects. Since banks were in business for profit, this was not surprising. The solution was the establishment of specialised development banks for agriculture, industry and housing. The expectation was that they might be effective in reaching the target population and creating the desired impact. Since the target groups were deemed to be poor, they had to be lured into taking out loans by charging them highly subsidised interest rates (Adams, 1971). Thus the development banks needed huge funds for on-lending as well as subsidies and technical assistance to maintain themselves.

The failure of this model is well documented (Von Pischke, 1983 and Adams, 1984). The reaction that followed blamed partner institutions for behaving too much like banks and governments for interfering in the operations of these development institutions. Non-bank and non-governmental organisations were drafted into the picture to reach the target population. But these channels had their own drawbacks. Their operations were still costly, unstable and unprofitable. They were unable to have a long

lasting impact (Krahnen and Schmidt, 1995) because of the huge number of farmers and businesses they had to reach. It could be argued that from the perspective of this second view and from that of donors the understanding of finance and the notion of a financial system have been broadened and received the recognition they deserve. But funnelling funds in order to provide credit (capital) as an input for production in order to fill a gap did not provide the answer to the development problem (Levitsky, 1986 and 1989). The next move was to look at why the focus shifted to the financial system, which was ignored in the second view.

The financial systems of most developing countries have been operating under financial repression regimes (World Bank, 1989). Thus, the third view entailed an attack on the policy of financial repression[51]. It argued that the financial system had been used as an instrument and thereby had been misused and misunderstood (Von Pischke, 1983). The policy implications of the third view encompasses both macro-economic (liberalisation) and micro-economic (institution-building) aspects. The macro-economic aspect is associated with Shaw (1973) and the micro-economic with the Adams (1984) of the Ohio State University. Their common argument is that a financial system unconstrained by unnecessary regulations will be able to mobilise a large volume of savings, transform them with respect to terms, size and risks and allocate these funds to socially valuable investment projects. This view, therefore emphasises financial intermediation as the essence of the financial system. It has three main propositions, (a) that the quality and quantity of financial intermediation available to a given society is an

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[51] Econometric models (Shaw and McKinnon, 1973), have shown that financial depth measured as broad money (M_2 over GNP) is important for growth as savings for investment. In countries where financial systems are more developed and less restricted i.e. deeper, a given savings rate is usually associated with higher growth compared to those with the savings rate but repressed financial systems.

important determinant of development, (b) that the quality and quantity of financial intermediation is determined by the type of policy pursued by the respective government and (c) that the best policy is a drastic deregulation of the financial system (Krahnen and Schmidt, 1995). The focus on financial intermediation is based on the fact that financial institutions take deposits from savers and lend them to potential investors. By this function, they meet the demand of both depositors who want to transfer resources to the future and of borrowers who want to use funds before receiving income. The main difference between the third view and the first two is that the first two views held that the fixing of interest rates below market rates would have important effects by (1) inducing more investments because of the low cost of capital and (2) inducing social justice because poor people are assumed to be unable to bear high interest costs. The third view argues that more investment can only be undertaken if more savings were available in a form suited for on-lending i.e. in the form of financial savings. But low interest rates make people save less. It argues further that financial repression leads to less savings which leads to less investment. In addition, financial repression is regarded as having a negative impact on the quality of investment leading to lower growth. To demonstrate these points, McKinnon (1973) states that financial repression normally includes ceilings for interest rates on loans which are below the level that market rates would reach had there been an efficient and properly functioning market for financial services. Because capital is subsidised, borrowing is attractive for some investors with projects which would not yield a high enough return to enable them to pay the market interest rate. Under financial repression, banks would ration credit according to non-economic criteria such as political influence. Because these criteria for allocation of

resources are not designed to exclude such borrowers, the allocation system leads to a lower average productivity of all the investment projects which receive funding and in the final analysis, to low growth.

The financial repression school argues further that if financial institutions are not allowed to charge market clearing rates of interest, bankers will prefer those borrowers whom they regard as personal friends, those with political clout, those who can pay bribes, those whose credit requests are easier to evaluate and those who request large loans with relatively low administrative costs (Gonzalez-Vegas, 1984b). Thus the Iron Law of Interest Rate Restrictions holds true in this situation (see Chapter Two for more detailed discussion). But the objective of making loans affordable for lower income segments of the population is never realised (op. cit.). Instead the subsidy goes to those who least need credit and can borrow large amounts of loans (Ladman and Tinnermeier, 1983). Moreover, financial repression has a negative impact on the financial institution itself, by preventing it from performing its economic roles of intermediation and transformation of capital. Low lending rates force banks to pay low deposit rates, which in turn reduce the bank's lending capacity in terms of volume and prevent it from realising economies of scale and increasing its efficiency (Adams, 1984 and Gonzalez-Vegas, 19984a). The overall impact is that a majority of the target population are denied access to credit and other services.

Financial repression also has a negative impact on the whole financial system. The artificially low lending rates apart, clever and influential borrowers avoid repayment, leading to an inefficient and financially fragile banking system, unavailability of credit for most potential borrowers and conspicuous lack of deposit facilities (McKinnon, 1973).

The policy implications are clear. At the macro level they entail financial liberalisation involving deregulation of interest rates to permit the banking system to perform its true economic functions, an increase in the flow of capital through the financial system, improved allocation of resources and enhance economic growth (Shaw, 1973). In recent years the World Bank has made liberalisation of the economic system, including the financial sector, a central condition of its Structural Adjustment Programmes (SAPs) for LICs. At the micro level, banking is regarded as any other industry which provides services at a cost. If left to its own devices, according to Shaw (1973), competition will occur and it will provide services and products as long as clients are willing to pay cost-covering prices for them. Thus according to the financial repression view, development aid projects should not provide foreign funds, as this will only weaken the savings mobilisation incentive and undermine the local financial system. Instead they should provide technical assistance and support to governments for the creation of a conducive environment so that deregulation of the financial system can be achieved. Although there has been criticism that empirical evidence to support these propositions is limited to only a few countries, this perception is useful in explaining what is happening in the credit markets of LICs, including Sierra Leone's.

Further criticism, however, that deregulation is not sufficient to solve the problems characteristic of repressed financial markets, namely information asymmetry and incentive problems (Stiglitz and Weiss, 1981) was instrumental in ushering a fourth perspective. Information asymmetry is at the heart of this fourth view. Associated with the New Institutional Economics (NIE) it holds that the lack of economic development in LICs is due to the unavailability of 'good institutions' which are in turn a consequence

of poor financial systems. Institutions are regarded as good if they provide the type of incentives which promote savings, capital accumulation and allocation of resources in a way that leads to growth (Stiglitz and Weiss, 1981). It is also held that in financial and labour markets information is asymmetrically distributed and costly and that it is impossible to write and enforce contracts which would cover all contingencies. Financial contracts almost always create incentive problems which are characterised as moral hazard (Arklof, 1970; Stiglitz, 1981). Stiglitz (1986b, p. 20), further argues that because of the pervasiveness of information and incentive problems in financial markets, it is unlikely that liberalisation would solve them.

The issue is, therefore, not either free market or bureaucratic intervention, but which institution functions, in what way, on the basis of the information it has and the incentives to which its agents are subject. Moreover, institutions themselves are regarded as products of long-term competition or market processes[52]. Thus to improve the financial system (both informal and informal sectors) of a country, one would have to study how existing institutions operate in solving the information and incentive problems, because market allocations are not always efficient in reality and institutions are not always optimally designed (Stiglitz, 1981). It is difficult to find the right starting point for intervention. But to avoid counterproductive intervention, it is imperative to begin by analysing the status quo i.e. the relevant market institutions functioning in the current state (Stiglitz, 1981).

The NIE perspective provides a deeper understanding of the problems of financial systems and development in LICs than previous ones. In recent literature the

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[52] McKinnon (1986, 1989 and 1991), has revised earlier views in the light of the work by Stiglitz and Weiss (1981)

fourth view has included and emphasised the importance of reducing transaction costs to improve savings mobilisation and the costs incurred by customers when dealing with the RFI (Floro and Yotopoulos, 1991). This chapter is strongly influenced by the third and fourth views because, as discussed in Chapter Three, the financial system in Sierra Leone during the 1980s and early part of the 1990s operated under financial repression and it is within the same context that RBs have been operating since 1985.

6.11 Organisation of the Rural Banks in Sierra Leone

A variety of strategies for the development of the RFM including RBs have been tried in many LICs. Rural Banks in LICs can be divided into four categories namely co-operative development banks, development banks, commercial banks and independent RBs. The strategies have enjoyed different degrees of success in different settings, but rural banks have shown particular promise.

Co-operative development banks are based on regional co-operatives. China and Kenya have tried this approach (Von Pischke, 1983) as have Pakistan and India. In Pakistan in 1976, the government established a Federal Bank for Co-operatives (Aleem, 1990), bringing co-operative finance under state control. The state co-operative banks in India have played important roles in mobilising rural savings, extending credit and bringing socio-economic development to rural areas. The State Co-operative Bank in Assam in the north-eastern region of India, for example, has 43 branches spread throughout the rural areas and has recorded high levels of savings deposits (Desai, 1983). A study of the activities of these state co-operative banks indicates that they have played important roles in the socio-economic development of the rural areas. However,

their ability to perform these roles is predicated on effective co-ordination between governmental agencies and other banks (Desai, 1983).

In Tanzania, state-run development banks have made a tremendous effort in extending branches to rural areas. Studies, however, have found that these banks are doing the things that private banks did prior to nationalisation and that is they had failed to achieve their objectives and credit rationing was practised (Doriye, 1988).

In the quasi-commercial bank model, governments encourage and sometimes compel, commercial banks to open branches in rural areas through central bank directives, with a view to taking banking activities to the doorsteps of, and providing credit to, rural residents. However, it is reported that commercial banks are invariably reluctant to carry out these directives in full. In Nigeria, for example, commercial banks did not meet the target number of rural branches that central bank directives requested because of cost considerations and the lack of bankable collateral in the rural areas (Ogundipe, 1980; Okorie, 1991).

The independent rural banking model is exemplified by the Grameen Bank in Bangladesh as well as RBs in Ghana and Sierra Leone. The Grameen Bank model has been hailed as a success story and it has been replicated and adapted in several countries including the United States of America (Balkan, 1993). Rural banks in Ghana, on the other hand, have produced mixed results (Owusu and Tetteh, 1982).

6.12 Rationale for Rural Banking In Sierra Leone

After the disappointing performance of credit programmes instituted in the last four decades (chapter three), the Bank of Sierra Leone (BSL) was approached by the government to seek ways of mobilising rural savings, providing credit to rural people

and filling the gap created by the phasing out of IADPs and the reluctance of CBs to lend to the agricultural sector, with a view to enhancing production and productivity and "minimising the exploitative hold over farmers by moneylenders and traders" (Bank of Sierra Leone, 1984). It was decided to organise RBs as unit banks on similar lines as those in Ghana and in 1985, the rural banking scheme was launched. Rural banks are organised as Joint-Stock Companies, with each being a separate entity and operating within the ambit of the Banking (Amendment) Act 1970 and RBs' bye laws, which stipulate that the BSL and any private organisation(s) in collaboration with indigenous people in the rural areas can set up an RB[53]. Ownership was to be spread as widely as possible among the inhabitants of the locality (service areas) through subscriptions to equity capital (BSL, 1984).

In Sierra Leone, as in Ghana, each RB operates independently and its staff members are employees of that RB and can only keep their jobs if it survives. The standard organisational structure in Sierra Leone is given in Fig. 1. Each RB is run by a separate Board of Directors, a Manager and support staff who cannot be transferred to another RB. The average staff strength of RBs in Sierra Leone is 12 (Table 6.3). The top three positions (Manager, Accountant and Loans Officer) are usually filled by graduates and retired central bank personnel. It should be noted that with the exception of BRB and SRB all the other RBs had their Managers and Accountants deputed to them from the BSL mainly because of the lack of qualified personnel motivated enough to give up the 'glare' of the city for the 'darkness' of the rural environment. The rest of the staff are

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[53] In the Bank of Sierra Leone (Amendment) Act 1970 (section 30), provision is made for the Bank of Sierra Leone to contribute directly or indirectly to development projects. On the basis of this provision, the Bank of Sierra Leone has contributed to the share capital of RBs.

TABLE 6.1 **OPERATING RURAL BANKS IN SIERRA LEONE (as at December, 1993)**

(Location, Date of establishment, and Coverage)

Name of Rural Bank	Date established	Province Location	District Location	Chiefdoms Serviced	Chf/dom Pop.*	Total Population
Yoni (YRB)	8 March, 1985	Northern	Tonkolili	Yoni	59584	
				Rochen Malal	14027	
				Kholifa Mabang	11055	**84666**
Marampa/ Masimera (MMRB)	10 December, 1986	Northern	Port Loko	Marampa/Masimera	63230	
				Buya Romende	24013	**87243**
Daru (DRB)	16 March, 1987	Eastern	Kailahun	Jawi	22829	
				Malema	10113	
				Mandu	13857	
				Njaluahun	30522	**77321**
Kunike (KRB)	20 March, 1987	Northern	Tonkolili	Kunike Barina	12496	
				Kunike Folawoso	20237	
				Tane	17029	**49762**
Mattru (MRB)	18 September, 1987	Southern	Bonthe	Jong	21783	
				Sogbeni	5179	
				Kpanda Kemo	7531	
				Yawbekaw	3299	
				Imperri	13072	**50864**
Moamale (MOARB)	20 October, 1989	Eastern	Kailahun	Peje West	10667	
				Peje Bongre	10263	
				Malegohun	11852	
				Yawei	9514	**42296**
Sewama (SRB)	24 April, 1992	Eastern	Kenema	Simbaru	13897	
				Gorama Mende	25327	
				Falla Wandor	16403	**55627**
Bombali (BRB)	20 May, 1992	Northern	Bombali	Bombali Sebora	22078	
				Paki Massabong	11277	
				Biriwa	24546	
				Pendembu Gowa	22141	
				Libeisaygahun	8384	
				Makari Gbanti	19696	
				Safroko Limba	16612	**124734**
TOTAL						**572513**

Note:- 1985 census Figures.

Source: Development Finance Department, BSL, 1984

Table 6.2 MOVEMENT OF SHARE CAPITAL OF ALL RBs IN SIERRA LEONE
(As at December, 1993)

(in Le 000)

RB	Shares	1985	1986	1987	1988	1989	1990	1991	1992	1993
YRB	Authorised	250	250	250	500	1000	2500	3000	3000	3000
	Total paid up	174.8	214	284	500	646.5	1559	2607	2848.2	2994
	Indigenous	49.8	88.8	159	250	396.5	1309	2357	2598.2	2744
	BSL	125	125	125	125	125	125	125	125	125
	Others	..	..	..	125	125	125	125	125	125
MMRB	Authorised	..	500	500	500	500	1000	5000	3000	5000
	Total Paid up	..	403.2	401.8	403.2	448	882.2	1140.4	2267.8	2610.7
	Indigenous	..	153.2	151.8	153.2	198	632.2	890.4	2017.8	2360.7
	BSL	..	250	250	250	250	250	250	250	250
	Others	..	..	..	..	..	..	..	..	..
DRB	Authorised	..	..	500	1000	2000	2000	2000	2000	2000
	Total Paid up	..	..	761.8	869.3	1058.4	1299.9	1299.9	1299.9	1299.9
	Indigenous	..	..	511.8	619.3	708.4	749.9	749.9	749.9	749.9
	BSL	..	..	250	250	250	250	250	250	250
	Others	..	..	..	..	100	300	300	300	300
KRB	Authorised	..	..	500	1500	1500	2000	2000	2000	2000
	Total Paid up	..	..	664	592	903.1	1187.5	1256	1381.5	2040.7
	Indigenous	..	..	414	4592	653.1	937.5	1005.5	1131.5	1790.7
	BSL	..	..	250	250	250	250	250	250	250
	Others	..	..	..	..	..	..	..	..	..
MRB	Authorised	..	..	500	1000	1000	5000	5000	5000	5000
	Total Paid up	..	..	709.9	765.2	921.3	1527.8	1790.2	2456	3016.5
	Indigenous	..	..	459.9	515.2	671.3	1277.8	1540.2	2206	2766.5
	BSL	..	..	250	250	250	250	250	250	250
	Others	..	..	..	..	..	..	..	..	..
MOARB	Authorised	..	..	..	..	1000	1000	1000	1000	1000
	Total Paid up	..	..	..	..	1183.3	1279.2	1279.2	1279.2	1279.2
	Indigenous	..	..	..	..	583.3	679.2	679.2	679.2	679.2
	BSL	..	..	..	..	250	250	250	250	250
	Others	..	..	..	..	350	350	350	350	350
SRB	Authorised	..	..	..	..	..	..	..	10000	10000
	Total Paid up	..	..	..	..	..	..	..	3290	3347
	Indigenous	..	..	..	..	..	..	..	2790	2847
	BSL	..	..	..	..	..	..	..	500	500
	Others	..	..	..	..	..	..	..	..	..
BRB	Authorised	..	..	..	..	..	..	..	20000	20000
	Total Paid up	..	..	..	..	..	..	..	3347	4021.6
	Indigenous	..	..	..	..	..	..	..	3347	4021.6
	BSL	..	..	..	..	..	..	..	..	..
	Others	..	..	..	..	..	..	..	..	..
All RBS	Authorised	250	750	2500	4500	7000	13500	18000	46000	48000
	Total Paid up	174.8	617	2822	3379	5160.6	7735.4	9372.5	18170.3	20009
	Indigenous	49.8	242	1697	2129	3210.6	5585.4	7222.5	15220.3	17359
	BSL	125	375	1125	1125	1375	1375	1375	1875	1875
	Others	..	..	..	125	575	775	775	775	775
Total	**(shareholders)**	**489**	**950**	**1561**	**2040**	**2477**	**2794**	**2828**	**3684**	**3765**

Table 6.3. **Staff Position in RBs as at March, 1994**

Position	YRB	MMRB	KRB	MRB
Manager	1	1	1	1
Accountant	1	1	0	1
Asst. Accountant	1	0	1	1
Loans officer(s)	1	1	0	1
Asst. Loans officer(s)	1	0	1	1
Loans clerk(s)	0	1	0	0
Cashier(s)	1	1	1	1
Counter clerk(s)	2	2	0	3
Bookkeeper(s)	2	1	1	1
Messenger(s)	1	1	0	0
Cleaner(s)	1	1	1	0
Security or watchmen	3	3	3	1
Driver(s)	0	0	0	0
Total staff	**15**	**13**	**9**	**11**

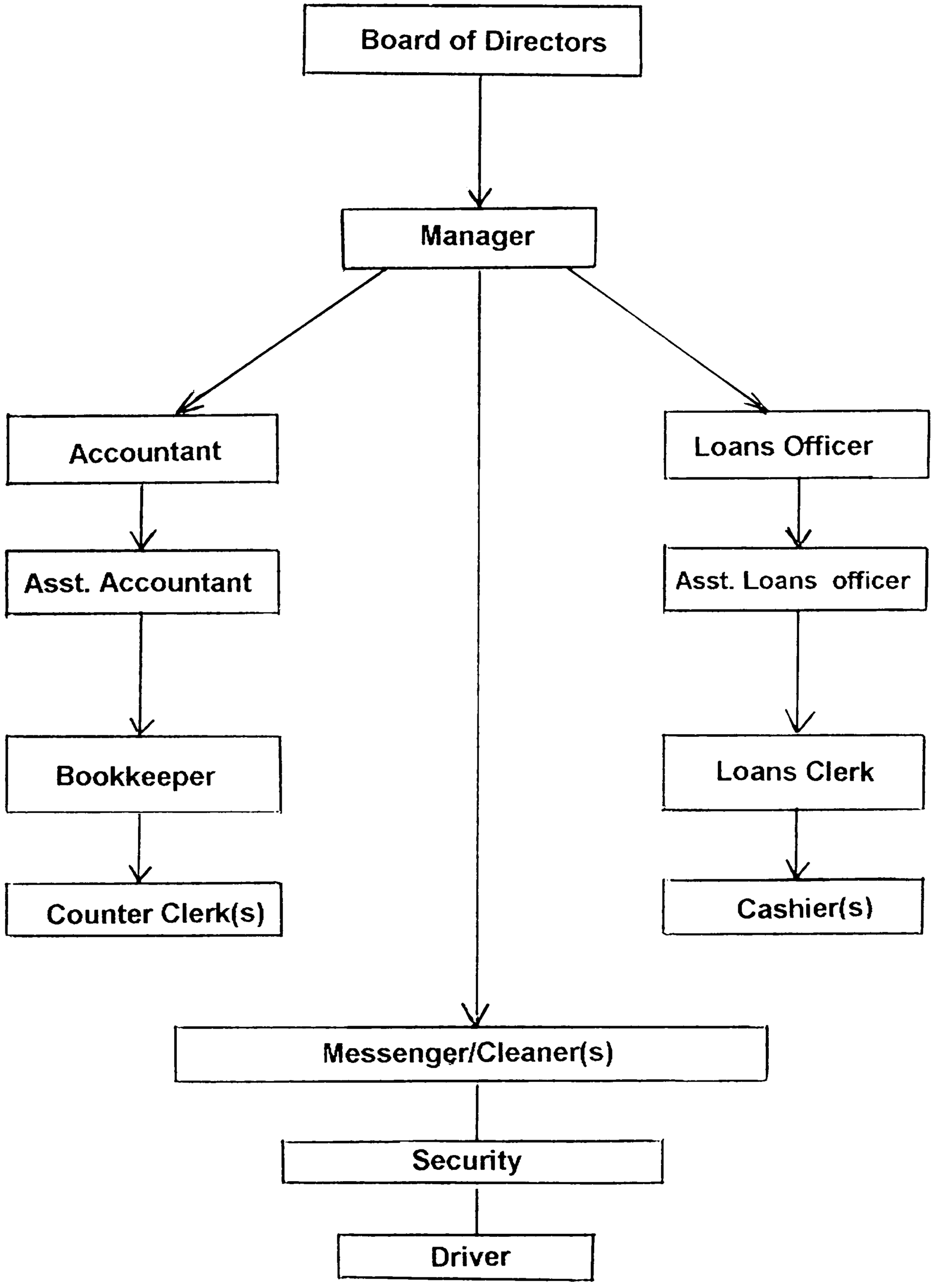
Source:- Survey of RBs in Sierra Leone, 1994.

mainly school leavers who, according to the RB Managers, were using the RBs as stepping stones to more lucrative jobs or waiting for opportunities to enter university. It is therefore no surprise that there has been a high staff turnover. For example, eight or about 30 per cent of staff have left the YRB since its inception, the MMRB lost six or 46 per cent, the KRB five or 30 per cent and the MRB and KRB have lost three each (The Survey, 1994). Some staff have left RBs and joined other institutions with better conditions of service. A cashier in an RB, for example, earns less than one-tenth of the salary of his or her counterparts in commercial banks (CBs, 1978). There are virtually no opportunities for further training and professional advancement. Commercial bank managers informed us that staff turnover in their institutions has been below 10 per cent in the last ten years and most of those who left did so not because of poor conditions of service but to go to university or abroad for advanced educational training. Few were

relieved of their positions because of malpractices. They also confirmed that apart from mining companies, commercial banks have better conditions of service than other indigenous establishments. It could reasonably be assumed, therefore, that RB staff are not well motivated and prepared for work in rural areas. In the Grameen Bank, part of the incentive system provides a proportion of the loans recovered as a bonus payment to staff and there is room for professional advancement (Wahid, 1993). In the absence of such incentives, the lack of motivation in RB staff is reminiscent of the situation with past credit schemes that failed (chapter three).

