INFORMAL FINANCIAL MARKETS: THE CASE OF CAMEROON

Hermann Logang, Calvin Shipley** &K. Michael Casey****

Abstract: Informal financial markets play an important role in providing capital in less developed countries. This paper presents the organization of such markets and provides examples of how these markets operate concurrent with the formal financial sector. Specifically, the paper provides a case study of the informal financial markets in the country of Cameroon.

INTRODUCTION

Castells and Portes (1989) define an informal economic sector as an "unregulated income-generating" sector "in a legal and social environment in which similar activities are regulated." In such a sector, producers and consumers ignore the rules and regulations of the formal sector. The informal sector simultaneously encompasses flexibility and exploitation and is essentially an "underground" micro economy of markets for goods and services.

Adams (1992) indicates that in this micro economy, individuals or groups of individuals may also lend or borrow money to satisfy financial needs. The informal financial sector that will be examined in this paper is very common in less developed countries and is an important source of financing for many small businesses in the informal sector. This paper will present and analyze the characteristics and relationships of the informal financial sector in Cameroon.

DESCRIPTION OF THE INFORMAL FINANCIAL MARKET

According to Adams and Ghate (1992), there are some Important contrasts between formal and informal financial markets yet they exist side-by-side and in many instances complement each other. The informal financial sector functions outside the regulations imposed on the formal sector with respect to capital, reserve and liquidity requirements, and rate ceilings on loans and deposits.

An informal financial sector exists, in part, because it satisfies consumer demand for services which are not provided by the formal financial markets. Informal financial markets tend to be more convenient with lower transactions costs than the formal markets.

Adams (1992) indicates that women in some less developed countries have a higher propensity to save but due to cultural factors, find it difficult to enter the formal financial market for deposit services. In addition, formal financial institutions often specialize in long-term loans of large amounts requiring collateral and they ignore the market demand for small, short-term, unsecured loans. Due to their low income, the majority of inhabitants of less developed countries are not regarded as credit worthy by the formal financial sector (Adams and Ghate, 1992).

The informal financial sector serves small farmers, retailers, entrepreneurs, and individual borrowers and lenders from nearly every socio-economic category. It provides deposit services and small loans for short-term purposes, although both intermediate and longer term

* Graduate student, Henderson State University
** Associate Professor, Henderson State University
*** Associate Professor, (Finance) Henderson State University, Arkadelphia, Arkansas, USA.

financing can be arranged. Individuals or groups accept deposits and lend to other people and groups may work on the basis of rotating savings and credit associations (ROSCAs). Whatever the classification of players, informal borrowing and lending is characterized by face-to-face transactions and flexibility with respect to the structure of debt, interest rates, collateral requirements, rescheduling maturity periods, and the qualification process. The flexibility and amorphous nature of the informal financial sector, along with the unusually close working relationship between borrowers and lenders, enables foffilallenders to reduce transaction costs to levels that are usually well below those of the foffilal sector (Adams, 1992).

Advantages of the Informal Financial Sector

The informal financial sector owes its ubiquity in the less developed economies to several factors. The informal sector is remarkably flexible with respect to structuring credit arrangements. It is an unregulated market and therefore, is not encumbered by the rules and regulations of the formal sector. In addition, the informal sector is characterized by its ability to respond quickly to market conditions. The most important role of the informal financial sector is to fill the void created by the restrictions of the formal sector. According to Adams (1992), among the comparative advantages enjoyed by the informal sector are its lower transaction costs, broad market reach, ability to respond quickly in extending credit, flexibility in packaging and distributing credit, and its ability to take advantage of cultural biases peculiar to specific regions.

Disadvantages of the Informal Financial Sector

From the individual lender's or borrower's point of view, a major disadvantage might be the lack of ability to pursue legal action. If disputes arise, there is no legal recourse. Informal financial markets tend to deal with this issue by making these transactions in a more personal face-to-face arrangement. The borrower and lender may have a great deal of informal but valuable information about each other.

From a broader, policy point of view, informal financial markets may not be capable of funding major projects which are necessary for economic development. The existence of the informal sector makes it difficult to implement monetary policy because a significant portion of the money supply is not included in economic statistics. Finally, the income generated by the informal sector is not a part of the tax base and governments' potential tax revenues are reduced. For these reasons, governments of less developed countries have frequently practiced the policy of providing cheap credit through formal credit unions. The objective of such a policy is to bring an increased share of funds into the formal financial sector. However, Basu (1994) indicates that this policy typically fails to achieve its desired result.

INFORMAL MONEY MARKETS IN CAMEROON

The terminology commonly used to define informal financial markets in Cameroon is "tontine" in the francophone provinces and "djanggis" in the anglophone provinces. The "tontine" is named for Lorenzo Tonti, a Neapolitan banker who started similar a scheme in France in 1653, although it may have existed in Italy earlier. Each subscriber paid an amount into a fund and in return received dividends from the money invested. As each person died, his share was divided among all the others until only one member was left, reaping all of the dividends. In the original scheme, the capital reverted to the government when the last subscriber died. Originally, the idea was developed to fund buildings and other public works. Later, there were private schemes in which the last survivor got the capital as well. Seibel (1996) indicates that these "tontines" were eventually banned because there was too much incentive for subscribers to kill each other to increase their share of the fund or to become the last survivor, claiming the capital. Today, in Cameroon, the "tontine" is used differently. In fact, the financial crisis that shook the French-speaking African countries in the late 1980's revealed the inability of formal financial institutions (copied on the western model) to provide sufficient deposit and credit services. This led to the growth of informal financial institutions - "tontines" or Rotating Savings and Credit Associations (ROSCAs.) There are various forms of ROSCAs but each of them is founded on traditional values such as mutual aid or conviviality. These groups accept deposits and grant loans to individuals who have often been rejected by formal financial institutions. There are three different market types in which these institutions function-the mutual informal money market, the commercial informal financial market, and the bidding informal money market. The following sections will review the characteristics and describe the operation of each of these market forms.

Importance of informal finance in Cameroon

A brief summary of the Cameroon economy is provided in the Table 1. Indicators show that after some difficulties in the late 1980's and early 1990's, the economy of Cameroon has, in recent years, been quite healthy.[1]

Table 1: Summary of Cameroon's Key Economic Indicators

World Bank classification	Lower income
Population	$13,396,000 (1997)
GDP	$9,115,000,000 (1997)
Real GDP growth	5% (1998)
Average annual inflation	6.4% (1990-1997)
Inflation	1.5% (1997)
Bank leading rate	22% (1998)
Gross national savings	15.9% of GDP (1997-98)

[1]http://www.newafrica.com/economy/Cameroon.asp

Table 1: Continued...

World Bank classification	Lower income
Change in broad money	7.8% (1997 – 98)
Central bank discount rate	7.5% (1997-98)

Sources:
http://www.newafrica.com/business/environment/Cameroon.asp and
http://www.newafrica.com/economy/Cameroon.asp

However, conditions in the formal banking and financial sector are less encouraging. While the banking system is regulated by the Banque des Etats de l' Afrique Central (BEAC) which sets rates on lending and borrowing, there have been a series of financial difficulties, the most recent in 1998. A major restructuring a decade ago has not alleviated the problems. Since 1989, nine banks have been liquidated, closed or merged with other banks. Only seven full-service banks remain in operation in the entire country. Plans are underway to restructure four of the remaining banks and liquidate another. Banks in Cameroon have overextended credit and are now under strict requirements and close monitoring to correct the situation.