The rural banking scheme was to be implemented in three phases. In phase one, three pilot RBs (one each in Northern, Southern and Eastern provinces) were to be established within three years. These pilot RBs were to serve as models for the establishment of others. In phase two, thirteen RBs (one in each of the thirteen Districts, including the Western Area) were to be established. This second phase was expected to form part of a new Agricultural Development Plan (AGDEV 5) jointly funded by the World Bank, other international donor agencies and the government of Sierra Leone (MAFF, 1989). The third phase was scheduled to be implemented at Chiefdom level, where one or a group of Chiefdoms, after meeting the necessary guidelines on management and capitalisation, could apply to the BSL for a licence to open an RB. The guidelines stated that at least one quarter of the authorised share capital should have been raised from the indigenous people and residents of the service area. In addition, there should be proof that at least two Directors of proven rectitude are available; and these are to be indigenous to the service area (BSL, 1980). Phase three would have been spread over a period of five years.

Fig. 1 STANDARD ORGANISATIONAL STRUCTURE OF A RURAL BANK IN SIERRA LEONE.



Source:- Development Finance Department, Bank of Sierra Leone.

On an area meeting the above requirements, the BSL conducts a socio-economic survey of the proposed area to determine its suitability. Where the BSL is satisfied that the area can provide a conducive environment[54] permission is granted for publicity, sale of shares and preparations for establishment to commence. It should be noted that a large proportion (at least 75 per cent) of pre-establishment expenses[55] are borne by the BSL.

The first pilot RB (the YRB) was established in March, 1985 at Mile 91[56] in the Northern Province. Soon after its establishment, events overtook the programme. Politicians seized the opportunity and used the rural banking scheme as a campaign tool by promising their constituencies that RBs would be established in their constituencies in order to provide loans for farming and other enterprises. The BSL was inundated with applications from politicians of all persuasions. The BSL was initially reluctant to yield to this political pressure, but with government interference, it had to relent. In other words politicians hijacked the rural banking scheme and brought pressure for RBs to be established in their constituencies. By the end of 1993, eight RBs had been established (Table 6.1) and the pilot phase was abandoned. The reluctance of the World Bank and other international donor agencies to invest in this development venture under AGDEV 5 may not be unconnected with this turn of events.

Rural banking in Sierra Leone is based on the concept of financial intermediation, accepting deposits and extending loans. These savings are to be deployed within the

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[54] A conducive environment is narrowly defined as one with enough economic activity (trade, agriculture and other businesses), some government departments, a project(s), a police station and a market (Bank of Sierra Leone, 1984).

[55] These expenses include per diem allowances, salaries and transport costs for central bank staff engaged in publicity campaigns and building materials for refurbishing buildings to house the RB.

[56] Mile 91 is approximately 91 miles from the capital, Freetown.

areas from which they were mobilised, by granting loans to agriculture, trade, transport, and other small-scale enterprises; and contributing to development projects such as road repairs, building of market infrastructure, schools and clinics, with a view to influencing increased production and productivity. One of the first policies to be adumbrated is that an RB should confine its operations within a twenty-five mile radius (the service area). This is to prevent residents within one service area from acquiring loans in another. Secondly, any rural resident who wishes to avail himself or herself of the loan facilities should either become a shareholder or maintain an account (demand or savings) with the RB (Bank of Sierra Leone, 1984)[57].

6.13 Objectives of the Rural Banking Scheme

The objectives of the rural banking scheme are not prioritised. Taken together they include (1) the mobilisation of savings, (2) provision of supervised credit to rural residents, (3) taking banking to the doorsteps of rural residents, (4) influencing increases in production and productivity through the use of modern inputs, such as fertilisers and improved seed, (5) monetising the rural economy, (6) creating investment funds and enhancing employment opportunities in the rural areas thereby reducing out-migration, (7) contributing to development projects such as those mentioned earlier from retained profits, (8) creating an environment in which rural dwellers will assume greater responsibility in the decision-making process of RBs through the purchase of shares, membership of Board of Directors (BODs) and Local Loans Committees (LLCs), (9) helping to create markets for inputs and output in collaboration with other government

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[57] This policy is silent on the amount of loan an individual is entitled to, vis-à-vis the amount of savings in his or her account. In Togo and Cameroon, a borrower is not allowed to borrow more than two or three times respectively, of his or her savings (Gurgand, et al., 1994).

agencies and development projects located in the service areas and (10) "minimising the exploitative hold of moneylenders and traders over farmers" (BSL, 1984).

6.14 Board of Directors

Each RB is run by a seven-member Board of Directors which meets once a month to review operations and policy. Each BOD is peculiar to its RB and its members are appointed as follows:-

-- One member representing Class 'A' shareholders: this class of shares[58] is reserved for the BSL and carries veto powers. The exercise of veto powers is confined to issues relating to the operations of an RB which border on the contravention of the Banking (Amendment) Act 1970; or the RB bye laws as laid down in the Memorandum and Articles of Association (M & A)[59] and to ensuring prudential banking practices. It was expected that the Class 'A' shares held by the BSL would be sold and converted to Class 'C' shares when demand for them is demonstrated by the indigenous people of the service area.

-- One member representing Class 'B'[60] shareholders: these shares are reserved for other financial and development institutions operating in the service area. Such institutions include IADPs, Co-operative Societies, Development projects, Commercial banks and other financial institutions, and any other business or project operating within the service area.

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[58] These shares are Preference shares; they do not attract dividends and the BSL is committed to selling them off as class 'c' shares when the demand for them is established. Class 'A' shares constitute 1/4 of the authorised share capital of the RBs (Bank of Sierra Leone, 1984).

[59] The M & A of all RBs in Sierra Leone are the same except for the name of the RB, its BOD and the authorised share capital (Survey, 1994).

[60] Class 'B' shares constitute at least 25 percent of the authorised share capital of the RBs (Bank of Sierra Leone, 1984).

-- Five members representing Class 'C' shareholders: these Directors are the indigenous people and hold office for three years; but can be re-elected at the Annual General Meeting (AGM).

The functions of BODs are: (a) authorising and sanctioning loans and advances granted by Managers and LLCs, (b) reviewing RB lending policy and (c) directing policy on management and administration. A major stipulation connected with the appointment of directors is that no sitting member(s) of Parliament or PC(s) within the service area should become a director. The rationale is to prevent an RB from being politicised and to eliminate bias in the provision of services to customers. One of the members of the BOD should be resident in the area and he or she should act as Chairperson of the Local Loans Committee (LLC) which is comprised of four members[61]. The LLC is a body created to help RBs identify high risk borrowers by using their knowledge of the area and the residents, a function akin to that performed by moneylenders who reside near their customers. The LLC's effort is expected to assist in reducing the adverse selection of risk and moral hazard problems. It should, however, be noted that the risk of patronage is still present.

Due to lack of specialist training and experience, most BODs cannot interpret financial statements. The MMRB was the only RB that had a Chairperson with a commercial banking background. Therefore the ability of the BODs to execute their duties is questionable. There has been only one training session which was organised for BODs in 1989. The emphasis, however, was on administrative and policy issues as opposed to diagnostic tools and evaluation of rural bank's operations. In contrast, Bank

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[61] One resident Director and three members appointed from among shareholders resident within the area serviced by the RB (Bank of Sierra Leone, 1984).

of Ghana organises training and refresher courses regularly for such Directors which emphasise, among other things, interpretation of balance sheets and profit and loss statements of accounts (Owusu, 1985).

6.15 Share Capital Analysis

The authorised share capital (ASC) of each RB was originally fixed at Le 250,000 (BSL, 1984); but various BODs have revalued and even doubled this amount, reflecting the demand and, even more so, the inflationary situation (Table 6.2). Newly established RBs such as the BRB and SRB have ASCs of Le20 million and Le10 million respectively. Each share is valued at Le1.00 to be purchased in multiples of fifty. Another restriction imposed is that no single individual is allowed to own more than Le40,000 worth of shares (BSL, 1984); but this figure was revised to Le200,000 in 1990 (BSL, 1992). This is expected to prevent one shareholder from exercising a controlling influence on an RB.

The total paid up share capital (TPU) of the eight RBs has been high. It increased from Le0.174 to Le20.0 million between 1985-1993 (Table 6.2). At the commencement of each RB, TPU was over 50 per cent of ASC, indicating an initial enthusiasm by rural people to have a financial institution they could call their own and would invest in if opportunities were offered. This tends to rebut the traditional notion that rural people do not save. The TPU of the eight RBs, as at March, 1993, was 41.7 per cent of the ASC. The BSL's contribution was 3.9 per cent and other institutions contributed 1.6 per cent.

The proportion of Class 'C' shares to TPU is 86 per cent. However, excluding the BSL's and other institutions' contributions, paid up Class 'C' share capital is 36.2 per cent of the ASC (Table 6.4).

In some RBs there has been a decline in paid up share capital. For example, in the YRB in 1990, it declined by 3 percentage points following an inflation-led upward revaluation of ASC by 150 per cent from Le1.0 million to Le2.50 million (Table 6.2). But the savings rate (Table 6.11) continued to be below inflation, although increased by 5 percentage points from 15 to 20 per cent in 1991. It was lowered again in June, 1993, to 10 per cent per annum mainly due to a fall in inflation (see Table 3.3).

Overall, the rural banking scheme has not succeeded in spreading ownership of RBs among the target population. The proportion of Class 'C' shareholders, as at March 1993, was less than 1 per cent (approximately 0.66 per cent) of the total population in

Table 6.4 **Contribution to Share Capital in Eight RBs - 1985 to Dec., 1993**
(in million Leones)

Item	**1985 (1)**	**1986 (2)**	**1987 (5)**	**1988 (5)**	**1989 (6)**	**1990 (6)**	**1991 (6)**	**1992 (8)**	**1993 (8)**
ASC	**0.25**	**0.75**	**2.5**	**4.5**	**7.0**	**13.5**	**18.0**	**46.0**	**48.0**
Class 'A'	0.125	0.375	1.125	1.125	1.375	1.375	1.375	1.875	1.875
Class 'B'	nil	nil	nil	0.125	1.575	0.775	0.775	0.775	0.775
Class 'C'	0.049	0.242	1.697	2.129	3.211	5.585	7.223	15.22	17.36
TPU	**0.175**	**0.617**	**2.822**	**3.379**	**5.161**	**7.735**	**9.373**	**18.170**	**20.01**
No. of share-holders	489	950	1561	2040	2477	2794	2828	3684	3765
'C' as % of ASC	**19.6**	**32.3**	**67.9**	**47.3**	**45.9**	**36.5**	**40.1**	**33.1**	**36.2**

Notes:- **ASC** = Authorised Share Capital.
TPU = Total Paid Up Capital.
Figures in brackets indicate the number of RBs in operation during that year.

Source:- The Survey, 1994.

the service areas of the eight RBs (Tables 6.1 and 6.4). Managers of RBs informed us that the majority shareholders (owning about 60 per cent of paid-up Class 'C' shares) were the Chiefdom Authorities, members of BODs and affluent individuals residing in urban areas who claimed to be indigenous to the RBs' service areas. They also informed us that these people purchased shares in the names of their family members, most of whom were invariably unaware that they 'own' RB shares. It could, therefore, be reasonably assumed that these directors, chiefdom authorities and affluent people circumvented the policy which limits the amount of shares an individual can own, by purchasing them in the names of family members[62]. Thus the policy of spreading the owner-ship of the RBs among rural residents may not have been achieved. It may rather have created a small group of rural elite who are indirectly controlling RB operations and determining the direction of loans by co-signing/guaranteeing loan applications (see Section 6.31).

6.20 Evaluation Criteria

Several performance indicators can be used to determine the level of achievement of an RFI. Two methodologies, Outreach and the Subsidy Dependence Index (SDI), have been used here to analyse and assess the level of achievement of RBs in Sierra Leone. These methodologies provide a closer look at various aspects of operations including those not covered by financial statements such as the level of subsidies received by an RB. They also facilitate international comparison, an aspect not easily achieved with the use of conventional financial ratios (Yaron, 1992b).

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[62] Rural Bank Managers did not provide names for fear of contravening the secrecy code; but they were firm about the existence of 'fictitious' shareholders.

6.21 Outreach Analysis

Outreach refers to the degree of achievement in reaching the target group which could be the whole population or a segment of it. In Sierra Leone's rural banking context, the target group is the rural residents of the service area (farmers, traders, small industrialists and other entrepreneurs). Outreach will be measured in terms of the value of total savings deposits, the number and average value of savings accounts, loans to savings ratio, the amount of loans extended, the number of branches or units established, the proportion of the target population reached and the rate of women's participation.

6.22 Savings mobilisation

Although savings mobilisation has been described as "the forgotten half of rural finance" its importance has been emphasised by Vogel (1984). Such neglect can largely be attributed to the traditional but faulty assumption, already discussed in Chapter Two, that rural people do not save. Informal financial institutions such as the *osusu* in Sierra Leone provide sufficient evidence to contradict this assumption (see Chapter Five).

Savings mobilisation creates a continuous source of funds that is independent of government and international donors and provides information on clients and potential borrowers. Thus, savings mobilisation is the basis for a developed financial market capable of bringing about improved resource allocation and of allowing financial institutions to perform their intermediation role. This aspect relates to the role of interest rates in savings mobilisation. In theory, an economic agent's reaction to variation in interest rates is not clearly defined because of two opposing effects (Fry, 1977). When interest rates increase, opportunity cost of current consumption rises and future consumption is preferred, savings are expected to rise. This is the substitution effect. But

there is an opposing income effect, where high interest rates raise expected income and induce individuals to increase both present and future consumption. The net effect of these outcomes depends on the magnitude of the elasticity of substitution between present and future consumption and the marginal propensity to save (Fry, 1977 and 1988; Giovannini, 1985). According to Balassa (1989), the size of these parameters is an empirical issue. Empirical studies have not provided strong evidence that interest rates create efficient incentives to save. In contrast, the safety of deposits appear to be a more significant factor in relation to deposit rates. The implication is that given a moderately positive deposit interest rate, in real terms, an RFI may be more successful in inducing savings by improving access to deposit services. Rural Banks in Sierra Leone rely mainly on savings mobilised from clients; but access to its services have been limited to larger customers (see below).

Table 6.5 depicts an overall increase in growth rate of savings mobilised by the RBs between 1985 and 1993. The growth rate of deposits was high during the first two years of the rural banking scheme; but slowed down after 1990 even with an increase in the number of RBs in operation. On a bank to bank basis, the fluctuation in growth rate was most pronounced at the YRB, where it dropped from 23.5 per cent in 1988 to minus 15.7 per cent in 1989, increasing again in 1990 and dropping the following year by 31.9 per cent. This fluctuating trend was due mainly to the liquidity crisis experienced during 1989 to 1990 followed by an increase in parallel market activity (Chapter Three). Although more currency notes were printed, this government decision, among other things, helped to fuel year-on-year inflation from 76 per cent to 103 per cent from 1985 and 1991 (Table 3.3) without a corresponding increase in savings rates.

Some caution is required in interpreting these savings mobilisation figures, given that there were 1,040 dormant accounts, as at March, 1994, representing 15.9 per cent of the total number of accounts. These dormant accounts held Le9.75 million, or 3.2 per

Table 6.5 **Growth in Total Deposits (Demand and Savings) in Four RBs (Le M).**

RB	1985	1986	1987	1988	1989	1990	1991	1992	1993*
YRB	.33	2.9 (784.4)	5.7 (96.6)	7.1 (23.5)	5.9 (-15.7)	11.8 (96.5)	8 (-31.9)	20.3 (153.6)	15.8 (-21.9)
MMRB	..	..	1.1	3.3 (195.6)	5.8 (73.9)	15.4 (165.6)	16.9 (9.2)	11.9 (29.5)	30.9 (160.4)
KRB	..	..	1.5	2.3 (50.3)	1.7 (-27.3)	2.2 (33.9)	6.1 (177.4)	3.1 (-50.9)	5.4 (75.5)
MRB	..	..	.8	3.2 (320)	11.6 (269)	15.7 (35)	17.6 (11.9)	28.3 (61.4)	43.5 (53.5)
Total	**.3**	**2.9 (866.7)**	**9.1 (213.8)**	**15.9 (74.7)**	**25.0 (57.2)**	**45.1 (80.4)**	**48.6 (7.8)**	**63.6 (30.9)**	**95.6 (50.3)**

Note:- Figures in brackets are percentage change over the previous year.
* up to June, 1993.
Sources:- Financial Statements of RBs, 1985 - 1993.

Table 6.6 **Analysis of Savings in Dormant Accounts in Four RBs (1985 - 1993).**

RB	Total deposits (Le M)	Total no. of accounts in RB	No. of dormant accounts	Deposits in dormant accounts (Le M)	Dormant accounts as % of total no. of accounts	Deposits in dormant accounts as % of total deposits
YRB	77.8	2668	195	2.5	7.3	3.2
MMRB	85.3	1573	461	3.16	29.3	3.7
KRB	22.3	897	231	1.48	25.7	6.6
MRB	120.7	1386	153	2.61	11.0	2.2
Total	**306.1**	**6,524**	**1,040**	**9.75**	**15.9**	**3.2**

Source:- Financial statements of RBs, 1985-1993 .

cent of total deposits mobilised by the four rural banks (Table 6.6). The KRB has the highest percentage (6.6 per cent) of total deposits. This situation may not be

unconnected with the cross-firing of cheques incident[63] in 1990 which may have led to a confidence crisis.

It may also have introduced a systemic risk in the rural banking system. The incident brings into question the ability of BOD members and Bank of Sierra Leone to monitor and supervise the operations of RBs. Another reason for the high number of dormant accounts is that many clients open accounts for the sole purpose of acquiring a loan and when it is acquired, the operation of the account ceases (interview with Managers of RBs).

6.23. Savings Outreach

When a financial intermediary is genuinely independent and not just a credit outlet it generally provides savings services to a significant number of depositors, with the number of savers normally exceeding the number of borrowers (Yaron, 1992a). In this regard, none of the RB has been successful. All the four RBs had more borrowers than savers (Table 6.7). The overall ratio of depositors to borrowers in the four RBs as at December, 1993, is 1:2.8, reflecting the unattractive savings options provided (Yaron, 1992a; Gurgand, et al., 1994). For most clients, the exposure to deposit and savings facilities is usually the only way of becoming associated with services offered by an FFI

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[63]Huge loans were granted by the manager to Lebanese diamond mining customers under the cross-firing of cheques incident in 1989/90. These customers also had accounts in several commercial banks and drew cheques at divers dates. These cheques were honoured without reference checks or clearing because most were treated as overdrafts. This cross-firing of cheques almost brought a run on the KRB. It appeared to be a case of collusion between the manager and some officials of other commercial banks and the Lebanese customers, to take advantage of the poor communication links between RBs and commercial banks and the long bank clearing period. It should be noted that due to the poor means of communication (no telephone or fax links between commercial banks and between RBs and BSL as well as poor roads), cheques drawn on RBs could take at least 4 weeks before clearing takes place. During this period, several cheques could have been issued and encashed by an unscrupulous customer, but not without collusion between a senior commercial and or a RBs official.

(Yaron, 1992a). Savings mobilisation is important for the sustainability of operations. The idea of group savings as it is operates in Togo, Cameroon and Rwanda and the Grameen Bank in Bangladesh has not yet been considered by RBs in Sierra Leone[64].

Table 6.7. **Ratio of Savers to Borrowers in Four RBs (1985 - 1993)**

rural bank	period	number of savers	number of borrowers	ratio of savers to borrowers
YRB	1985-1993	2,668	4,821	1:1.8
MMRB	1986-1993	1,573	9,200	1:5.8
KRB	1987-1993	897	2,626	1:2.9
MRB	1987-1993	1,386	1,870	1:1.3
Total	**1985-1993**	**6,524**	**18,517**	**1:2.8**

Source:- Computed from Tables 6.8, 6.9 and financial statements of rural banks.

In Sierra Leone, high inflation has been a persistent problem. Nominal interest rates paid on savings by RBs (15 per cent from 1985; 20 per cent from 1991 to June, 1993 and 10 per cent after June, 1993), have been negative in real terms (Table 6.11) because of the high rates of inflation (Table 3.3). This negative real interest rate returns may have contributed to potential depositors holding savings in value-appreciating real assets such as crop inventories, animals and jewellery, since these provide a more effective way of hedging against inflation. The initial increase in deposits observed (Table 6.5) may have been induced by the need to be eligible for loans. Another factor which may have contributed to low savings mobilisation is the on-going 'rebel' war, which has created instability in the whole economy. It has already caused the closure of two RBs - DRB and MOARB - and may lead others to cease operations if it continues.

Although RBs offered lower interest rates on savings deposits compared to commercial banks, the initial increase in deposit mobilisation may reflect an increase in

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[64] See Gurgand et al. (1994) for more details.

the monetisation of the rural economy, rather than the reallocation of existing financial resources from one institution or sector to another. One major achievement of RBs in Sierra Leone, however, is that they have brought new clients into the formal sector who were not serviced by commercial banks. In this regard RBs have made a net contribution to financial intermediation. Furthermore, women now form a substantial part of the RB clientele. Fifteen per cent of the clients of the four RBs are women contributing almost 31 per cent of total deposits as at end of December, 1993 (Table 6.8). Considering the increase in the number of business women (ILO, 1985), it is likely that the proportion will increase significantly in future. Commercial bank managers informed us that less than 10 per cent of their customers, especially in the rural areas, are women due mainly to women not wanting their husbands and other relatives to know about their savings and to avoid unwelcome pressure and requests. Other factors include distrust of formal institutions and inferiority complex. They added that the widespread use of *osusu* groups

Table 6.8. **Women Clients in Four RBs (as at March, 1994)**

Rural Bank	No. of savers	Women savers	Total savings of women (Le M)	Women a as % of total savers	Women's savings as % of total deposits in RB*
YRB	2,668	352	18.4	13.2	23.7
MMRB	1,573	102	12.6	6.5	14.8
MRB	1,386	234	49.1	16.9	40.7
KRB	897	309	14.7	34.5	65.9
Total	**6,524**	**997**	**94.8**	**15.3**	**30.9**

Note:- * as per cent of total deposits (see Table 6.5).
Source:- The Survey, 1994.

by women also makes them uninterested in banking institutions. But the high proportion of women saving with RBs may also be the result of women asserting themselves and

becoming more economically independent as they become more educated (Table 1.1) and as development progresses (ILO, 1985). The KRB has the highest proportion of women clients (34.5 per cent), and their savings are a significant proportion of total savings mobilised from 1987 to March, 1994 mainly due to the gold mining activities which attracts a large number of traders, especially women, to its service area and hence attracts borrowers. But this is only part of the explanation, as will be seen in Sections 6.34 and 6.35.

6.24. Lending Outreach

In terms of lending outreach (number of borrowers reached), the RBs have made limited progress (Table 6.9). By end 1993, the eight RBs had reached just 21,020 borrowers i.e. 3.7 per cent of the population in the service areas. This is low compared to RBs in Ghana which had reached over 20 per cent of their target population between 1973 and 1983 (Owusu and Tetteh, 1982). Eighty per cent of the control sample in the survey informed us that they are observing the RBs' operations for a while before participating because of the unpleasant experience rural people have had with past formal financial institutions, such as co-operatives (see Chapter Three). These co-operatives failed because of misappropriation of funds, among other reasons. The IADPs also provided grounds for scepticism because extension officers were accused of falsifying credit accounts and inflating repayments due from borrowers (Johnny, 1985; Reddy, 1985). It may therefore be that rural residents still regard formal institutions with suspicion and tend to shy away from them. Rural bank managers informed us that though the issue of misappropriation of funds in past credit institutions may be fundamental, the main reason for the low client base and the high number of dormant accounts is the lack

of mobility of personnel. Apart from the YRB and the KRB which had a vehicle each (up to 1989), no other RB had any means of transport. Thus, the unavailability of transport facilities have prevented RBs from embarking on savings mobilisation drives. In similar RFIs such as the Grameen bank in Bangladesh, weekly deposits are collected by bank personnel on the doorsteps of customers and potential clients. In India, the Syndicate Bank appoints rural agents on a commission basis to collect deposits through what is known as the 'pigmy deposit scheme' (Padmanabhan, 1988). In Niger a savings bank makes daily deposit collection at market sites (Gurgand, et al. 1994). Savings mobilisers

Table 6.9. **Outreach Analysis (Lending) for the Eight RBs, 1985 - 1993.**

RB	Pop. in service area	No. of groups*	No. of members in groups	Indivi-dual borrowers	Total no. of borrowers	Borrowers as % of pop. in service area
YRB	84,666	228	4,560	261	4,821	5.7
MMRB	87,243	55	1,100	8,100	9,200	10.5
KRB	49,762	102	2,040	586	2,626	5.3
MRB	50,864	86	1,720	150	1,870	3.7
DRB	77,321	65	1,300	333	1,633	2.1
MOARB	42,296	30	600	63	663	1.6
SRB	55,627	0	0	18	18	0.03
BRB	124,734	4	80	109	189	0.15
Total	**572,513**	**570**	**11,400**	**9,620**	**21,020**	**3.7**

Note:- * These groups are loose associations formed mainly by farmers and cloth dyeing (*gara*) women's' enterprises mainly to take advantage of loan facilities.
Source:- Financial statements and other returns from RBs.

were also employed by the Self-Employed Women's Co-operative (SEWA) in Ahmedabad in India. These agents explain to illiterate clients the procedures for depositing and withdrawing funds; and it is reported that in the first year, eleven of them were able to mobilise as much as 1.1 million Rupees from 3,000 clients (Padmanabhan, 1988). In Ghana, RBs have used school savings schemes to increase savings (Owusu

and Tetteh, 1982). In contrast, RBs in Sierra Leone wait for customers and potential customers to come to the bank to transact business. Apart from the initial publicity, prior to the commencement of operations, no follow up campaigns have been undertaken by any RB.

6.25 Loan-to-deposit Ratios

Table 6.10 provides a trend in loans-to-deposit ratio in the RBs, for which data are available. Although the ratios look impressive and reflect an overall increase in loan volume, as far as intermediation is concerned, they do not reflect prudent liquidity management, especially when we consider the high default rates observed (Section 6.31).

Table 6.10 **Loan-to-Deposit Ratios in the Eight RBs**

Year	National	All RBs	YRB	KRB	MM RB	MRB	DRB **	MOA RB**	S RB	B RB
1985	29.1	22.3	22.3	..	..	..	..	..	..	..
1986	19.4	9.4	9.4	..	..	..	..	..	..	..
1987	17.7	23.2	37.5	9.9	..	..	..	..	..	..
1988	22.1	49.9	73.8	50.6	28.9	11.9	218.2	..	..	..
1989	37.6	50.5	100.6	89.2	24.3	10.9	218.2	..	..	..
1990	41.7	563.8	107	11812*	81.9	23.2	218.2	..	..	..
1991	48.1	751.6	102.8	6315.7*	59.8	58.7	218.2	120.4	..	..
1992	40.6	480.6	93.4	1047.2*	115	47	218.2	120.4	28.4	..
1993	N/A	334.8	79.3	6046.6*	169.6	30.6	218.2	120.4	13.5	38.7

Note:- * effect of the cheque incident.
** closed down due to 'rebel' war.
N/A = Not Available.

Source:- Financial Statements of RBs and Commercial banks, 1986-1993.

Losses incurred from the extension of huge loans to not more than five clients (the cross-firing of cheques incident) without consideration to liquidity management brought the KRB to near collapse, but for the intervention of the BSL. The manager of KRB informed us that about seven-eighths of this amount has been recovered but this

was not reflected in the subsequent audited statement of account. The effect of this overextension of loans will become apparent in the default (Section 6.31) and SDI analysis (Section 6.40). Poor liquidity management focuses on the quality of management and supervision of RBs by both the BSL and the BODs. The lack of proper and adequate training in financial management for RB staff may be a contributory factor. The BSL organises a training course each year for loans officers and managers; but it is limited to administrative policies and lacks a critical analysis of operations and explanations for low levels of achievement (Harrison, 1990). This is reminiscent of the past credit schemes.

6.30 Lending Operations

Lending is one of the major functions of RBs and is guided by directives from the central bank (Bank of Sierra Leone, 1984). The main directives include the following:-

(1) **Sectoral allocation**

(a) Agricultural production (including agro-industries)	- 40% of total loans
(b) Trade	30% " " "
(c) Industries and services	20% " " "
(d) Personal/General	10% " " "

(2) **Interest rates on loans**

(a) Agricultural production	35%
(b) General trade	40%
(c) Industries and services	35%
(d) Personal/General	40%

(3) **Sanctioning limits**

(a) Manager	up to Le50,000
(b) Local Loans Committee	from Le50,001 - Le100,000
(c) Board of Directors	from Le100,001 - Le200,000
(d) Bank of Sierra Leone	above Le200,000

Source:- BSL, 1984.

The lending policy of the RBs provides for short-term, medium-term and long-term lending (BSL, 1984). But none of the RBs has been able to give medium- or long-term loans due mainly to low liquidity and high default. Tables 6.12 - 6.18 provides the analysis of RB lending from 1985 to December, 1993, for the four RBs.

Table 6.11. **Prescribed and Actual Interest Rates in RBs , 1985-1994**

Instrument	Policy	Actual 1985-1990	Actual 1991-1993, (June)	Actual After June, 1993
Savings	30	15	20	10
	Lending Rates			
Ag. Production	40	40	40-45	30
Ag. Marketing	35	35	40-45	30
Gen. Trade	35	35	50-55	35
Industry	35	40	50-55	35
O/D (personal)	40	60	50-55	40

Note:- A 3 per cent Commitment or Administrative Fee is charged on loans sanctioned. This Fee was reduced to 1 per cent in 1992 (Survey, 1994).

Source:- Rural Bank Survey, 1994.

Table 6.12. **Sectoral Distribution of Loans by Four RBs, 1985 - Dec., 1993 (LeM)**

Type of loan	YRB	MMRB	KRB	MRB	Total loans
Agricultural Production	16.9 (48.0)	24.3 (36.2)	18.1 (4.1)	13.1 (39.6)	**72.4 (12.7)**
Agricultural Marketing	7.7 (21.9)	6.4 (9.5)	5.5 (1.3)	13.8 (41.7)	**33.4 (5.8)**
General Trade	7.2 (20.5)	36.4 (54.2)	43.9 (10.1)	3.6 (10.8)	**91.1 (15.9)**
Animal Husbandry	0 (0)	0 (0)	4.6 (1.0)	0 (0)	**4.6 (0.8)**
Industry (cottage)	1.6 (4.5)	0 (0)	0 (0)	1.9 (5.9)	**3.5 (0.6)**
Mining	0 (0)	0 (0)	364 (83.4)	0 (0)	**364 (63.6)**
Personal	1.8 (5.1)	negligible	0.5 (.01)	0.7 (2.0)	**2.9 (0.5)**
Total	**35.2**	**67.1**	**436.6**	**33.1**	**571.9**

Note:- Figures in brackets are percentages of total loans.

Source:- Financial statements of RBs.

The total volume of loans extended (up to December, 1993) by the four RBs we surveyed was about Le572 million to 18,517 borrowers, an average loan size of Le30,890 (US$ 53.3 at 1993 prices). A closer examination of the sectoral distribution, however, shows that the largest proportion of loans has gone to the mining sector. The KRB cheque incident provided Le 364 million, an average of Le 72.8 million (US$ 627,586) per borrower. It could be concluded that these customers took advantage of the low interest rates, the long clearing period and lack of communications between RBs and commercial banks.

If we exclude mining loans, the picture is different. Total volume of loans to other sectors is just Le208 million (about US$ 358,621), an average loan size of Le 11,236 (about US$ 19.4). This amount is less than half the cost of cultivating 1.5 acres of upland rice (FAO, 1992). Table 6.12 shows a sectoral distribution in favour of trade. Trade (agricultural marketing and general trade) received about 60 per cent of total loans granted by the four RBs. Agricultural production only received about 35 per cent. On a bank to bank basis, YRB allocated 48 per cent, MRB 39.6 per cent and the MMRB 36.2 per cent of loans to the agricultural sector. All the four RBs satisfied the sectoral allocation to trade (agricultural marketing and general trade). It should be noted that general trade is mostly on imported goods such as second-hand clothing, provisions (milk, sugar, bread flour etc.). This sector received the highest percentage allocation (44 per cent) apart from the mining; and this bias has prompted some observers (Reddy, 1985; Conteh 1987), to note that the RBs are behaving like the commercial banks in directing their loans towards financing consumption instead of production. The industry (mostly cloth dyeing) is dominated by women who are usually in small groups of five to

Table 6.13 **Gender Distribution of Loans in Four RBs (1985 - Dec., 1993)**

Sector	Total Loans (Le M)	Total Beneficiaries	Women beneficiaries	Women as % of beneficiaries	Total loans to women (Le M)	loans to women as % of total
Agriculture	72.4	10,126	608	6.0	6.3	**8.7**
Agric. Marketing	33.4	891	254	28.5	10.6	**31.7**
General Trade	91.1	7,095	4,852	68.3	65.4	**71.8**
Animal Husbandry	4.6	15	0	0	0	**0**
Industry	3.5	284	269	84.7	3.2	**92.4**
Personal	2.9	101	3	2.9	0.6	**2.1**
Mining	364.0	5	0	0	0	**0**
Total	**571.9**	**18,517**	**5,986**	**32.3**	**86.1**	**15.1**

Source:- The Survey, 1994.

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to ten members. The allocation to this sector (about 2 per cent) is well below the guidelines.

Overall, however, the guidelines have not been followed and agriculture, the major sector of the economy, received less than 40 per cent of total loans. In terms of lending outreach, the four RBs have only reached 18,517 borrowers or about 6.8 per cent of the combined population of 272,535 in their service areas from 1985 - December, 1993 (Tables 6.1 and 6.13). Although 32.3 per cent of loan beneficiaries are women, they received only 15.1 per cent of the total loans. But excluding mining loans, women received about 41.4 per cent of total amount loaned. If we reasonably assume that 60 per cent of all loan beneficiaries are repeat borrowers, as is the case in most credit programmes in LICs (Adams, 1984), the proportion of the target population reached by the four RBs is below 5 per cent (approximately 4.1 per cent). These figures are relatively low compared to RBs in Ghana which have been able to reach at least 15 per cent of over 8 million of their target population between 1973 and 1983 (Owusu and

Tetteh, 1982). The Grameen bank's figures is 932,574 borrowers i.e. over 20 per cent of the target population, between 1986 and 1994[65]. On a bank to bank basis, the MMRB has the best performance among RBs in Sierra Leone. It extended loans to 9,200 or 10.5 percent of its target population. The YRB reached 5.7 per cent, the KRB 5.3 per cent and the MRB 3.7 per cent of the population in their respective service areas.

Group lending has been a major factor in reaching potential clients of RBs in many countries such as Bangladesh, Ghana, Nigeria, Togo, and Niger to name but a few (Gurgand et al., 1994). The YRB extended credit to 228 groups, the KRB, 102; the MRB, 86 and MMRB, 55. The number per group in the RBs in Sierra Leone has been, on average, 20 people for men's groups. Women's groups ranged from five to ten members. About 4 per cent of the groups are of mixed sex; 82 per cent and 14 per cent are male and female groups respectively. Group membership is high compared to the Grameen Bank in Bangladesh where the average size is five members (Mizan, 1993; p. 128).

The emphasis on groups is intended to minimise default problems using the built-in joint-liability and peer pressure mechanisms (Stiglitz, 1990). Keeping the group to a manageable size (as in the Grameen Bank) is very instructive for monitoring purposes. It ensures choice of low risk members and reduces monitoring costs within the group itself. It also allows the enforcement of proper credit use and facilitates repayment. The small size of groups is one of the factors that has enabled the Grameen Bank to record impressive repayment rates of 98 per cent (Rahman and Samad, 1993; pp. 175-177). And while the Grameen bank has branches scattered in the remote areas, none of the

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[65] See Wahid (1994. p. 34)

RBs in Sierra Leone has established branches with the exception of the KRB which runs an Agency[66] about 15 miles away from its Headquarters. This is mainly due to inadequate reserves resulting from poor liquidity management, high default rates and losses.

6.31. Default rates in RBs

The default rates in the RBs in Sierra Leone are at institutional-life-threatening levels. Tables 6.14 and 6.15 show default rates of the four RBs. On a bank to bank basis, the KRB has the worst default rate, with an average of about 74 per cent (1988-1993), mainly because of the cross-firing of cheques incident which occurred in 1990. Excluding that incident (mining loans), the KRB is still the worst performer with a default rate of about 45 per cent. The manager reported that most of the loans were acquired ostensibly for agricultural production and trade but were diverted mainly into mining activities. Overall, default rate in the four RBs is 65.4 per cent (as at March, 1994). Excluding the KRB, the reported average default rates was about 37 per cent (Table 6.14). Rural banks do not have disaggregated figures for repayment by gender; but managers reported that

Table 6.14. **Aggregate Loans, Average Loan Size (LeM), Beneficiaries and % Default.**

RB	period	Amt. disbd.	Amt. recovd.	No. of ben.	Av. Loan size	% deflt.
YRB	1985-93	35.2	21.9	4821	.0073	37.8
KRB	1987-93	436.5	113.2	2626	.1662	74.1
MMRB	1988-93	67.1	41.3	9200	.0073	38.5
MRB	1988-93	33.1	21.2	1870	.0177	35.9
All RBs	**1985-93**	**571.9**	**197.6**	**18517**	**.0106**	**65.4**

Source: Financial statements of RBs 1985 - 1993.

[66] The Agency was a compromise between two chiefdoms (Kunike Barina and Kunike Folawoso) which vied to have the RB located in their chiefdom headquarters.

repayment by women was as high as 96 per cent, which suggests that the high default rates observed are mainly caused by male borrowers.

Two important issues should, however, be noted. Firstly, members of BOD have also received loans. At the MMRB, loans to Directors constituted, on average, 3.2 per cent of total loans to all borrowers. Total loans to Directors in the four RBs were 0.40 per cent of total loans to all their borrowers. The average size of loans to 21 Directors[67] was Le110,000 compared to Le7,100 for agricultural production, Le 12,800 for trade and Le 37,500 for agricultural marketing. We do not have disaggregated data on Directors' repayment; but the size of the loans indicates a loan bias in their favour and tends to suggest the existence of credit rationing.

Another factor that suggests the existence of credit rationing is the proportion of the population reached by the four rural banks (6.8 per cent) and the number of applications rejected. The four RBs received a total of about 9,682 loan applications between 1985 and 1993, of which 7,336 or 75 per cent were rejected, mainly on the grounds of the lack of a co-signer (guarantor). The main co-signers used by borrowers are the wealthy traders, Chiefdom councillors and influential individuals who would normally only co-sign if they knew the group or individual. It is unlikely that they would guarantee borrowers who are not 'loyal' to them (The Survey). This also lends credence to the proposition that these influential people, who are invariably majority shareholders, may be influencing the direction of RB loans. Applications are also rejected on the grounds that projects are unviable. However, the method of determining the viability of projects is not clearly defined.

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[67] This figure excludes one RB for which information on loans to Directors was not available.

Table 6.15. **Summary of Loans Analysis of Four RBs (LeM)**

RB	item	'85	'86	'87	'88	'89	'90	'91	'92	'93	Total
YRB											
	disb.	.086	.28	1.7	3.7	4.9	6.6	3.9	9.8	4.2	35.2
	rcvd.	.016	.14	.4	1.6	2.3	3.9	3.6	6.8	3.1	21.9
	dflt.	81.4	50.0	76.5	56.8	53.1	40.9	7.7	30.6	26.2	37.8
KRB	disb.	...	...	.14	1.5	3.0	411.7	1.97	7.2	11.0	436.5
	rcd.	...	...	.13	1.4	2.9	100.1	1.91	6.4	5.4	113.2
	dflt.	...	...	7.1	6.7	3.3	75.7	3.0	11.1	50.9	74.1
MMRB	disb.	...	...	...	.9	2.4	9.4	21.6	22.1	10.7	67.1
	rcvd.	...	...	...	.84	2.0	8.0	16.9	8.9	4.7	41.3
	dflt.	...	...	...	6.7	16.7	14.9	21.8	59.7	56.1	38.5
MRB	disb.	...	...	...	.16	1.4	2.9	6.3	10.5	11.8	33.1
	rcvd.	...	...	...	.08	.82	1.5	2.9	7.8	8.1	21.2
	dflt.	...	...	...	50.0	41.4	48.3	53.9	25.7	31.4	35.9

Notes:- disb. = Amount disbursed in Le Million
rcvd. = Amount recovered in Le Million
dflt. = Percentage default.

Source:- Financial Statements of RBs, 1985-1993

Table 6.16. **Loans to Directors of RBs (LeM)**

RB	Item	'85	'86	'87	'88	'89	'90	'91	'92	'93	Total
YRB	Amt.	0	0	0	0	0	.025	.054	.055	0	.134
MMRB	Amt.	...	...	0	0	.004	.013	.018	.47	1.63	2.14
MRB	Amt.	...	...	0	0	.0012	.036	0	0	0	.037
All 3 RB	Amt	**..0**	**0**	**0**	**0**	**.005**	**.074**	**.072**	**.53**	**1.63**	**2.31**

Note:- figures do not add up due to rounding up.

Source:- Audited Statements of Accounts of RBs

Secondly, the KRB was not alone in experiencing misappropriation of funds from its accounts by staff members. In 1990, the MMRB had problems with defalcated accounts amounting to Le3.1 million or 47 per cent of the total loans extended by that bank for that year. Other similar incidents, though minor, have also been reported in other RBs. These misappropriations, coupled with high default rates within an inflationary environment, have contributed to the erosion of the lending base of RBs and have posed serious liquidity problems. During our survey we witnessed an occasion

when MMRB could not meet customers' withdrawal demands. Although the manager explained to angry customers that blame should be placed on the central bank for shortage of cash, the problem was more complex. The MMRB failed to recall loans from borrowers some of whom were described as 'powerful' people (Directors, Chiefdom councillors etc.). The MMRB management declined to provide us with further details concerning these 'powerful' people.

Default rates have threatened the very survival of RBs in Sierra Leone. When compared to similar rural financial institutions in sub-Saharan Africa, RBs in Sierra Leone have performed poorly. In addition, there is an apparent absence of legal and enforcement mechanisms to ensure repayment. In contrast, moneylenders use socio-cultural measures to enforce repayment (see Chapters Four and Seven). The types of collateral that have been accepted by RBs are, moreover, questionable in terms of foreclosure and their realisability in the event of a default.

6.32. Collateral requirements

It is generally acknowledged that rural borrowers do not have tangible assets to be used as collateral (Adams, 1983; Udry, 1990; Stiglitz, 1986b). In addition, the absence of well defined property rights, especially in land (due to the type of land tenure system), and limited ownership of physical and financial assets are frequently cited as contributory factors for lack of collateral. Even where land is used as collateral, foreclosure is impossible because of the absence of a legal framework and enforcement mechanisms. The process of foreclosure can also be very costly for the lender (Johnson, 1972). This is the situation in Sierra Leone. Because of the above constraints, land is not included as a collateral in the lending policy of RBs (Chapter Three).

The most popular types of collateral used by RBs in Sierra Leone are the joint and several liability of groups and co-signers (guarantors) for individual borrowers. But no mechanisms have been put in place by RBs to surveillance the use of credit or to enforce repayment. The lack of mobility of the rural bank personnel, especially Loans officer(s), means that RBs rely on borrowers to come to the bank to make repayment. In some countries in sub-Saharan Africa, attempts have been made to improve loan collection. For example, the Credit Unions in Cameroon and Togo have partially overcome this problem by limiting loans to not more than two and three times, respectively, of the borrowers deposits. In addition, 100 per cent of the loans are guaranteed by borrowers' and/or co-signers' savings. When a loan is delinquent, savings cannot be withdrawn (Gurgand et al., 1994). In the Grameen Bank, repayments are made in 56 weekly instalments. The Credit Solidaire in Burkina Faso follows the example of the Grameen Bank. But repayment of loans from RBs in Sierra Leone is at the end of the term of the loan, usually 12 months. In Sierra Leone, loans are usually over ten times the size of savings in the groups' or individuals' accounts. When default occurs, the RB has virtually nothing to fall back on.

6.33 Reasons for Default

There are several reasons why default occurs in RFIs, some of which have already been identified in Chapter Four. Reasons for default applying to the IADPs in Sierra Leone (Richards and Karimu, 1981; and Lappia, 1980; Johnny, 1985) are similar to those for default by RB customers. We will repeat some of them to emphasise their importance and to identify policy changes that are needed to improve the performance of RBs. In our survey 18 per cent of the RB customer sample reported that one of the

reasons for default was the delay in the disbursement of credit (Table 6.17). Some of the RBs, such as the YRB, co-ordinated with the MAIDP (before it closed down) to supply inputs (fertiliser and seeds, hoes etc.) to borrowers. Delays in the supply of these inputs were reported to be between three to five weeks and sometimes longer. This delay can have adverse effects on output because agricultural production processes are time specific (Moinuddhin, 1969; Spencer and Byerlee, 1977). Any delay in ploughing or seeding can adversely impact on yields. The respondents also informed us that when these delays occurred credit was often diverted to other uses.

Indebtedness to informal financial intermediaries, especially moneylenders, is the most important reasons for default in RBs in Sierra Leone. Rural people depend on village moneylenders for credit especially during 'hungry season' (the period between the completion of ploughing/seeding and harvest) when food reserves are low. At the harvest, the moneylender is the first to arrive to demand payment, in kind or cash. The remaining portion of the harvest, after repaying of the moneylender's debt, is usually inadequate to repay RBs loans and at the same time feed the family. Fifty nine percent of our respondents gave 'indebtedness to informal lenders' (mainly moneylenders) as the reason for default. The closeness of the moneylender to the borrowers gives him an advantage in collecting repayment compared to an RB.

Spencer and Byerlee (1977) and Lappia (1980) also reported that because of poor road network and lack of market infrastructure, the farmer is often forced to sell at the farmgate, sometimes to moneylenders after repayment of loan or itinerant traders. Other contributory factors to default are the poor seed quality, shortage of inputs and

use of traditional technology which lead to low output, low incomes and hence low capacity to repay.

Table 6.17 **Reasons for Default by Customers of RBs**

Reasons for default in RBs	**Frequency**	**Percentage**
Late loan disbursement	35	17.5
Indebtedness to informal sources	118	59
Poor infrastructure and technology	26	13
Low prices for output	11	5.5
Institutional factors	10	5
Total	**200**	**100**

Source:- The Survey, 1994 .

On the whole, RBs' savings and lending outreach have had little impact in terms of both savings mobilisation and lending. Some of the reasons alluded to in the foregoing discussion are only part of the explanation. There are other barriers as well to the successful operations of RBs in Sierra Leone.

6.34 Barriers to Outreach.

Effective outreach has been hampered, as stated earlier, by the lack of mobility (i.e. transport) of RBs staff. But factors which are specific to agriculture have also created barriers to outreach and have impaired performance. Many elements of the rural sector are underdeveloped. Markets for inputs and output, as well as land use in LICs, are frequently localised and inefficient (Knickel, 1988; Hoff et al. 1990). The financial system has often been impaired by fiscal imbalances, a volatile inflation, financial repression (Chapter Three) and a weak legal and regulatory framework. Sierra Leone is, however, not unique in this region in experiencing financial crisis. The financial crisis in Benin in 1987 also illustrates the weaknesses of the financial sector in sub-Saharan Africa (World Development Report, 1993). The poor infrastructure, especially roads,

further constrains RBs from reaching residents in remote rural areas. Another bottleneck to outreach is the lack of confidence in public institutions. The unfortunate experience with co-operatives and IADPs still lingers. Therefore, the RBs need more publicity campaigns to educate potential customers and to restore confidence in formal institutions.

The staff position, especially the ratio of loans officers to borrowers is another contributory factor to poor performance. The ratio of loans officer to borrowers is 1:4,629 (The Survey, 1994), is even worse than the national extension worker/farmer ratio of 1:1200 (FAO, 1992). In this context, even were transport is available, one loans officer is unlikely to meet and supervise loan distribution and loan use.

The high transactions cost incurred by borrowers is another contributory factor to low levels of outreach. Rural bank customers surveyed reported that it takes at least four visits and three to four weeks, on average, before a loan is sanctioned compared to an average of two visits and one day to secure a loan from a moneylender (Chapter Four). This delay imposes high transaction costs on the RB customer. For example, a typical borrower residing 25 miles from the YRB, borrowing an average of Le30,000 (US$48.4), could incur high costs exclusive of the nominal interest rate on the loan (Table 6.18). It should be recalled (Table 6.11), that a 3 per cent commitment (administrative) fee is charged the borrower (reduced to 1 per cent in 1992) and subtracted from the loan before it is disbursed. Therefore, a borrower who applies for an agricultural production loan of Le30,000, will receive only Le29,100; but interest is calculated on Le30,000. The total transaction cost (as a proportion of loan) incurred by such a borrower, exclusive of the interest rate charged, would be 12.2 per cent (Table

6.18). Thus the actual interest rate paid by the borrower for a Le30,000 loan is 52.2 per cent, which is higher than the average indicative interest rate (about 46 per cent) charged by moneylenders (Chapter Four).

Table 6.18. **Estimated Transactions Costs of a Typical Borrower Residing 25 Miles from YRB**

Expenditure items	Cost (Le)	% of total cost
Fare to and from village (average 4 visits @ Le500/visit)[1]	2000	54.4
Food/entertainment (average 4 visits @ Le20/visit)[2]	80	2.2
Opportunity cost for an average 4 days visit (@ Le166/day)[3]	664	18.1
Bribes to fill in, and get forms processed quickly[4] etc.	30	0.8
Commitment Fee = 3% of loan[5]	900	24.5
Total transaction cost	**3674**	**100**

Notes:- (1) Average fare for 25 mile journey in rural areas at 1994 prices (the Survey).
(2) Average number of visits before loan is sanctioned (The Survey).
(3) Agricultural wage rate (Agricultural Sector Review, FAO, Aug., 1992).
(4) As indicated by the Survey.
(5) See Table 6.11

Sources:- The Survey, 1994 and FAO (1992).

The transaction costs computed in Table 6.18 may not be typical for all borrowers in other RBs but considering that YRB is located in an area that is relatively motorable, the costs could well represent a lower boundary for transaction costs in other RBs. The above analysis suggests that a borrower could incur high transactions costs when borrowing from an RB compared to almost zero transaction cost (see Chapter Four) when borrowing from a moneylender. This may be one of the reasons, among others, why rural residents tend to prefer moneylenders for borrowing purposes. The policy implication is a reduction of borrowers' transaction costs to attract borrowers.

In addition to the above constraints, the cost of operations especially administrative costs of RBs, can also have a significant impact on the level of

achievement. The following section examines administrative and other costs in the operation of RBs and provides a basis for the SDI analysis in Section 6.40.

6.35 Cost of Administration.

In this section the trends and level of operating expenses of RBs are examined. The analysis relates cost of administration to loans mainly because RBs' operations centre around mobilising the rural poor and the administration of loans and advances to them.

The RBs' administrative expenses as a percentage of loans and advances has been very high (Tables 6.19 to 6.21). Ratios of total expenses to loans in all the four RBs studied averaged 54 per cent during 1985-1993. In the Credit Unions in Cameroon which now function as banks, the ratio ranges from just 4.9 to 7 per cent (1988-1991); in Rwanda, it is about 7 per cent (1986-1992); in Togo it is between 2.3 and 7 per cent and in the Grameen Bank it is between 8.6 and 18.1 percent (1984-1986) (Gurgand, et al., 1994). This high ratio in RBs in Sierra Leone suggests that administrative costs have not been properly monitored and managed. The proportion of administrative expenses observed, should be regarded as lower-bound estimate of the level of transactions costs in RBs compared to what would be the case if subsidies were removed.

Total staff salaries have been lower than administrative expenses because the salaries and allowances of the managers and accountants of the four RBs were paid by the BSL up to December, 1989; and those costs were not included in the accounts. From 1990 onwards, salaries of the managers and accountants were borne by the RBs themselves and became significant expenditure items.

Cost of operations are higher in all the RBs during the first three years of operation than subsequently, mainly due to start-up costs (buildings, other fixed assets, etc.). Economies of scale are normally expected to be realised as an institution grows in size (Yaron 1992a); but RBs' have not provided clear evidence in this regard. An item labelled "other expenses" in the balance sheets of all RBs has been loaded with costs which were not disaggregated (RBs Audited Statements of Account, 1985 - 1993). In all the RBs, this item has accounted for not less than 15 per cent of total expenditure for each year of operation, suggesting that accounting procedures need to be examined to ensure that various expenditure items are classified under their appropriate heads and sub-heads. This would enable management to identify escalating costs and initiate corrective action before a situation deteriorates. However, to be able to identify and put such costs under their appropriate heads and sub-heads, appropriate training is necessary (Conteh, 1987).

The poor level of management is again evident in the actual cost of administering loans. On average, RBs spent Le 0.54 for every leone lent. The YRB, for example, spent an average of Le 1.23 for every leone lent during its first two years of operation. It dropped to Le 0.58 in 1987 and thereafter, it fluctuated upwards reaching Le 0.81 in 1993. Compared to similar institutions in other countries, RBs in Sierra Leone have performed relatively poorly. In the Cameroon, for example, credit unions spent just CFA 0.032 for each CFA lent; the Grameen bank averages 0.145 Rupees for each rupee lent (Yaron, 1992a).

As mentioned earlier, the operations of RBs in Sierra Leone have been hampered by many factors, including high inflation, loan interest rates well below inflation and their

Table 6.19

YRB's TRENDS IN COST OF ADMINISTRATION
(From date of est. to Dec. 1993)

	Expenses (Le000)									Expenses as % of Total Liabilities								
Item	1985	1986	1987	1988	1989	1990	1991	1992	1993	1985	1986	1987	1988	1989	1990	1991	1992	1993
allowances	37.7	55	109	213.7	498.7	1588.8	1669	4336.5	4846	2.5	1.3	1.4	2.1	4.5	8	6.2	13.9	17.9
Admin. Expenses	47.2	173.4	318.8	691.9	1076	3517.9	4222	2843.2	4485	3.1	4.2	4.1	6.8	9.7	17.8	15.6	9.1	16.6
Depreciation	14.8	34.3	62.2	38.3	94.3	174.6	183.8	349.9	296.7	1	0.8	0.8	0.4	0.9	0.9	0.7	1.1	1.1
Provision for bad debt	0	0	32.8	0	0	0	110	121.9	2362	0	0	0.4	0	0	0	0.4	0.4	8.7
Total expenditure	**100**	**262.7**	**523**	**944**	**1669**	**5281.3**	**6184**	**7652.5**	**11990**	6.6	6.4	6.7	9.3	15.1	26.7	22.9	24.6	44.3

	Expenses as % of Loans and Advances									Expenses per each Leone lent								
Item	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**
Salaries & allowances	50.8	23.2	5.1	4.1	8.3	12.6	11.1	22.9	32.8	1.35	1.11	0.24	0.18	0.28	0.42	0.41	0.4	0.81
Admin. expenses	63.6	73.1	14.6	13.2	17.9	27.9	28.1	14.9	30.4									
Depreciation	19.9	14.5	2.8	0.7	1.6	1.4	1.2	1.8	2									
Provision for bad debt	0	0	44.2	0	0	0	0.7	0.6	16									
Total expenditure	**134**	**110.8**	**23.9**	**18**	**27.7**	**41.9**	**41.2**	**40.4**	**81.3**									

Source:- YRB's Audited statements of accounts, 1985-1993.

Table 6.20 **MRB's TRENDS IN COST OF ADMINISTRATION**
(From date of est. to Dec., 1993)

	Total Expenses (Le000)							Expenses as % of Total Liabilities						
Item	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**
Salary & Allowances	42.8	91.1	174.8	640.7	1047.1	NA	NA	2.9	2.1	1.3	2.1	3.1	NA	NA
Admin. Expenses	223.7	322.6	627.4	1850.9	2405.0	NA	NA	14.9	7.4	4.7	6.1	7.2	NA	NA
Depreciation	0.0	33.1	31.7	129.6	161.3	NA	NA	0.0	0.8	0.2	0.4	0.5	NA	NA
Provision for bad debt	0.0	0.0	0.0	0.0	0.0	NA	NA	0.0	0.0	0.0	0.0	0.0	NA	NA
Total	**267**	**447**	**834**	**2621**	**3613**	**NA**	**NA**	17.8	10.2	6.3	8.7	10.8	NA	NA

	Expenses as % of Loans and Advances							Expenses per each Leone lent						
Item	1987*	1988	**1989**	**1990**	**1991**	**1992**	**1993**	**1987***	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**
Salary & Allowances		24.2	13.8	17.6	12.6	NA	NA							
									1.19	**0.66**	**0.72**	**0.43**	**NA**	**NA**
Admin. Expenses		85.7	49.6	50.8	28.9	NA	NA							
Depreciation		8.8	2.5	3.6	1.9	NA	NA							
Provision for bad debt		0	0.0	0.0	0.0	NA	NA							
Total		**119**	**65.9**	**71.9**	**43.4**	**NA**	**NA**							

N/A = Not Available.
Source:- Audited Statements of Accounts, 1987-1993.

Table 6.21

MMRB's TRENDS IN COST OF ADMINISTRATION
(From date of est. to Dec. 1993, in Le'000')

Item	Total Expenses									Expenses as % of Total Liabilities								
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1985	1986	1987	1988	1989	1990	1991	1992	1993
Salary % Allowances		..	57.8	101.6	215.4	703.3	1151	3605.8	3770	...	...	3.7	2.7	2.7	2.4	1.4	6.9	4.6
Other Expenses	..	..	190.2	329.3	359.9	2095.4	3668	7146.9	5376	...	...	12.2	8.7	4.6	7.3	4.4	13.8	6.6
Depreciation	...	...	4.3	15.7	17.5	24.9	27.6	133.6	501.6	...	...	0.3	0.4	0.2	0.1	0.03	0.3	0.6
Provision for bad debt	...	...	...	40.3	68	128.3	240.5	431.7	539	...	...	...	1.1	0.9	0.4	0.3	0.8	0.7
Total	...	...	252.3	486.9	660.8	2951.9	5087	11318	10187	...	...	16.2	12.8	8.4	10.2	6	21.9	12.5

Item	Expenses as % of Total Loans and Advances									Expenses per each Leone lent								
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1985	1986	1987	1988	1989	1990	1991	1992	1993
Salary & Allowances	...	...	...	10.5	15.3	5.6	11.4	26.4	7.2	...	...	...	0.5	0.47	0.23	0.5	0.83	0.19
Other Expenses	...	...	...	34	25.5	16.6	36.3	52.3	10.2									
Depreciation	...	...	...	1.6	1.2	0.2	0.3	0.9	0.9									
Provision for bad debt	...	...	...	4.2	4.8	1	2.4	3.2	1									
Total	...	...	...	50.3	46.9	23.4	50.3	82.8	19.4									

Sources:- Audited Statements of Accounts, 1987-1993.

Table 6.22

KRB'S TRENDS IN COST OF ADMINISTRATION
(From date of est. to Dec. 1993, in Le'000')

Total Expenses										Expenses as % of Total Liabilities								
Item	1985	1986	1987	1988	1989	1990	1991	1992	1993	1985	1986	1987	1988	1989	1990	1991	1992	1993
Salary & Allowances	...	...	61.9	91.9	280.4	728.3	N/A	2718.4	N/A	...	...	2.5	2.4	6.6	0.3	N/A	1.7	N/A
Other Expenses	...	...	117.7	251.6	614.6	1663.4	N/A	2384.9	N/A	...	...	4.8	6.6	14.5	0.6	N/A	1.5	N/A
Depreciation	...	...	24.1	25.6	25.6	25.6	N/A	34.1	N/A	...	...	0.9	0.7	0.6	0.09	N/A	0.02	N/A
Provision bad debt	...	...	...	11.3	15	4602.2	N/A	3207.7	N/A	...	...	...	0.3	0.4	1.7	N/A	2	N/A
Total	...	...	203.7	380.4	935.6	48439	N/A	8345.1	N/A	...	...	8.2	9.9	22.1	18.2	N/A	5.2	N/A

Expenses as % of Total Loans and Advances										Expenses per each Leone lent								
Item	1985	1986	1987	1988	1989	1990	1991	1992	1993	1985	1986	1987	1988	1989	1990	1991	1992	1993
Salary & Allowances	...	...	41.2	7.9	18.7	0.3	N/A	0.8	N/A	...	...	1.36	0.33	0.63	0.19	N/A	0.03	N/A
Other Expenses	...	...	78.4	21.9	41	0.6	N/A	0.7	N/A									
Depreciation	...	...	16	2.2	1.7	...	N/A	0.01	N/A									
Provision for bad debt	...	...	...	0.9	1	17.6	N/A	1	N/A									
Total	...	...	135.6	33	63.5	18.5	N/A	2.6	N/A									

N/A = Not Available.
Source:- Audited Statements of Account, 1987-1993.

concomitant negative interest incomes, and poor infrastructure. It is interesting to note that since our survey in 1994, one of these RB (the MMRB) has closed down mainly because it has been unable to recall loans and the Bank of Sierra Leone has become reluctant to provide further subsidies to RBs.

With such high transactions costs coupled with high inflation and high default rates, the question is, how and why are these RBs still operating?. The answer to the above question lies in the level of their subsidy dependence.

6.40 Subsidy Dependence Index (SDI) Analysis

A financial institution can achieve self-sustainability when the return on equity, net of any subsidy received, equals or exceeds the opportunity cost of its equity. This section analyses the level of subsidies received by RBs using the Subsidy Dependence Index (SDI). The SDI is the inverse of self-sustainability (Yaron, 1992a).

Rural financial institutions have been sustained by various implicit or explicit subsidies in LICs; but financial statements of such RFIs do not usually reflect these subsidies (Gurgand, et al., 1994). Subsidies which have been used to sustain RBs in Sierra Leone include, interest rates differentials between market rates and interest paid on concessional loans and direct reimbursement of some operating costs. For example, each RB, with the exception of the BRB and the SRB, initially had a Manager and an Accountant seconded to them from the BSL. These BSL officers served RBs for 4, 4, 3, and 3 years at YRB, MMRB, KRB and MRB respectively. Their salaries and allowances were paid by the BSL; and such costs were not reflected in their financial statements. When a subsidy is extended to a RB, the value should be assessed against the volume of business (Yaron, 1992b).

The SDI methodology identifies the following conditions as important in eliminating subsidy dependence: (a) positive interest rates on loans that are high enough to cover non-subsidised financial costs as well as administrative costs and still maintain the value of equity, (b) an active policy which ensures that voluntary savings become an increasingly significant factor in financing the loan portfolio, (c) a high rate of loan repayment and low loan losses and (d) low administrative costs through implementation of efficient techniques and procedures in lending operations and the mobilisation of savings (Yaron, 1992b).

The amount of subsidy received by an RFI is defined and assessed as follows:

$$S = A (M - C) + [(E * M) - P] + K^{68}$$

Where:

S = Annual subsidy received by the RFI

A = RFI's concessional borrowed funds outstanding (annual average).

M = Interest rate the RFI would be assumed to pay for borrowed funds. if access to borrowed concessional funds were eliminated.

C = Weighted average annual concessional rate of interest actually paid by the RFI on its average annual concessional borrowed funds outstanding.

E = Average annual equity.

P = reported annual profit before tax (adjusted, when necessary, for loan loss provisions, inflation etc.).

K = The sum of all other types of annual subsidies received by the RFI (such as partial or complete coverage of the RFIs operational costs by the state and credit guarantee cover etc.)

The financial ratio which is the Subsidy Dependence Index (SDI) is defined as:

$$SDI = \frac{S}{LP*n}$$

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[68] Where figures for a particular year are incomplete or unavailable, the previous year's are used (Yaron, 1992b).

SDI = Index of subsidy dependence of the RFI.

S = Annual subsidy received.

LP = Average annual outstanding loan portfolio of the RFI.

n = Weighted average on-lending interest rate of the RFI[69]

An SDI of zero suggests that a RB achieved full self-sustainability; an SDI of 100 per cent suggests that a doubling of the average on-lending interest rate is required to eliminate subsidies. Similarly, an SDI of 200 per cent indicates that a threefold increase in the on-lending interest rate is required to compensate a RB for subsidy elimination. A negative SDI indicates that a RB has achieved self-sustainability and that its annual profits, minus its capital (equity) charged at the approximate market interest rate, have exceeded the total annual value of subsidies. A negative SDI further implies that a RB could have lowered its average on-lending interest rate while simultaneously eliminating any subsidies received in the year for which the SDI is computed (Yaron, 1992b).

6.41. Computation of SDI for Four RBs.

The data used in this analysis come from computed financial statements of RBs. As stated earlier, there are limitations to this data. Firstly, subsidies are not reported in the audited statements of accounts and financial returns of RBs. Secondly, the extent of loans covered under the CGS is not reflected in the accounts.

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[69] n is calculated as interest earned as a percentage of average annual loan portfolio. This implies that whenever interest is not accrued on non-performing loans, while no provision for loan losses are made, n would be lower compared with the interest earned on performing loans.

Table 6.23 **Assumptions for calculating the SDI for YRB**

Item/Year	1985	1986	1987	1988	1989	1990	1991	1992	1993
A	.71	.60	.60	.60	.84	.64	.64	.60	1.80
M* (%)	12	14	16	16	16	55	55	45	30
C (%)	10	10	10	10	10	30	30	25	20
M-C (%)	2	4	6	6	6	25	25	20	10
E	.33	.55	1.6	1.9	3.1	4.6	4.6	6.4	4.6
P (loss)	(.04)	.02	.73	.79	1.2	1.2	2.1	2.1	(.69)
K**	.03	.06	.83	.81	1.0	.81	.53	.03	.01
n (%)	36	39	39	35	35	35	35	35	35
LP	.026	.045	.87	.64	.85	1.2	1.2	1.0	.78

Note:- Where not indicated, the unit is Le Million

*central bank discount rate

** Include Salaries and allowances of the Manager, Accountant and the credit guarantee cover.

Source:- YRB's audited statements of account, and BSL records.

Table 6.24 **Computation of SDI for YRB**

ITEM	1985	1986	1987	1988	1989	1990	1991	1992	1993
1. Average annual borrowed funds = A (LeM)	.71	.60	.60	.60	.84	.64	.64	.60	1.80
2. Market (reference) interest rate* = (LeM)	12	14	16	16	16	55	55	45	30
3. Interest rate paid by RBs = C	10	10	10	10	10	30	30	25	20
4. Subsidy on concessional rate of borrowing = A(M-C) (LeM)	.014	.024	.036	.036	.050	.16	.16	.12	.18
5. Annual Average Equity = E (LeM)	.33	.55	1.6	1.9	3.1	4.6	4.6	6.4	4.6
6. Subsidy on equity = (E*M) (LeM)	.04	.077	.256	.304	.496	2.53	2.53	2.88	1.38
7. Miscellaneous Subsidies** = K (LeM)	.03	.06	.83	.81	1.0	.81	.53	.03	.01
8. Profit = P (losses) (LeM)	(.04)	.02	.73	.79	1.2	1.2	2.1	2.1	(.69)
9. Total Subsidy = (4+6+7-8) (LeM	.124	.141	.392	.360	.346	2.3	1.12	.93	2.26
10. Interest income = LP*n (LeM)	.0094	.018	.339	.224	.298	.42	.42	.35	.273
11. SDI (%)	**1319**	**783**	**116**	**161**	**116**	**548**	**267**	**266**	**828**

Note:- * Central bank Discount rate

** Include tax exemption, salaries and allowances of Manager and Accountant and cost of donated vehicle, and Credit Guarantee Cover).

Source:- YRB's audited statements of accounts and BSL records

Table 6.25 **Assumptions for Calculating SDI for MMRB**

Item/Year	1988	1989	1990	1991	1992	1993
A	0	0	6.1	56.5	21.0	23.3
M* (%)	16	16	55	55	45	30
C (%)	10	10	30	30	25	20
M-C (%)	6	6	25	25	20	10
E	.19	.05	.48	(1.0)	(3.1)	(6.7)
P (loss)	(.21)	(.4)	(1.1)	(3.9)	(7.1)	(10.9)
K**	.015	.012	.012	.01	.014	.015
n (%)	35	36	37	36	36	35
LP	.06	.20	1.4	4.7	13.2	6.0

Note:- Where not indicated, the unit is Le Million
*Central bank discount rate
** Include salaries of Manager, Accountant, and Credit Guarantee cover.

Source:- MMRB's audited statements of account and BSL records.

Table 6.26 **Computation of SDI for MMRB**

Item	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**
1. Average annual borrowed funds = A (Le)	0	0	6.1	56.5	21.0	23.3
2. Market interest rate = M* (%)	16	16	55	55	45	30
3. Interest rate paid by RB = C (%)	10	10	30	30	25	20
4. Subsidy of concessional borrowing rate = A(M-C) (LeM)	0	0	1.53	14.13	4.2	2.33
5. Annual average equity = E (LeM)	.19	.05	.48	(1.0)	(3.1)	(6.7)
6. Subsidy of equity = (E*M) (LeM)	.030	.008	.26	(.55)	(1.39)	(2.01)
7. Miscellaneous subsidies = K** (LeM)	.015	.012	.012	.01	.014	.015
8. Profit/(loss) (LeM)	(.21)	(.4)	(1.1)	(3.9)	(7.1)	(10.9)
9. Total subsidy = S ((4+6+7-8) (LeM)	.255	.42	2.91	17.49	9.92	11.24
10. Interest income = LP*n (LeM)	.021	.072	.52	1.69	4.75	2.1
11. SDI (%)	**1214**	**583**	**560**	**1035**	**209**	**535**

Note:- * central bank discount rate
** includes salaries of manager, accountant and Credit Guarantee cover

Source:- MMRB's audited statements of account and BSL records.

Table 6.27 **Assumptions for Calculating the SDI for MRB**

Item/Year	1988	1989	1990	1991	1992	1993
A	0	0	.011	0	0	0
M* (%)	16	16	55	55	45	30
C (%)	10	10	30	30	25	20
M-C (%)	6	6	25	25	20	10
E.	.27	.74	2.33	.56	.56	.56
P. (Loss)	(.49)	(.17)	(.17)	(4.6)	(4.6)	(4.6)
K**	.03	.15	.12	.10	.03	.01
n (%)	36	35	35	36	36	36
LP	.08	.58	1.4	3.4	2.7	3.7

Note:- Where not indicated, the unit is Le Million
* Central bank discount rate
** Include salaries, allowances for the Manager,
Accountant and the Credit Guarantee cover.

Source :- MRB's audited statements of accounts and BSL records.

Table 6.28 **Computation of SDI for MRB**

Item	1988	1989	1990	1991	1992	1993
1. Average annual borrowed funds = A (LeM)	0	0	.011	0	0	0
2. Market interest rate = M* (LeM)	16	16	55	55	45	30
3. Interest paid by RB = C (%)	10	10	30	30	25	20
4. Subsidy on concessional rate borrowing = A(M-C) (LeM)	0	0	.003	0	0	0
5. Annual average equity =E (LeM)	.27	.74	2.33	.56	.56	.56
6. Subsidy of equity = (E*M) (LeM)	.043	.12	1.282	.308	.252	.168
7. Miscellaneous subsidies = K** (LeM)	.03	.15	.12	.10	.03	.01
8. Profit/(Loss) (LeM).	(.49)	(.17)	(.17)	(4.6)	(4.6)	(4.6)
9. Total subsidy = (4+6+7-8)	.563	.44	1.58	5.01	4.88	4.78
10. Interest income =LP*n (LeM)	.03	.20	.49	1.22	.97	1.33
11. SDI (%)	**1877**	**220**	**322**	**411**	**503**	**359**

Note:- *Central bank discount rate.
** These include tax exemption, salaries of Manager and Accountant and Credit Guarantee cover.

Source:- MRB's audited statements of account and BSL records

Table 6.29 **Assumptions for calculating the SDI for KRB**

Item/Year	1987	1988	1989	1990	1991	1992	1993
A	.048	.60	.60	.85	.85	.60	.60
M* (%)	16	16	16	55	55	45	.30
C (%)	10	10	10	30	30	25	20
M-C (%)	6	6	6	25	25	20	10
E	.56	.81	1.84	8.38	8.38	8.6	8.6
P	(.10)	(.034)	(.98)	(13.5)	(13.5)	(8.1)	(8.1)
K**	.05	.02	.02	.01	.01	.01	.02
n (%)	36	37	35	36	38	35	35
LP	.11	.10	.41	21.5	4.70	2.89	10.65

Note:- Where not indicated, the unit is Le Million

* Central bank discount rate.

** Include salaries and allowances of Manager and Accountant, and Credit Guarantee cover.

Source:- KRB's audited statements of accounts and BSL records.

Table 6.30 **Computation of SDI for KRB**

Item	1987	1988	1989	1990	1991	1992	1993
1. Average annual borrowed funds = A (LeM)	.048	.60	.60	.85	.85	.60	.60
2. Market interest rate = M* (%)	16	16	16	55	55	45	30
3. Interest rate paid by RB = C (%)	10	10	10	30	30	25	20
4. Subsidy on concessional rate of borrowing = A(M-C) (LeM)	.003	.036	.036	***	.213	.12	.06
5. Annual average equity = E (LeM)	.56	.81	1.84	8.38	8.38	8.6	8.6
6. Subsidy on equity = (E*M) (LeM)	.089	.130	.294	2.10	4.61	3.87	2.58
7. Miscellaneous subsidies** = K (LeM)	.05	.02	.02	.01	.01	.01	.02
8. Profit/(Loss) (LeM)	(.10)	(.034)	(.98)	(13.5)	(13.5)	(8.1)	(8.1)
9. Total subsidy = (4+6+7-8) (LeM)	.242	.22	1.33	15.61	18.33	12.10	10.76
10. Interest income =LP*n (LeM)	.04	.04	.144	***	1.79	1.01	3.73
11. SDI (%)	**605**	**550**	**924**	***	**1024**	**1198**	**288**

Notes:- *Central bank discount rate.

**These include, salaries & allowance for Manager and Accountant and Credit Guarantee cover

***SDI not computed for this year. The Manager claimed that 7/8 of these 'overdrafts' have been recalled but not yet in the accounts as the matter is still under investigation.

Source:- KRB's audited statements of accounts and BSL records.

Table 6.31 **Summary of SDI for YRB, MMRB, KRB and MRB (%)**

RB	1985	1986	1987	1988	1989	1990	1991	1992	1993
YRB	1319	783	116	161	116	548	267	266	828
KRB	...	...	605	550	924	***	1024	1198	288
MMRB	...	...	...	1214	583	560	1035	209	535
MRB	...	...	...	1877	220	322	411	503	359

Note:- ***SDI is not computed because of the distortion caused by the cheque incident.

Sources:- Computed from Tables 6.23 to 6.32

However, the Subsidy Dependence Index isolates these costs and uses them in the computation to arrive at a close approximation. We have used the Central Bank's discount rate 'M' to be able to determine the extent of subsidy on the concessionary funds received by an RB. The BSL charges the RBs a modest rate, 'C'. In addition, the rural banking policy (BSL, 1980) provided that the BSL would make a loan of Le 0.6 million to a RB at the commencement of its operations. The 'A' (in the model) includes this amount. It should be noted that not all the RBs received this loan.

6.50 **Results of SDI analysis**

From the analysis, the RBs are highly subsidy dependent (Table 6.31). Their SDIs also indicate the magnitude of the subsidies they have received. For any of the RBs to be subsidy independent they would have had to increase their on-lending interest rate to the

Table 6.32 **New On-Lending Interest Rate to allow RBs to be Subsidy Independent**

RB	1985	1986	1987	1988	1989	1990	1991	1992	1993
YRB	511	344	84	91	76	227	128	128	325
KRB	...	...	254	241	358	***	427	454	136
MMRB	...	...	...	460	246	244	409	111	222
MRB	...	...	...	712	112	148	184	217	165

Notes:- The new interest rate is calculated by: [(n*SDI)+n]

*** A new on-lending rate is not computed because of the distortion caused by the cheque incident.

Source:- Computed from Table 6.32

level indicated for the particular year (Table 6.31). For example, for YRB to have been subsidy independent in 1985, it would have had to charge borrowers 511 per cent on loans. This new lending rate is arrived at by multiplying the on-lending interest rate (n) by the SDI and adding the result to the on-lending interest rate. Thus the interest rates that would have made RBs subsidy independent or self-sustainable are given in the Table 6.32. Although we only have data for four RBs out of the eight in operation, we can reasonably assume that the others have also been kept afloat by subsidies because all RBs operate under an identical policy environment and received the same services from the BSL. Therefore, RBs in Sierra Leone would have had to raise their interest rates substantially if they were to become subsidy independent i.e. self-sustainable.

As discussed earlier, it is unclear what impact an increase in interest rates would have on savings mobilisation, demand for credit or loan recovery. Furthermore, a reduction in loan delinquency and expansion of operations into remote rural areas may not be sufficient to eliminate subsidy dependence (Yaron, 1992b). Wider issues relating to the economy including market infrastructure (roads network etc.), input supply, output marketing and less government interference need to be addressed to provide the RBs with a more conducive environment before questions of subsidy independence can be seriously entertained.

The absence of adequate emphasis on institution building (a common characteristic of supply-leading RFMs in LICs) constitutes the difference between an institution that will depend permanently on subsidies and one that can eventually attain self-sustainability (Yaron, 1992a). The RBs in Sierra Leone are in the first category. They have devoted few resources to adequate and appropriate training for both staff and

customers, management information systems, staff incentives and savings mobilisation drives.

6.51 Conclusions

The analysis in this chapter has shown that none of the RBs in Sierra Leone can be considered viable. All of them exhibited considerable weaknesses in their operations. Outreach (savings mobilisation and lending) has been limited by several factors including a hostile economic environment, lack of mobility and poor management.

The ownership of the RBs which was to be spread among a large number of rural residents has been concentrated in the hands of a small percentage (0.66 per cent) of target population. The percentage of the population reached, in terms of loans, has been below 5 per cent. The rural banks have concentrated their loan portfolio in trade and mining to the disadvantage of agriculture. The concentration of loans in the trade sector and share capital in the hands of a few clients tends to suggest that there has been some credit rationing in RBs.

Outreach in terms of savings mobilisation has also been low. The reasons for this low outreach involve a number of factors which the RBs cannot possibly solve on their own. The economy has been hostile during the mid 1980s to the first three years of this decade. Inflation has ranged between 72 and 110 per cent (1985-1993), while savings and lending rates have been negative in real terms, leading to an erosion of the RBs' capital and loan portfolio. High transaction costs of RBs have also contributed to low levels of outreach and overall achievement.

High transaction cost are related to poor management and or mismanagement of resources which can be linked to the poor calibre of staff and poor training of both the

Directors and the RB staff, as well as, poor supervision by the Bank of Sierra Leone (Harrison, 1990).

High transaction costs incurred by borrowers create an added disincentive for customers to take advantage of services offered by the RBs. The transactions costs of the RBs themselves also placed added obstacle to expanding operations.

The above factors contributed to low levels of achievement and hence to the high subsidy dependence observed. Rural banks' financial intermediation role is therefore questionable. It could reasonably be concluded that rural banks have been largely ineffective in the rural financial market. They also failed not only to counteract the so-called 'evil deeds' of the moneylender but also failed to attract clients from them.

Overall, RBs have not met their objectives and the high subsidy dependence indicates that they have been incurring huge losses. Their mode of operation has also tended to discourage potential clients. For example, the long time spent in appraising loans is a disincentive to would be clients.

Some RBs are on the verge of introducing innovations such as a school deposits scheme, group voluntary accounts and restrictions on the amount granted as loan in relation to the amount in the individual's or groups' deposit account. It is unlikely that these measures would ensure subsidy independence. What can the government of Sierra Leone, the central bank and owners of the rural banks do to save these RBs from collapsing and to make them self-sustainable? These issues, among other things, are the subject of the next chapter.

PART THREE FINDINGS AND CONCLUSIONS.

Chapter VII Restructuring the Rural Financial Market in Sierra Leone

7.00 Introduction.

This chapter summarises the main findings of the research and field studies on the operations of the rural financial market (RFM), particularly the rural banks (RBs), moneylenders and the *osusu* in Sierra Leone. It is divided into four sections, the first of which begins with a discussion on the problems and constraints of supplying credit to rural residents in Sierra Leone comparing, as it progresses, the modes of operation of the RBs, Moneylenders and the *osusu*. The second section discusses the main findings of the research, focusing on five major aspects: outreach (access), transaction costs, default, interest rates and viability using the results of the regression and SDI analysis carried out in Chapters Four and Six respectively. Other findings will be highlighted as far as they apply to the level of achievement of these rural financial intermediaries. Section three lays down guidelines for a model of co-operation between the two sectors of the RFM, with a view to enhancing the supply of credit and rural financial intermediation. The final section concludes the chapter.

7.10 Problems and Constraints of Supplying Credit to Rural Residents.

The supply of credit to rural residents in Sierra Leone over the last four decades has been a difficult task. The policies that were adumbrated did not produce the desired results. Government intervention in the form of subsidies and influence over the direction of credit created distortions as well as problems and constraints in the credit market.

7.11. Problems Affecting the Supply of Credit

The problems and constraints of credit supply can be viewed from several perspectives. The debate on the role of the informal credit sources in LICs has usually been tainted with emotion, lack of facts and limited understanding of the role they play and their mode of operation in the rural areas (Barton, 1979; Adams, 1980; Von Pischke, 1981; Bouman, 1981). The assumed existence of monopoly profit and the 'vice-like grip' of informal sources, especially moneylenders, has been part of the rationale for establishing specialised credit programmes such as rural banks to dispense cheap credit (Bouman, 1981, p. 2; Adams, 1984). But rural borrowers tend to prefer moneylenders to RBs for their credit needs for several reasons (Adams, 1980). The loan portfolios of the latter do not accommodate non-production loans. According to Johnny (1985), subsistence credit forms between 65 and 70 per cent of the credit needs of rural residents in Sierra Leone. In Zimbabwe and Zambia, 87 and 43 per cent respectively, of farmers' subsistence credit needs are met by informal sources (Germidis, 1990). Moneylenders do not discriminate on the end-use of loans. To them, the assurance of repayment is more important (Bouman, 1977).

Another problem of credit provision in Sierra Leone is the high administrative costs associated with the small size of loans demanded and the numerous and widely dispersed nature of borrowers in the rural areas. Hence supervision and follow-up are very costly. The lack of adequate mobility for RB staff further exacerbates the problem. Moneylenders' experience of such problems is minimal, because they are typically part of the 'rural landscape', residing and working along-side their clientele in the rural areas

and frequently in contact with them in other markets. Thus, they have more information about borrowers compared to rural banks and their transaction costs tend to be lower.

A related problem associated with formal lending in Sierra Leone, as in other LICs, therefore, is the information asymmetry. A lender's willingness to lend to a particular borrower may depend on having enough information (as in the case of moneylenders[70]) and to have confidence in a borrower's ability and capacity to make repayments (Aleem, 1990). Such information is not readily available to RBs and other formal credit institutions; and it is very costly to collect and interpret. There are no references from which to determine the creditworthiness of borrowers and no complementary institutions to provide such information, as is the case in developed countries. In contrast, moneylenders continually collect information through their interaction with borrowers and potential borrowers. Thus, while RBs face adverse selection and moral hazard problems, moneylenders minimise such problems mainly through credit/market interlinkages. Our survey of moneylenders revealed that over 60 per cent were engaged in credit/market interlinkage. In other words, moneylenders have more information about clients and potential clients, as well as, the opportunity for developing trust, confidence and better understanding of each other's circumstances.

Due to red-tape and cumbersome bureaucracy, RB customers complain about delays in the disbursement of loans. In addition, transport and opportunity costs are also high for farmers living far away from an RB, whereas almost zero transaction costs are incurred by a farmers borrowing from moneylenders. The moneylender also provides social support to clients in times of disaster or bereavement. Ninety per cent of

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[70] See Chapter Four for details.

respondents in our samples (both customers and non-customers of RBs) reported that the village moneylender contributes to both social and cultural events affecting his or her clients. Formal institutions do not provide such services. Their loan portfolios do not make provision for such events.

Rural banks, moreover, face risk of default by one or more large borrowers which can introduce systemic risk and endanger the whole financial system. The Kunike Rural Bank cheque incident[71] is a case in point. What aggravates the default problem is the lack of enforcement mechanisms. The problem is further exacerbated by the absence of well defined property rights in the rural areas of Sierra Leone due to the communal land tenure system[72]. Moneylenders' experience of default is much lower compared to formal institutions. While moneylenders reported default rates ranging from 1-6 per cent, RBs experienced defaults of between 36 and 72 per cent[73]. Farmers readily honour their debt obligations to moneylenders to avoid loss of creditworthiness and respect in the community (Due, 1983) and to ensure access to loans the following year (Stickley and Tapsoba, 1980). In addition, moneylenders use socio-cultural methods to enforce repayment even after the death of a borrower. For example, in rural Sierra Leone, debt obligations are inheritable, so that the unpaid debts of the deceased are passed on to his or her survivors. This is demonstrated in a small ritual that usually takes place before a deceased person is buried. Before the burial ceremony, two important questions are asked: Who does the deceased owe? Who owes the deceased? Even where these questions are not asked, lenders are known to alert relatives to the deceased person's

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[71] See Chapter Six for details.
[72] See Chapter Three for more details.
[73] See Chapters Four and Six.

outstanding debt obligations[74]. In this way, outstanding debt obligations are identified and new arrangements made to effect repayment. Thus, socio-cultural sanctions may persuade individuals to repay loans where RBs are unable to do so (Udry, 1990a). The above findings and discussion tend to suggest that moneylenders are more effective credit agents in rural areas than formal institutions have proved to be. There are, however important constraints that undermine the smooth functioning of both formal and informal credit institutions in Sierra Leone to which attention must be drawn.

7.12 Constraints Affecting the of Supply Credit.

Some of the constraints formal credit institutions face in rural Sierra Leone are associated with the lack of enforcement and a harsh economic environment. Government has been reticent on the issue of foreclosure on loans in rural areas. It could, therefore, be concluded that government is part of the problem. Government-backed credit programmes have experienced high default rates since credit organisation began; but no defaulter has ever been successfully prosecuted or foreclosed (Deen, 1977; Johnny, 1985; Reddy, 1985). Part of the reason may be that loans are concentrated in the hands of large, politically influential farmers and other economic operators. Because of the smallness of Sierra Leone rural society, default tends to have a demonstration effect. As a result, borrowers take out loans in the well-founded expectation that they will not be obliged to repay. Consequently, one could suggest that borrowers have come to regard credit as their own share of the 'national cake'. The failure to impose sanctions weakens incentives for borrowers to invest in good projects and strengthens those for rent

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[74] Culturally, rural people believe that the consequences of unpropitious action(s) of a family member can haunt the whole family. Creditors or people who have been offended usually seek quick redress by threatening to invoke a 'curse' (African voodoo) on the whole family. Moneylenders use this method with good effect to enforce repayment.

seeking. Given the political constituencies that government has to serve, it is unlikely to be able to enforce repayment in programmes that it backs.

Operations of formal credit institutions are further constrained by the harsh macro-economic conditions that have characterised most African countries, including Sierra Leone, over the last two decades. The drastic devaluation of the local currency, the Leone, accompanied by an inflationary upsurge from 1985 through 1992,[75] greatly reduced the funds available to RBs and other formal credit institutions. RBs have only been kept afloat by huge subsidies[76] and revaluation of physical assets. Formal financial institutions cannot increase interest rates because of the ceilings imposed. If these funds were operated, for example, by *osusu* clubs, the rate of circulation would have been faster, repayment periods shorter and there would have been fewer or no cash assets to depreciate. The *osusu* tends to be superior to formal credit institutions in several respects. It is adaptable to the circumstances of members and tends to be less costly (Adams, 1990; Bouman, 1994). There are no accumulated assets and therefore the temptation to be dishonest is minimal. The *osusu* combines savings with credit and demonstrates types of relationship that are conducive to the participation of the poor. Relationships are built on behavioural norms which ensure that participants are both accountable and disciplined[77].

Other constraining economic factors include urban-biased pricing policies (sometimes prices are artificially controlled to appease urban dwellers), poor extension services to bring new technology to producers and poor market infrastructural

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[75] See Chapter Three for details
[76] See Chapter Six for details
[77] See Chapter Five for more details.

development. Improvements in production technology may raise physical yields; but such changes do not result in corresponding increases in farm incomes unless marketing facilities, input supplies and prices create incentives to ensure the effective use of credit (Schultz, 1977; Brown, 1978). A number of commentators agree that production and equity objectives of credit programmes are often defeated by poor marketing conditions and urban-biased price policies. Credit per se is a weak instrument for promoting agricultural development if these distortions and constraints are not removed or minimised.

In Sierra Leone, public investment in agricultural research, extension and infrastructure development has been decreasing in real terms over a number of years (Dahniya, 1993). Feeder roads that were constructed by IADPs have not been maintained. A study by ABCO (1980), revealed that 96 percent of the road network in the country as a whole, was in a state of disrepair. For LICs, including Sierra Leone, investment in infrastructure has alluring benefits. Where communication and other types of market infrastructure are inadequate, an increase in their supply can do much to boost productivity and growth. But where income and productivity are depressed by inadequate infrastructure, the financial resources needed to underwrite investment are difficult to mobilise (Eichengreen, 1995). Pricing policies have tended to be urban biased and infrastructure neglected, rendering agriculture unprofitable (Dahniya, 1993). Under such conditions, credit will be ineffective even at very low interest rates.

7.20 **Findings of the Research**

Despite the optimistic view of the role RBs were expected to play in financial intermediation, the reality has been disappointing. This is not surprising. Based on an

extensive review of available literature on RFMs in Sub-Saharan Africa, Meyer, Graham and Cuevas (1992) concluded that:

> "The supply-leading approach has been shown to have several fundamental weaknesses. It ignored savings mobilisation and created a dependency syndrome in which lenders became dependent on cheap government and donor funds. It created rent seeking opportunities in which non-targeted borrowers used political influence to gain access to cheap funds. Financial Institutions were undermined because they were often not allowed sufficient margins to cover their costs and risks. Finally, credit was treated as an input in production so its value as a fungible resource was ignored" (p. 13).

The results of our study of RBs in Sierra Leone tend to lend support to the above conclusion. Like most other FFIs in the rural areas of countries in sub-Saharan Africa, RBs in Sierra Leone have been weakened by inflation, financial repression, high default rates and the absence of a strong legal and regulatory framework. The overall result has been low outreach, high transaction costs, and a high dependence on subsidies derived mainly from the central bank. Although there is no universal method of assessing the level of achievement in rural financial institutions (Yaron, 1992a), this study uses Outreach and the Subsidy Dependence Index (SDI) to examine levels of achievement.

7.21. **Outreach.**

The level of achievement of RBs in terms of outreach (savings mobilisation and lending) has been low. In terms of savings mobilisation, the four RBs studied reached only 6,524 or 2.4 per cent of the target population of 272,535 within their service areas during the period 1985 to 1993 inclusive (Table 6.7). The total volume of savings mobilised was Le 306.1 million (US$ 527,586),[78] with an average size of Le 46,919 (US$ 80.9). Even this relatively low level of savings of the target population tends to rebut the traditional assumption that there are no savings in the rural areas. But internal

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[78] The average exchange rate in 1993 was Le 580/US$ (Bank of Sierra Leone, 1993)

problems and external constraints have militated against the broader mobilisation of potential savings. Apart from the Kunike Rural Bank (KRB) which has an Agency at Masingbi, about 15 miles away from its headquarters, no other RB has established a second office. Rural banks in Ghana, the Grameen Bank in Bangladesh, the Co-operative d'epargne et de Credit in Togo, and the Credit Unions in Cameroon, to name but a few, have developed savings mobilisation schemes, involving mobile units and agents to reach potential clients in remote areas (Thillairajah, 1993). In contrast, rural banks in Sierra Leone rely on customers to travel to the bank and effect transactions. Considering the low percentage of the population reached, it is not unrealistic, however, to suggest that the RBs could have increased savings considerably if more savings mobilisation drives had been mounted using, for example, mobile units to reach potential clients in remote areas. Even acknowledging constraints, Rural bank staff seem to have settled down to a quiet or even venal life, providing no competition for moneylenders.

There are other factors associated with the low savings mobilisation in RBs in Sierra Leone. Firstly, the nominal interest rates for savings have been below the rate charged by commercial banks (Tables 3.3 and 6.11). They have also been below the rate of inflation, suggesting a negative real rate of return on savings (Table 3.3). It could be deduced that potential savers may have preferred to hold their savings in the form of value-appreciating real assets, since these may provide superior returns to those of fixed rate financial assets and are a more efficient way of hedging against inflation. The initial increase in savings observed (Table 6.5) may have been induced by the need to be eligible for loans. This conclusion is supported by our interview with managers and the large number of dormant accounts observed in the books of RBs (Table 6.6). In the four

RBs we studied, there were 1,040 dormant accounts representing about 16 per cent of the total number of accounts. The volume of the savings in these dormant accounts was 3.2 per cent of the total volume of savings in the four institutions. Our interviews with managers and loans officers further revealed that most of these dormant accounts were opened to fulfil one of the criteria for loan eligibility, which is that an individual will only be granted a loan if he or she has bought shares, or opened an account with an RB (Bank of Sierra Leone, 1984). Consequently, some of these accounts ceased to operate after their holders have acquired a loan. Secondly, potential savers were holding out and waiting to see if RBs were reliable. Our interview with non-customers of RBs (the control sample in our survey) revealed that potential savers were suspicious of formal financial institutions, following their experiences with co-operative societies and IADPs. Mismanagement and corruption within co-operative societies left many farmers disillusioned (Samura, 1978 and Johnny, 1985). In addition, falsification of accounts and inflating debt repayments due from illiterate farmers in the AIDPs also left farmers with the impression that formal financial institutions are run by corrupt and dishonest officials (Johnny, 1985). This lingering distrust of institutions associated with government also tends to dissuade people from exposing their assets in a way which, they fear, might invite interference, control and taxation. This conclusion was also reached by Abebe (1987), who added that:

> "Consequently, African economies remain severely under-monetised, so depriving countries of the opportunity to make use of large amounts of development capital available literally at their doorsteps (op. cit.: p.11).

In contrast, the operations of the informal financial sector (mainly moneylenders and the osusu clubs) are carried out in an atmosphere of trust and intimate knowledge of the parties concerned. In many respects, "its distinguishing characteristic, which in fact is also its primary rationale, is the informal nature of its activities" (Chandavakar, 1984). Almost free from central bank and government controls, moneylenders operate with a degree of flexibility which cannot be matched by RBs in their present form.

Another factor which should not be ignored is the effect of the on-going 'rebel war' which has affected over three-quarters of the countryside. The instability caused by this war has affected major production areas and has also had the effect of savers converting their savings (financial or real asset) into foreign currency in the black market in readiness to flee the war affected areas or the country. Two RBs (MOARB and DRB) have already suspended operations on account of this 'rebel' war.

Despite their poor performance, however, two positive effects of RBs are observed. One is the inclusion of women clients. Another is that they have brought new clients to the formal sector who were not serviced by other financial institutions. In this respect, RBs have made a net contribution to rural financial intermediation.

But in order to analyse intermediation, we related loan volume to the volume of savings. The ratio of depositors to borrowers is 1:2.8 (Table 6.7) which suggests, according to Gurgand et al. (1994), that savings options are unattractive. The ratio of savings to loans is 1:1.8, suggesting an over-extension of loans. The loans-to-deposit ratios are high and they may be too high for prudential liquidity management. Inadequate training and lack of refresher courses for RB staff in the art of financial management and monitoring of lending costs are contributory factors. Another reason

may be political pressure on RBs to grant huge loans to influential and wealthy clients regardless of the costs involved. The over-extension of loans may also have been caused by 'agricultural demand illusion' which is a consequence of low interest rates on loans (Ladman and Tinnermeier, 1983). The high loans-to-deposit ratios cannot, therefore, be reasonably interpreted as an indication of good financial intermediation.

The objective of spreading the ownership of RB shares widely among rural residents has not been realised. If we exclude Classes 'A' and 'B' shareholders,[79] the number of indigenous shareholders (Class 'C' shareholders[80]) in all the eight RBs was just 3,765 (as at December, 1993), representing 0.66 per cent of the target population within their service areas (Table 6.1). It should be noted that some of these shares were bought by wealthy and influential rural and urban residents in the names of their relatives to circumvent the policy which states that "an individual will not be allowed to own more than Le 40,000 worth of shares" (BSL, 1984). Our interviews with Managers and Loans officers of RBs revealed that some of these relatives do not know that they own shares in these institutions. Considering the small proportion of the target population owning shares, and the fact that some of these so-called shareholders are 'proxies', one could conclude that, ownership of RB shares has been concentrated in the hands of a few wealthy and influential people. The concentration of ownership of RBs' shares may have also influenced decisions about the allocation of loans.

Outreach in lending has also been low. Total loans extended (Table 6.9) by the four RBs for the period 1985-1993 inclusive, was Le 572 million (US$ 986,207 at 1993

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[79] Class 'A' share are reserved for the Bank of Sierra Leone (the central bank) and Class 'B' shares for other financial and development institutions operating in the area serviced by an RB.
[80] Class 'C' share are for the indigenous people resident in and hailing from the designated service area of an RB.

prices). The number of loan beneficiaries as at end December, 1993, was 21,020 or 3.7 per cent of the target population in the designated service areas of the eight RBs. The average size of loan was Le 31,000 (US$ 53.4 at 1993 prices), which is inadequate to cultivate 1.5 acres of upland rice farm[81]. It should be noted that most loan beneficiaries of formal financial institutions in LICs are repeat borrowers (Adams, 1979). According to the managers and loans officers of RBs, this applies to at least 65 per cent of loan beneficiaries. Therefore, if we reasonably assume that 60 per cent are repeat borrowers, the estimated proportion of beneficiaries in these four RBs is below 3 per cent of the target population. This observation lends support to the World Bank's (1974) conclusion that in Africa, less than 5 per cent of the rural residents have access to formal credit.

Taking the four RBs as a whole, the policy of allocating 40 per cent of the loan portfolio to the agricultural sector was not achieved. The sector received about 13 per cent of the total loan portfolio (Table 6.12), while mining received 63.9 per cent of total loans funds extended. This sector is dominated by wealthy and influential businessmen who may have taken advantage of the low interest rates to create an agricultural demand illusion. Mining was not among the priority sectors to be financed by the rural banking scheme. One could, therefore, suggest that the RBs have been engaged in some credit rationing. The quantum of loans extended to marketing (agricultural and general trade), also dominated by wealthy and influential people, could also be the result of credit rationing. The average size of loans to this sector for the four RBs studied, was Le 60,000 compared to an average size of Le 31,000 for agricultural production loans. It should be noted that the agricultural sector is dominated by small and poor farmers. It is

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[81] The predominant ecology for rice farming is the uplands. According to the FAO (1992), estimated cost for cultivating an average of 1.5 acres of upland rice is Le 60,000.

also instructive to note that three out of the four RBs studied granted loans to members of their Boards of Directors (BOD). The number of members of BOD for these three RBs, excluding the central bank's and other institutions' representatives, is 19 representing 0.09 per cent of total loan beneficiaries. The total volume of loans to these Directors was Le 2.31 million or 1.7 per cent of their total loans of Le 135.4 million[82] (US$ 233,448.3) granted from 1985-1993 (Table 6.16). The average size of loan was Le 121,600 (US$ 209.6) compared to an average size of Le 31,000 (US$ 53.4) for agricultural loans. This means that a few wealthy individuals received disproportionately large loans, while poorer borrowers received smaller loans. This conclusion tends to support the Iron Law of Interest Rates Restrictions (Gonzalez-Vegas, 1984), which states that:

> "When interest-rate ceilings become more restrictive, the size of the loans to non-rationed borrower classes increases, while the size of the loans granted to the rationed borrower classes diminishes" (op cit., p. 86).

It can, therefore, be concluded that RBs have engaged in credit rationing and in general have not achieved their objectives of making credit more widely available to the rural population.

Outreach (savings and lending) has been very low and influenced by a combination of factors that can be grouped into two categories. The first is internal factors which include lack of mobility, low moral and poor incentives for staff. The second is external factors relating to the unstable economic and political environment. Such factors include high inflation, low and restrictive interest rates on loans and savings, low technology, low output prices and a poor marketing infrastructure. All of

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[82] This amount excludes loans made by the Kunike Rural Bank.

these factors combined to constrain outreach. However, the above factors are not exhaustive. This study identified four more, which are the focus of the subsequent sections.

7.22. Default

The default rates in the RBs have been on an institutional life-threatening scale since their inception. The highest default rate of 72 per cent, recorded in the KRB, was mainly a result of the cheque incident mentioned earlier. The other three RBs, however, also had high default rates ranging from 35-38 per cent (Table 6.15). In contrast, moneylenders reported default rates ranging between 1-6 per cent[83]. Our survey shows that 59 per cent of RB customers surveyed gave 'repayment to moneylenders' as one of the main reasons for default (Table 6.17), suggesting that even with the presence of RBs rural residents still borrow from moneylenders. Respondents explained that they cannot easily escape the moneylender. He/she is always in the village observing clients with 'beady eyes' (Bouman, 1977). He or she is also at the farm gate during harvest to collect payment and also allows repayment by instalments.

About 18 per cent of RB customers reported that 'late disbursement of loans' was also another major reason for default. They explained that because most agricultural production functions such as ploughing and seeding are time-specific, late disbursement led to loans being diverted to other uses. According to the conclusion of the USAID evaluation study[84] which reviewed 50 rural credit projects funded by USAID between 1973 and 1985 in LICs, unsuccessful projects had default rates ranging from 10-75 per cent, with most falling between 25 and 50 per cent. The successful projects had default

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[83] see Table Chapter Four for details.
[84] USAID, 1985, p. 23.

rates of around 0-15 per cent. The rates in partially successful projects were around 20 per cent. On the basis of this conclusion, none of the RBs studied can be judged successful.

Default has several undesirable consequences for rural credit programmes. Most important is that it gradually destabilises the credit system (Von Pischke and Adams, 1983). When defaulters are the big farmers the system becomes unjust inasmuch as they are subsidised by small farmers who repay. Since the cost of administration is high, default further pushes up lending costs without any corresponding increase in loan turnover. Defaults reduce the resource base for further lending, weaken staff morale and affect the borrowers' confidence in the institution. The evidence we collected suggests that the major reason for low rates of default experienced by the moneylender is not coercion but considerable effort and resources invested in obtaining information about the credit worthiness of borrowers. Borrowers were carefully screened and information on defaulters pooled in the market, thereby reducing the risk of default. In contrast, RBs had very high default rates. While political pressure and borrowers' attitudes to repayment may have influenced default in RBs, our assessment is that the main factor was a sub-optimal level of screening by RBs among others.

7.23. Interest Rates

The issue of interest rate has been at the forefront of the debate on credit supply and savings mobilisation in LICs. The thesis of financial repression (McKinnon, 1973; Shaw, 1973) deals with both the supply and demand sides of the RFMs. It proposes that individual savers respond to the reward of holding financial assets conditional on the risk of holding these assets. The interest rate is the reward on savings and inflation is the risk.

This interest-elasticity approach prescribes, therefore, that high real interest rate and price elasticity are the main instruments for eliciting savings. In contrast, cheap credit stifles the growth of formal financial institutions. These two effects are products of interest rate ceilings which do not allow banks to increase their resources through savings mobilisation, Such institutions, therefore, depend on central banks' rediscount windows for loanable funds and become mere credit outlets.

The above analysis tends to explain the operations of RBs in Sierra Leone. Table 6.11, shows savings rates in RBs from 1985-1993 which were 15 per cent from 1985-1990, 20 per cent from 1991 to June, 1993 and 10 per cent as from July, 1993. In comparison, interest rates in CBs (Table 3.3), have been higher than RBs; and also below inflation which has been, on average, 90 per cent per annum between 1985-1993. Negative real interest rates have, therefore, been the norm for most of the period.

Low interest rates have had adverse implications for the RBs. Gonzalez-Vegas (1984), Adams (1984), Von Pischke (1991) and many others have argued that, a low interest rates policy creates excess demand for loans, building up arbitrage pressure and necessitating non-price credit rationing. Interest rate policy of government has a vital role to play in the promotion of repayment. When the real rate is excessively low, as observed in RBs in Sierra Leone, borrowing and consumption will be much more profitable than savings and repayment. According to Padmandhan (1988, p. 40), rural people are rational and do take advantage of attractive interest incomes on deposits. An increase in the interest rate makes current consumption more expensive than future consumption. But it can also be argued that with a higher interest rate the amount of present savings necessary for a given level of future consumption would be less.

Although we do not have enough data to support the above statements, the evidence in South Korea and Taiwan supports the first assumption. When interest rates were increased in these countries, financial institutions mobilised large rural savings. In countries where real deposit rates became negative due to inflation, such as that in Sierra Leone, savings mobilisation has been seriously constrained. Overall, it has been found that financial deposits respond more to real interest rates than national savings, due to the substitution of financial investment for other investments (Fry, 1984). The policy implication, therefore, is to allow interest rates to be determined by market forces.

Although traditional literature associates variation in interest rates with fragmented markets and with the existence of barriers to entry, when it comes to credit markets, the view on rent-seeking takes a special form (Krueger, 1974). Government regulation often imposes, as in the case of Sierra Leone, barriers to entry with interest rate ceilings that are below market rates. The policy implication is deregulation and removal of barriers to entry. But the New Institutional Economics sees fragmentation as a natural outcome of the existence of non-zero transaction costs mostly observed in the informal credit market (Floro and Yotopoulos, 1991).

7.24. **Transaction Costs.**

Transaction costs in RBs include administrative overheads associated with lending and savings mobilisation. These costs covering staff salaries and allowances, establishment expenses, transportation and administrative expenses have been high in the four RBs studied. Transaction costs vary from Le 0.18 to Le 1.36 for each leone lent (Tables 6.19-6.22), or, on average, Le 0.54. Loans were granted by the banks at an average rate of interest of 38 per cent whereas inflation was, on average, 90 per cent

(1985-1993) (Table 3.3); and with a default rate of over 36 per cent, coupled with a high loans to savings ratio, it is not surprising that to stay afloat, RBs depended on subsidies from the central bank (see Section 7.25 below). Neither is it surprising that one of the RBs, the MMRB, was closed down at the end of 1994 due to the depletion of resources as the result of high default rates, low interest rates, mismanagement and the central bank's withdrawal of subsidies. High transaction costs are an obstacle to the development of a financial market and it, however, remains to be seen how long other RBs will continue to operate in the face of this reduction of subsidies and continued interest rate restrictions.

High transaction costs are not limited to RBs alone. Borrowers also incur high transaction costs when dealing with RBs. Table 6.18 provides typical transaction costs facing a customer residing 25 miles away from an RB, showing that cheap credit may not be so cheap after all. Such a borrower pays a real interest rate of 52 per cent compared to an average of 46 per cent when borrowing from a moneylender[85]. Although nominal interest rates are low in RBs compared to those charged by moneylenders, the out-of-pocket expenses and opportunity costs of time incurred by borrowers in carrying out loan transactions are very high. This may be one of the reasons why rural residents tend to prefer moneylenders to RBs. It also suggests that the moneylender does not necessarily receive monopoly rent. The results of our regression analysis of the transaction costs of the moneylenders (Chapter Four) suggest that transaction costs, especially at the level of loans granted, are high. In particular, result of our regression analysis (Chapter Four) suggests that duration of loan and risk of default are positively

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[85] See Chapter Four for details.

correlated to the level of interest rates charged and are significant at the 99 per cent level.

Credit/market interlinkage provides certain advantages for the moneylender. It implies a better basis for observing clients and potential clients and it also helps to overcome the moral hazard and adverse selection problems (Stiglitz and Weiss, 1981; Aleem, 1990). Interlinking credit with input and output marketing services also creates confidence and trust between the two parties in the credit contract. In a situation where marketing infrastructure is poor, and in some places non-existent, the moneylender performs valuable services in input supply and output marketing. Rural banks, in contrast, are not designed to handle input/output marketing. Credit/market interlinkage helps to solve the problem of information asymmetry and tends to serve as a substitute for the missing network of complex legal and market institutional infrastructure that are present in the developed countries (Stiglitz and Weiss, 1981).

These factors suggest that moneylenders are particularly effective channels of credit in the rural areas of Sierra Leone in comparison with formal sector financial institutions. Prohibitive costs in terms of time and inconvenience often make prospective clients shy away form using RBs for loans and deposits. It is important, therefore, for the RBs to reduce transaction costs by improving their techniques, mode, and scope of operations. All of these can combine to influence viability.

7.25. **Viability (SDI)**

It has been demonstrated in Chapter Six, using the Subsidy Dependence Index that RBs in Sierra Leone are not self-sufficient, i.e. that they are not viable in their present mode of operations. Rather, they depend heavily on subsidies from the central

bank. The volume of such subsidies to the four RBs studied are summarised in Table 7.1. In total they amounted to Le 126.053 million (US$ 217,334.5 at 1993 prices), representing 22 per cent of total loans extended or 34 per cent of total savings mobilised from 1985 to 1993 (Table 7.1). The subsidies include salaries and allowances of senior staff seconded to RBs from the central bank, acquisition of funds at below discount rates from the central bank, loan guarantees under the Credit Guarantee Scheme operated by the central bank and tax exemptions. It should be noted that the audited statements of accounts of these RBs do not reflect these subsidies. The use of the Subsidy Dependence Index analysis helps in isolating these costs and allows an analysis that provides a clearer picture of the level of subsidies and hence an understanding of policy that might be redirected to enhance viability. On the basis of such analysis, RBs in Sierra Leone were found to exhibit SDIs varying from 116 to 1,319 per cent. It also shows that for RBs to have been self-sustainable, they would have had to charge interest rates on loans ranging from 84 to 712 per cent (see Table 6.32). The main reasons for this high subsidy dependence are the high default rates and lending rates that are far below inflation.

Table 7.1. **Estimated Volume of Subsidies Received By RBs (Le million)**

Rural Bank	Period	Subsidy (Le Million)
YRB	1985 - 1993	7.973
MMRB	1988 - 1993	42.235
MRB	1988 - 1993	17.253
KRB	1987 - 1993	58.592
Total		**126.053**

Source: Summed up from Row 9 of Tables 6.24, 6.26, 6.28 and 6.30.

A further factor which influenced the high dependence on subsidies relate to the defalcation of accounts reported in some of the RBs[86].

On the basis of our outreach, default, interest rates, transaction costs and viability analysis, it has been shown that RBs in Sierra Leone have performed poorly and are not viable. Their poor performance also raises questions of the quality of internal management and the supervision of the RBs. Supervision of RBs is the responsibility of the central bank. But the latter also has considerable problems. Staffing is insufficient in quality and remuneration is low compared to that in commercial banks. The work of the supervising department is also constrained by the shortage of transport facilities to undertake on-site monitoring; such work, moreover, is often based on poor accounting systems and sketchy and meaningless prudential reports. The paperwork involved is often overwhelming and not enlightening to the supervisor. There is little use of computer or analytical methods for off-site surveillance, while on-site surveillance emphasises compliance of administrative regulations rather than the financial health of the institutions.

Management in the RBs is itself plagued by problems of poor accounting procedures, low incentives, virtually no room for professional advancement, lack of adequate quality training and insufficient transport to carry out essential functions. The net result is low staff morale, a carefree attitude and high staff turn-over, all of which have conspired with other factors discussed earlier to produce low levels of outreach, high default rates and poor financial intermediation. The rural credit market is an integral part of the rural economy, closely linked with other markets. Thus any distortion in the

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[86] See Chapter Six for details.

credit market will spill over into other markets and will influence both the pace and shape of the rural development. The next question therefore is, what can be done to arrest and improve the situation.

7.30. Proposals for Improving Credit Supply and Rural Financial Intermediation.

The objective of Sierra Leone public policy on rural credit has been to ensure cheap and plentiful credit to all rural households. The chosen instruments for these purposes have been first, the creation of special credit programmes, and second, the promotion of co-operatives followed by attempts to cajole the commercial banks and subsequently the creation of the NCDB, NDB and IADPs. Finally, about a decade ago, rural banks were established. But none of these strategies has enjoyed success. The moneylender still outperforms formal credit institutions in the provision of not only credit but essential services to rural residents. The reasons for the failure of government initiatives have already been discussed. It is in this context that public policy needs to be re-examined. This section of the thesis, therefore, draws on different features of the foregoing discussion to propose a model for credit supply, involving both the RBs and informal sector intermediaries to provide comprehensive and effective financial intermediation in the rural areas of Sierra Leone.

7.31. Guidelines.

A world-wide consensus is growing among researchers that formal financial markets are not meeting the needs of small farmers in LICs (Germidis, 1990; Yaron, 1992b; Gurgand et al., 1994; Bouman, 1994; Adams, 1990). But policy makers are still searching for models and concepts to improve the supply of credit on a sustainable basis

and financial intermediation in rural areas of Sierra Leone. This study makes a modest attempt to propose a model for achieving such a goal. The findings and discussion in this study, suggest that four main aspects need to be addressed in order to achieve it. These are, accessibility, self-sufficiency, self-sustainability and a conducive economic environment. These factors are closely interrelated. What is important, therefore, is to achieve an optimum combination of them rather than prioritising one against the other.

7.32 **Accessibility.**

Providing accessibility for the rural disadvantaged is usually an important criterion by which a credit programme can be judged. Several factors influence accessibility. Where banking outlets are situated far away from the clientele, it becomes difficult to forge an effective relationship with them (Abebe, 1994 and 1995). The relationship between the moneylenders and rural residents provides a stark contrast in this regard. Several alternatives are available to increase accessibility of RBs to rural residents. One is to permit RBs to employ private lenders to act as their agents. Under the 'one-man village banker' scheme in Pakistan, for example, a resident of the village is appointed as a banker by the financing institution and he or she is accessible to clients at his residence on a 24-hour basis (Padmanabhan, 1982).

There are a number of well-documented cases of private lenders having been employed by institutional lenders to act as agents in extending and recovering loans. According to Wells (1980), the credit programme of the Agricultural Bank of Malaysia appointed co-operatives, farmers' organisations and private lenders, after screening, to act as agents of the bank. The bank sets the interest rate the agents could charge clients and the commission they received. In the early 1970s, the interest rates were 9 and 6 per

cent for unsecured and secured loans, respectively, with a 3 per cent commission. These arrangements gave farmers a choice of lenders and created an incentive for agents to compete for clients. Wells (1990) noted that the decision to admit private moneylenders into the scheme was controversial; but that their superior performance in utilising lines of credit from the bank and recovering loans vindicated the decision to include them. One problem with this alternative is that if the commission is based on lending alone, enough incentive may not be created to compete for good customers. A way of overcoming this is to base the commission on the rate of recovery of loans they extend and to offer a small salary or allowance to make the burden of the lender's risk tolerable (Miracle, 1973).

Another alternatives to achieving greater accessibility involve mobile banking and flexible hours. The first involves the use of vehicle or transport of some sort and the second relates to keeping the bank or its branch open on special days (market days etc.) and for extended hours. The above alternatives should be determined on the basis of local custom and culture. In Sierra Leone, one or a combination of these alternatives can usefully be deployed to improve accessibility. In addition, lending procedures should be made simple for farmers to understand; and the provision of loans should not only cover production but also consumption needs. A small percentage, between 20 and 30 per cent, can be earmarked for the latter. Again one can recall that the moneylender's operations accommodate both production and consumption credit; and he or she is capable of achieving high repayment rates. Whatever alternative is preferred, frequent and effective monitoring procedures should be developed to discourage corruption which characterised formal credit institutions in the past.

7.33 Self-sufficiency

Self-sufficiency in resources is very important to a credit institution. To achieve this objective three main actions are necessary namely, reducing default rates, mobilising savings and guarding against inflation. Institutions that combine deposit mobilisation and lending become more familiar with their clients' cash flow, savings habits and wealth (Padmanbhan, 1988). This may be true especially for countries with low inflation and can provide positive real rates of return on savings with several savings options. In Sierra Leone, RBs and other formal financial institutions in rural areas do not have diversified savings options. Negative real interest rate returns on savings are more the norm. Thus, information about clients is not available to RBs. To overcome these problems, more savings options similar to the 'pigmy savings scheme' operated by the Syndicate Bank in India or the Grameen Bank's savings mobilisation schemes, which use both group and individual deposits collection procedures, could be deployed (Rahman and Samad, 1993, p. 41). In Cyprus and Mauritius, savings schemes have been introduced in schools to instil the habit of savings from a young age. The school savings scheme in Mauritius is sponsored by co-operatives and supported by government. Women's savings clubs like those in Zimbabwe; and Mobile banks and rural credit agents as known in Pakistan (Aleem, 1990), could also be used to tap the deposits at the doorsteps of rural residents.

In this regard, one recalls the operations of the *Master osusu* in Sierra Leone (Chapter Five), and the methods utilised in mobilising savings of *osusu* members, especially of market women. These *osusu* clubs could also be linked with RBs through providing attractive savings options as is done in South Africa and Ghana (Burman and Lembete, 1995, pp. 25-26). Whatever combination of the above savings mobilisation

strategies is adopted, the procedures for depositing and withdrawal should be made less cumbersome. These formalities should be simplified for the illiterate clients so that their confidence in the formal institutions can be developed. Rural people are usually cautious about letting others know about or handling their money. Thus, the safety of their money, secrecy and continuity of the financial institution are some of the factors that can foster confidence.

No interest rate is universally optimal. However, real interest rates should be positive and high enough to allow lenders to cover operations costs and compensate them for risk. Varying interest rates with the movement in the level of prices in the economy is a useful policy option. This study has shown that the levels of default in RBs in Sierra Leone are very high, and therefore contribute to their lack of viability. If self-sufficiency is to be restored, drastic reductions in default rates will have to be achieved. The first steps in achieving this objective include an improvement in loan appraisal procedures leading to financing good projects, providing transport facilities for field staff, eliminating cumbersome procedures in order to reduce delinquency, and introducing an incentive system for both borrowers and RB staff. The incentive to borrowers should emphasise larger subsequent loans after full repayment of the previous loan has been made and educating them about their responsibilities to the lending institution, about the effective use of credit and the adverse effects of default. For RB staff, incentives should be based on loan recovery performance rather than on achieving lending targets. Rural banks in Sierra Leone have not instituted any kind of incentive schemes for either staff or borrowers. It is, therefore, worthwhile to consider the

experience of the Grameen Bank in Bangladesh,[87] in this regard in order to reduce the default rates in RBs and other formal credit institutions in Sierra Leone.

Rural banking policy should consider linking of credit to input supply and output marketing. Credit/market interlinkage, it should be recalled, enables moneylenders to collect more information about their clients. This puts the moneylender in a better position than RBs in reducing moral hazard and adverse selection problems. Interlinkage also enhances repayment collection performance because the lender is in a position to deduct repayment at source from transactions in another market (Floro and Yotopoulos, 1991). Rural banks and most formal credit institutions in LICs are not structured to handle input/output marketing because of the specialist knowledge required and the need for additional staff. This problem can be solved by encouraging private entrepreneurs to set up input/output marketing outfits. But this calls for a high degree of co-ordination between financing institutions and the input/output marketing outlets. Procedures relating to this should be made less cumbersome and clear to the borrowers. They should know how much they owe, when and how much to repay. Repayment in kind should also be considered. Finally, a sound accounting and management information systems is essential for better repayment procedures. The absence of sound bookkeeping has been a major cause of default in many credit institutions in LICs. According to Padmanabhan (1988), only when the institution knows how much is due, from whom and when due will it be in a position to follow-up loan repayments.

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[87] See Atiur Rahman and Abdu Samad (1993), "Loan Recovery Performance of the Grameen Bank." In Abu N. M. Wahid (ed.), *The Grameen Bank: Poverty Relief in Bangladesh*; pp. 175-190, for a full exposition of the incentive schemes.

7.34 **Self-Sustainability**.

This research has also shown that RBs in Sierra Leone are highly subsidy-dependent and, therefore, not viable in the sense of being self-sustainable. To remedy this situation four main aspects need to be addressed. These are lending rates, borrowing rates, loan turnover and transaction costs. The fixing of lending rates for agricultural development is complex[88]. However, as we pointed out earlier, lending rates should be high enough to cover administrative costs, bad debts and to make a reasonable profit. They should also be positive in order to protect the institution's equity capital and maintain its efficiency in allocating scarce resources. In addition, lending rates should be differentiated and progressive to reflect short-term and long-term loans, as well as, small and large loans.

As Padmanabhan (1988) has pointed out, "higher margin with lower volume would be less profitable than lower margin with higher business in view of the high transaction costs". To increase turnover, 'saturation-lending' may be useful. This involves accommodating large number of clients in all categories, such as small, medium and large, as well as those involved in non-farm activities.

A policy of allowing the financial institution to compete and pay the full cost for external funds should also be encouraged. It is not a bad policy to provide some subsidy for start-up costs. The payment of these should, however, be spread over a number of years to allow the institution to achieve viability within the shortest possible time (Bourne and Graham, 1980 and 1983). The central bank cannot maintain subsidies in

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[88] For a discussion of the fixing of lending rates, see the World Bank (1975, pp. 45-51)
See also Virmani (1982); one of the conclusions of this paper is that credit markets differ fundamentally from the market for goods. Therefore, analysing the loans market according to the theory applicable to the goods market can be misleading.

perpetuity. In other words, there is a limit to the amount and tenure of external sources of funds, particularly concessionary funds. Rural banks will, therefore, be unlikely to be viable and sustainable unless they can raise the bulk of their resources through deposit mobilisation on competitive terms. Most importantly, an aggressive savings mobilisation policy should be adopted in order to increase resources. A sound liquidity management policy should also be made a priority. In this regard, adequate training and refresher courses for RBs staff are very useful measures to be considered. Provision for incentives and professional advancement should also be created. This would help to improve staff morale.

7.35. **The Need for a Conducive Environment**.

This section is devoted to pragmatic issues relating to what can be done to improve the economic environment in order to sustain the supply of financial services to rural residents, as well as to how RBs can to be structured to enhance their financial intermediation role. In order to achieve these objectives, three steps are necessary. These are structural adjustment, financial sector reform and institution building. The Sierra Leone economy has already undergone substantial structural adjustment during the period 1992 to 1994 and the process is continuing under an IMF-sponsored Rights Accumulation Programme. This thesis concentrates on financial sector reforms and institution building.

The macro-economic environment exerts a major influence on both the country's economic performance and on its financial system (Krahnen and Schmidt, 1995). Financial institutions find it hard to operate in the unfavourable economic environment that has characterised many sub-Saharan African countries such as Sierra Leone (World

Development Report, 1989). The principal agencies which should initiate action to create a conducive economic environment are government, the central bank and international donor agencies.

In particular, government should regard the rural financial market as an instrument for allocating scarce resources by instituting suitable macro-economic policies and the production of viable technologies through research should be encouraged. Credit can only play its legitimate role when there are opportunities generated in the economy through technology (Padmanabhan, 1988). But such technology should be appropriate and tested. Testing agricultural technology can be achieved by adaptive or on-farm research to make sure of its appropriateness to field conditions (Richards, 1982 and 1986; Dahniya, 1993). In the Sierra Leone context, it has been recognised that the country has had a long research tradition and considerable appropriate technology has been generated such as new varieties of seed and tubers; but the link between research and the farmer has been weak because of excessive centralisation, poor logistical support and low incentives (Richards, 1986). The extension/farmer ratio[89] which was around 1:800 especially during the IADPs in 1979, dropped to around 1:1,200 in 1990 (FAO, 1992). But a high extension/farmer ratio does not guarantee success (Lele, 1975) and several factors are necessary to enhance extension services. These include farmers' acceptance of the technology, its profitability, extension staff's ability to handle and solve specific and related problems and the separation of credit from extension functions. Given their low levels of income and the vagaries of the weather, farmers' fear of trying

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[89] This is the total number of extension officers to total number of farmers expressed as a ratio.

something new is reasonable although often not appreciated by extension workers and researchers.

An appropriate legal framework is also required to protect the resources of the RFM and to recover outstanding loans. Government officials and politicians should refrain from making pronouncements that imply debt forgiveness or which makes credit appear as government handouts. According to Mbat (1982), the famous banking theorem that 'deposits create advances and advances create deposits' is true only when amounts advanced are fully recovered. A kind of deposit insurance is therefore necessary to protect the resources of both lenders and savers. In addition, linking formal with informal lenders can help to strengthen enforcement, improve loan recovery and financial intermediation.

Supporting services such as input supply, training and infrastructure are other aspects of reform. A poor marketing infrastructure contributes to high production costs and low profit margins (FAO, 1992). Along with the possibility of crop failure (Richards, 1986), these add up to unacceptably high risks which lenders, such as commercial banks, understandably shy away from. Cheap credit cannot undo these deficiencies and many credit programmes operating in such environments meet with failure (World Development Report, 1989). It would not be unrealistic, therefore, to surmise that these deficiencies may have contributed to the poor performance of RBs in Sierra Leone. Some rural credit experts including those in the World Bank (World Bank, 1989.) have recommended that these facets of rural development should be part of a single programme. Without feeder roads and efficient means of transport, farmers will find it difficult to get their produce to the market and reaching the RBs will involve additional

costs and time, thus increasing borrowers' transaction costs. With poor communication facilities, access to information becomes limited. It is therefore incumbent on government to devote more resources to improving the market infrastructure. More specifically, existing feeder roads should be repaired and new ones constructed to link production areas. Market centres should also be constructed to facilitate the exchange of goods, services and information. This could improve producers' bargaining power.

High transaction costs are an obstacle to developing financial markets. Monetary and other costs tend to limit the services financial intermediaries are able and willing to offer. Prohibitive costs in terms of time and inconvenience can cause prospective clients to shy away from using financial institutions. It is, therefore, important for the intermediary to reduce transaction costs by improving their techniques, mode, scale and scope of operations. Although there are moves towards instituting regulations and procedures to improve operations, little effort has been devoted to devising management information systems with a view to improving efficiency, probity and loan portfolio management.

The liberalisation of interest rates and the removal of sectoral ceilings could enhance financial intermediation by channelling savings to higher yielding investments. The restructuring of financially distressed RBs, introduction of training programmes for their employees and improvement in supervision by the Bank of Sierra Leone can also enhance the soundness of future banking activities and increase confidence in the banking system. Ghana's financial sector reform and institution building programmes[90] can serve as a model for Sierra Leone to improve its financial system.

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[90] See S. Thillairajah (1993) for more details.

To achieve the above objectives, a detailed review of rural financial services, including those provided by the informal sector, should be undertaken as part of the country's financial sector reform. It is central to the argument pursued in this thesis that a better understanding of the informal financial system can provide insights into how to develop suitable formal financial services in rural areas. The informal financial sector already performs in a noteworthy fashion and should be encouraged to grow, diversify and integrate with the formal sector institutions. The long-term strategy for rural financial sector development should, however, be to improve and expand the formal financial system, concentrating on savings mobilisation which does not rely on external sources for long-term lending resources, and adopting a 'savings-deposit-led' strategy as opposed to the past 'supply-led' approach.

Much could be learned from the informal financial sector. It has been successful in the past in providing cost-effective and convenient savings/deposit facilities to rural residents, and has proved a dependable and ready source of loans without bankable/realisable collateral. Many of the services offered and some of the instruments used by this sector could be adopted, with modifications if need be, by RBs and other formal financial institutions. In this regard, Pattern and Rosengard (1992) have suggested that:

> "emulation instead of elimination of the informal financial system, and complementing instead of supplementing should be the strategy for policy makers in efforts to develop the formal financial sector".

Emphasis should also be placed on the autonomy of financial institutions. This implies that the lender should have the right to say 'no' to risky loan requests, and to any

borrower whose debt repaying capacity is low. Non-agricultural loans and loans to small- and micro-enterprises for any viable income-earning activity should be incorporated into the loan portfolio, thus diversifying risk and facilitating rural development.

7.36. Proposed Rural Banking Model

On the basis of the findings of this study and the guidelines discussed above, the salient features of the proposed model for successful rural banking in Sierra Leone are outlined as follows:

Rural banks should continue to operate as joint-stock companies. However, some changes are now necessary to enhance their operations, accessibility, self-sufficiency and viability.

(A) Organisation:

There should be a 7-person Board of Directors constituted as follows:

(i) 4 Members representing Indigenous shareholders (Class 'C' shares), 2 Members representing the Bank of Sierra Leone/Development institutions[91], and 1 Member representing Rural Bank Agents (see paragraph C below).

(ii) There should be a fair representation of women on the Board to reflect their increased participation in RBs and their good repayment record compared to male borrowers.

(iii) The local loans committee should be replaced by a RB Agents Committee[92].

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[91] According to Bank of Sierra Leone (1984), Development institutions mean any institution - co-operative society, credit union, commercial bank, self-help organisation etc. - operating within the area serviced by an RB.

[92] The RB Agents Committee will perform the function of the local loans committee because it will be is made up of local residents who live, know and work with clients of the RBs. They will, therefore, have more information about prospective clients.

(iv) The Bank of Sierra Leone should strengthen its supervisory role. It should sell off its shares as soon as the demand for them is established. This would mean giving up its veto powers and concentrating on supervision.

(v) Names of shareholders should be published to discourage the use of 'proxies' for circumventing of the rule that limits the amount of shares one individual can hold in an RB.

(B) Savings Mobilisation

One of the major objectives of the RBs should be savings mobilisation. This should be achieved by an aggressive savings mobilisation policy through,

(i) mobile banking to reach prospective clients living in remote areas.

(ii) school savings schemes to instil the habit of savings in school children.

(iii) groups savings schemes on the lines of the Grameen Bank in Bangladesh.[93] This measure should be aimed at linking *osusus* and other self-help groups with RBs.

(iv) opening for extended hours and on special days such as market days and on festive occasions.

(v) allowing some agents to mobilise savings.

(C) Provision of loans

Accessibility should be of paramount concern to the RBs.

(i) To improve accessibility, RBs should appoint agents resident in the villages after thorough screening and such agents should be shareholders in the RB.

(ii) Where they can be identified, moneylenders should be encouraged to become agents because of their superior knowledge of rural residents and their proven performance.

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[93] See M. Hossain (1988: pp. 33-34).

(iii) The number of agents should, however, depend on the size of the area and or the number of Chiefdoms serviced.

(iv) There should be a fair number of women agents both because of the proportion patronising rural banks and because of their superior repayment record compared to men.

(v) Agents should be represented on the Board of the RBs[94].

(vi) A salary and or a commission should be paid to an agent. This would serve as an incentive and compensation for the risk and services performed. The commission should, however, be based on recovery performance rather than on the quantum of loans extended.

(vii) Agents should meet regularly to share experiences and receive new decisions and or directives from the Board through their representative.

The use of agents has several benefits for RBs, the borrowers and the agents themselves. For the RB, dealing with agents would reduce administrative costs. The knowledge of the agents about their locality and its residents would also become available to RBs at minimum cost and this would help in selecting low credit risk borrowers. It would also help in the financing of good projects. Furthermore, agents would be in a better position to use socio-cultural methods to enforce repayment, thereby reducing default. Agents would have to compete for good borrowers. By having a seat on the Board, the institution would be able to liaise with agents, share field problems with other Board members and assist in policy formulation to enhance rural bank operations. On the whole, administrative and monitoring costs could be reduced,

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[94] The choice of the Agents' representative to the RB Board of Directors could be done either by the Agents themselves of by the RBs, using as a criterion, the recovery performance of Agents.

accessibility increased and financial intermediation improved. For the borrowers, accessibility would be improved and alternatives made available. Borrowers and agents would benefit from training programmes organised to teach simple record keeping skills, effective use of credit and the impact of default on the RB and the rural economy. Agents would also benefit from exposure to more sophisticated financial decisions.

(viii) Saturation lending should be explored. Farm and non-farm enterprises, small and large loans, as well as, short, medium and long-term loans should be included in the RB's loan portfolio. It should however be noted that extension of medium, long-term and large loans[95] should be handled by the RBs initially, until the performance of agents has been certified as satisfactory.

(ix) Group lending should be encouraged because of its benefits in minimising moral hazard and adverse selection problems, reducing default through joint and several liability peer monitoring and increasing accessibility to financial services. Groups should be kept small (five to ten members) to reduce group monitoring costs.

(D) Need for a Rural Bankers Association

Rural Banks should form an association as is the case in Ghana. This organisation should provide a forum for the exchange of ideas and experiences related to problems in operations in rural banking in particular and commercial banking in general. In the medium to long-term the association could liaise with other institutions and donor agencies on behalf of RBs with a view to facilitating the exchange of ideas and information.

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[95] Short-term loans have a duration of one year or less, Medium-term loans have a duration of between one and two years and Long-term loans are those with a duration of two to five years.
Large loans are those exceeding Le 100,000 for an individual and Le 500,000 for groups.

(E) The Role of Government and the Central Bank

The role of government has already been defined in Section 7.314. In general government should be a facilitator and should not be seen to intervene in how the market allocates resources. The central bank's role should be confined to monitoring and supervision. In addition, it should organise seminars to discuss issues related to rural financial markets and the operations of RBs. It should collect and disseminate information relating to relevant policy decisions affecting banking in general and rural banks in particular.

(F) The Role of Donor Agencies[96] and Non-Governmental Organisations.

In this model, the role of International Donor Agencies (IDAs) and Non-Governmental organisations (NGOs) are limited to institution-building. This entails helping the RBs to improve operations by providing training in all aspects of credit operation for staff, technical assistance to improve management information systems and exchange visits to similar institutions in other countries. Rural bank Agents and borrowers could also benefit from such training provided by IDAs and NGOs.

Figures 2 and 3 illustrate the kinds of reform required and the proposed rural banking model advocated for improving the effectiveness of RBs in financial intermediation. It must be emphasised that the proposed model demands a high level of co-ordination, monitoring and supervision of Agents to ensure that borrowers are not charged more than the interest rate recommended by the RB. This monitoring could be done during savings mobilisation drives or at meetings and training sessions with clients. It is envisaged that a successful restructuring and operations as outlined above would

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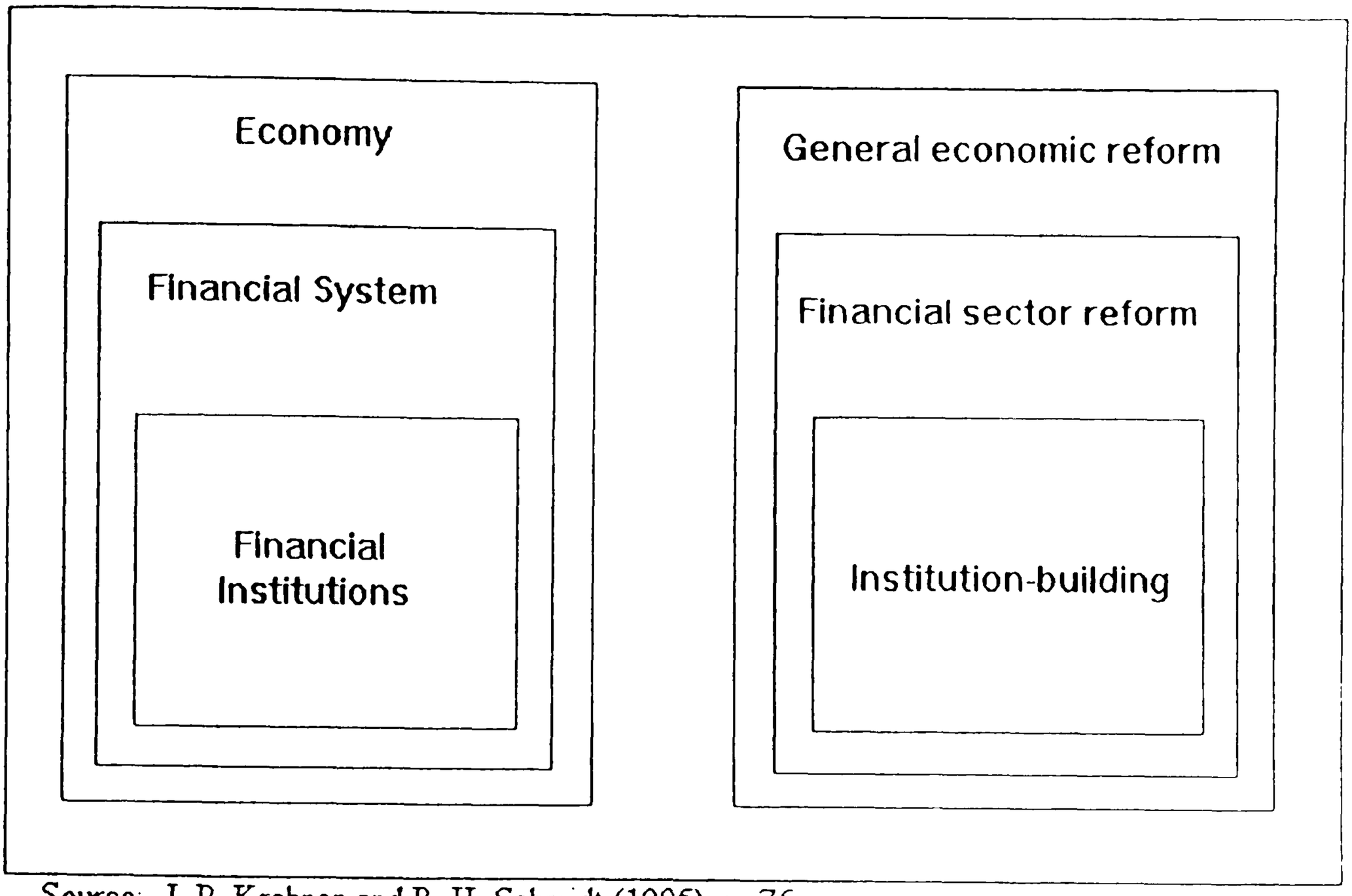
[96] IDAs refer to international banking institution and friendly governments.

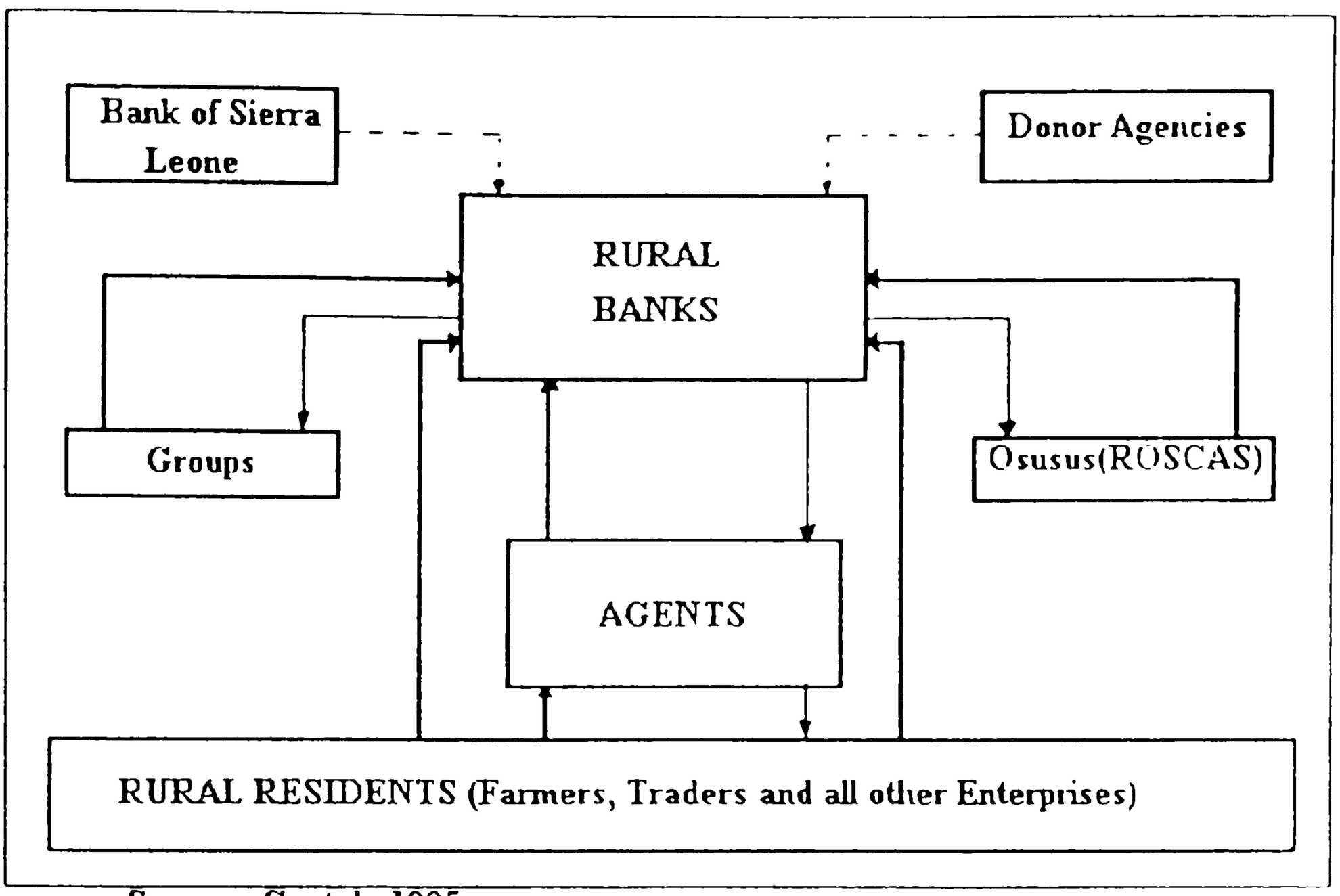
Figure 1. Economy, finance and institution-building: structure and reform



Source:- J. P. Krahnen and R. H. Schmidt (1995), p. 76

Note:- The two halves of this schema represent on the left, the economy, the financial system and the financial institutions operating within it and on the right, the type of measures necessary for creating a conducive environment for improving the operations of financial institutions. In Sierra Leone, for example, general economic reform is in progress under an IMF-sponsored SAP. In addition, we have recommended that the whole financial sector be examined with a view to identifying the kinds of institutions as well as the constraints and problems within which they operate and necessary reforms instituted. Moreover, the institutions themselves need to be strengthened (institution-building) through staff training, improving management information systems etc., in order to improve their operations and the services they provide.

Figure 3 Proposed model for Rural Bank Financial Intermediation



Source:- Conteh, 1995

KEY:-

——→ Savings Mobilisation.

——→ Lending operations.

- - - - → Supervision and Institution-building

improve savings mobilisation, credit supply and financial intermediation on a viable and sustainable basis in the rural areas of Sierra Leone.

7.40 **Conclusions.**

The study has revealed that RBs have not achieved the objectives for which they were set up. Outreach in terms of the proportion of the population reached has been below five per cent for both savings mobilisation and lending. A larger proportion of the loans went to larger and wealthier rural residents, suggesting that the RBs have been engaged in credit rationing. Thus the analysis tends to support the Iron Law of Interest-rates Restrictions, which is a consequence of low and restrictive interest rates that are below the rate of inflation. The low proportion of clients mobilised and the high loans to savings ratio suggests that RBs do not have attractive savings options and that there is considerable room for increasing savings if more savings mobilisation drives with attractive interest rates were offered.

The objective of spreading the ownership of RBs has not been achieved. Less than one percent of the rural residents own RB shares. It should be noted, moreover, that some of these shareholders are 'proxies' for wealthy and influential rural and urban residents, suggesting that the control of the RBs may have been in the hands of the latter.

Viability of RBs has been low due mainly to low savings mobilisation, high default rates, and high operating costs. All of these factors made RBs to be highly subsidy-dependent. The overall poor performance of RBs has been caused by a variety of factors, chief among which are, the volatile economic climate, a restrictive interest rates policy, lack of mobility of RBs staff, political interference and the effects of the on-going 'rebel' war.

In contrast, the informal financial sector (mainly moneylenders and *osusu* groups) has been performing relatively better. The default rates they experience are low mainly due to living in close proximity to their clients and the information they possess about rural residents which enables them to screen and eliminate bad risk borrowers. They are therefore, in a better situation than RBs to minimise the moral hazard and adverse selection problems. Although nominal interest rates charged by them are higher than those of RBs, transaction costs incurred by RBs' clients in contracting loans is high, and when these costs are computed, they produce higher real interest rates than those charged by the moneylenders. This suggests that moneylenders do not necessarily reap monopoly profit. It can also help to explain why rural residents tend to prefer them to RBs. On the other hand, the provision of other services such as interlinking credit with input/output marketing gives moneylenders further opportunity to weed out bad credit risks and attract more customers. The discussion has also shown that *osusu* clubs are also effective financial intermediaries demonstrating relationships that are more conducive to the participation of the poor.

. Against the background of the findings of the study and the discussion, any restructuring of the formal financial market, particularly the of RBs, should involve not only the overall economic reform but also financial sector reform and a linking of the formal with the informal sectors in the RFM. While it must be acknowledged that the on-going 'rebel' war, militates against these changes being carried out in the immediate future, it must be stressed that if the restructuring is delayed, rural banks may be wiped out before too long.

Chapter VIII Conclusion: Recommendations and Suggestions for Further Research

8.10 Conclusions

What have we learned from the analysis of the operations of the RBs, moneylenders and the *osusu* about the RFM in Sierra Leone? The rural financial market in Sierra Leone is influenced by a complex interaction of socio-economic factors and to get a better understanding of it we have taken a simplified view of reality. In our simplified world, we have focused attention on the operations of rural banks, moneylenders and the *osusu*; and we have been able to support some theories relating to the operations of RFMs in LICs. We have also been priviledged to gain considerable insight into how RBs operate, why they have repeated some of the mistakes of past credit schemes and why they have not been able to fulfil their objectives in enhancing economic development.

The macro-economic environment exercises a major influence on a country's economic performance and also has a significant impact on its financial system. In the last decade, the Sierra Leone economy has been volatile with high inflation, overvalued exchange rate, high budgetary deficits and lower than equilibrium administered interest rates on both savings and loans, leading to negative interest rate income. The market infrastructure is poor and in some places non-existent. Rural banks have been operating under this harsh economic regime since 1985. It is no wonder, therefore, that their levels of outreach have generally been low. It is also no wonder that RBs had to be heavily subsidy-dependent to in order stay afloat.

We are not advocating that government does not have a legitimate role to play as regards rural credit. But government's role should be a catalytic one, providing a conducive environment for the development of the financial sector. Rural banks have not fulfilled the objectives for which they were set up due partly to too much government presence and the lack of its commitment to legislate and enforce repayment. The target population, mainly the small farmers, has not benefited from the explicit and implicit subsidies, which have rather benefited the affluent borrowers, mainly through larger loans and credit rationing.

Profits reported in the profit and loss account of RBs are not necessarily indicative of their financial viability. We have demonstrated by using the Subsidy Dependence Index (SDI) that none of these RBs was viable. To achieve viability they would have had to charged interest rates in excess of 500 per cent for loans. The reasons for their high subsidy-dependence are many and interrelated. A financial intermediary's role is to provide credit, savings facilities and other financial services. By helping to transform the size and maturity of financial assets, it provides a medium of exchange between financial clients. It collects savings from many small depositors and makes the funds available to the borrowers who need loans to finance their investment. Rural and commercial banks and other formal financial institutions in Sierra Leone, however, have not been successful in reaching small borrowers or savers. A combination of effects, which is a result of interest rate ceilings, high transaction costs associated with lending small amounts of money to widely dispersed people who have no formal credit history, limited collateral and high default rates has provided these lenders with little or no incentive to reach low-income clients. On the savings side, the mobilisation of small

deposits from rural clients has been administratively costly. Thus, for both demand and supply reasons, the result has been that RBs have not been able to serve the weaker section of the rural population.

This weaker segment is made up of numerous small farmers who form the majority of the rural population. Their limited access to and distrust of formal financial institutions, including the RBs, has led them to rely on the informal sector, especially the moneylender. Our study has shown that the informal sector's mode of operation creates an ambience which accommodates the varied needs of this weaker segment of the rural population. The transaction costs incurred in dealing with the informal sector (e.g. in acquiring loans) is very low compared to that of dealing with RBs. The period of waiting to acquire a loan is also low in the informal sector compared with that of the RBs. Whereas in the former loans can be acquired within a range of 1-3 days, with the latter it takes 3-4 weeks. Although nominal interest rate for loans in RBs is low compared to moneylenders, the real interest rate paid by a borrower residing, for example, 25 five miles from a RB is higher that the average interest rates observed for moneylenders. This is due mainly to the out-of-pocket expenses (transport costs, bribes, entertainment etc.) and the opportunity cost of time incurred in contracting a loan. This partly explains why rural residents tend to prefer moneylenders to RBs for credit facilities in rural Sierra Leone.

Against this background, our analysis seem to suggest that the cheap credit provided by RBs is not cheap after all. It also suggests that the moneylender does not seem to reap monopoly profits as the traditional assumptions suggest. Our analysis shows that the level of interest rates observed in the moneylenders' credit operations is

positively correlated with the cost of information collection about potential borrowers, his perception of default and the interlinking of credit with other markets such as the purchase and sale of other goods and services. It should be noted that the interest rate is also influenced by the harsh economic climate that prevailed throughout the 1980s and the instability caused mainly by the on-going 'rebel' war.

The constraints and problems we identified though not insurmountable, have also created impediments for self-sustainable credit supply and financial intermediation. It appears, therefore, that the RBs were doomed to fail even before they started to operate because these obstacles were in place before the rural banking scheme was launched. In the absence of the kind of assessment that this study has undertaken, policy makers seem to have been unaware of the impact these obstacles have on the operations not only of the RBs but also of the rural financial market as a whole.

It is therefore envisaged that this study can serve as a 'wake-up' call for policy makers to reassess rural banking and credit policies before the mistakes are replicated in the move to establish yet more RBs in the countryside. It is also expected that an awareness of the need to restructure the rural financial market can lead to the creation of a conducive economic environment which will nurture self-sustainable and viable RBs and other similar credit supply and savings mobilisation institutions beneficial to the rural sector and the economy as a whole.

8.20 Recommendations

On the basis of our analyses and the broader literature reviewed, we make the following unprioritised recommendations:

1. The macro-economic and financial environment should be reviewed and restructured to provide a conducive climate for efficient intermediation. Distortions generated by urban-biased policies should be removed in preference to compensating part of the agricultural sector indirectly with subsidised credit.

2. Ceilings and restrictions on interest rate should be removed to allow RBs and other formal financial institutions to cover their high operating costs, adjust earnings to changes in inflation and progress towards achieving subsidy independence.

3. Government intervention in the operation of RBs and other formal financial institutions should be avoided and their management allowed to implement sound banking practices.

4. A significant amount of resources should be devoted to institution-building at all levels, emphasising training and the introduction of appropriate management information systems.

5. The mobilisation of savings should be emphasised with a view to achieving self-sustainability.

6. Group lending should be encouraged and adequately designed with a flexible delivery service.

7. Support to women for income-generating activities should be part of the programme. This would help to capitalise on the positive features of women's behaviour with regard to finance, including their emphasis on savings, greater discipline in loan repayment and respect for group obligations. Women should therefore be encouraged to place their savings with RBs which would help them to build a banking relationship and financial history that would be useful in future. Those with very small savings should be

encouraged to join groups. The strength in numbers could be adopted in helping women to participate in group loans and joint liability schemes to improve their access to lending institutions.

8. Incentives for borrowers, savers and staff should be adequately designed and objectively followed.

9. New policies, methods and modes of operation should be evolved in respect to changes in the economy.

10. Legal and enforcement frameworks should be introduced to enable RBs and other financial institutions to protect their resources as well as those of savers.

11. Strict prudential regulations for rural banking activities should be enacted and enforced. In this regard the central bank has a huge role to play. It should only intervene at the central bank level and not at the borrower level and it should concentrate on supervision and providing training to improve the quality of services provided by RBs. The 'assumed' responsibility of managing RBs should be relinquished. The central bank as an institution is not designed to assume this responsibility.

12. Support for private entrepreneurship and risk taking in the agricultural sector and micro-enterprise should be encouraged through sustainable credit operations which would help financial intermediaries reach a larger number of rural households, including farmers and women. Such operations should be undertaken in the context of financial sector reforms designed to improve the allocative efficiency of financial intermediation.

13. Liberalisation of interest rates, reduction of credit rationing, strengthening of credit institutions and improvement of collection rates are objectives that should feature

prominently on the agenda, with a view to improving access for small borrowers and depositors in rural areas.

In pursuing the above goals, caution should be exercised on stereotypical reform of the financial sector or the standardised adoption of types of innovations from other settings; because a solution in one socio-economic environment may not constitute the appropriate approach for providing financial services to the rural area of another environment. Thus, it is necessary to carry out thorough investigation to determine validity and appropriateness before introducing any new programme.

8.30. Suggestions for Further Research

This study has generated some findings relating to the present modes of operation of RBs and moneylenders. Most of the issues identified can, on their own, become major topics of research. As a follow up action, however, we suggest that the following investigations be carried out in the immediate future to complement this study.

(a) Review the existing banking laws, regulations, circulars and government policies affecting branch/unit banking operations to determine the incidence of their impact on different banking entities, thereby explaining the role of policy measures in the structure, conduct and performance of the banking system.

(b) Review and evaluate the organisational structure and manpower needs of the financial sector as well as their adequacy in performance in the light of the recommendations of this study.

(c) Assess training facilities, plans and programmes for staff as well as programmes for client development in all phases of branch/unit operations.

(d) Evaluate policies and procedures involved in bank planning, budgeting, promotion, banking services, technical services and community relations.

(e) Assess the impact of the new regulatory environment that has resulted from the evolving deregulatory measures (the SAP) recently embarked upon by the central bank and the government

(f) Identify and examine the role of supporting services and institutions (MAFF, etc.) in providing a conducive environment for the successful operation of financial institutions as well as for institution-building.

(g) Although RBs are not designed to handle input/output marketing, an evaluation of the impact this would have on financial intermediation should be carried out. This research should examine specifically what the impact would be if RBs were allowed to float their own input/output companies, conjointly, in their areas of operation through financing or encouraging private entrepreneurs to organise input/output marketing outfits.

(h) Appraise the allocative efficiency role of the informal sector, i.e. moneylenders and other self-help financial groups (e.g. *osusu* clubs), their private and social productivity and in particular the extent to which they alleviate inefficiencies that stem from too tightly or inappropriately controlled credit allocation by the formal sector.

(i) Quantify the volume of savings mobilised by *osusu* groups in the rural areas with a view to proposing appropriate measures for attracting such deposits into the rural banking system.

(j) Determine to what extent a change in the regulations governing RBs behaviour (e.g. allowing more portfolio diversification, different reporting systems etc.) would allow them more freedom to act like commercial banks and improve their viability.

While the above research questions are by no means exhaustive, they include some of the pertinent issues that need to be addressed in relation to the restructuring of the RFM in Sierra Leone. We are, however, aware that because of the present conflict in Sierra Leone, a far-reaching restructuring of the sort recommended is unlikely to be carried out immediately. But if delayed, the rural banks may become yet again, another failed attempt at credit supply in the rural areas.

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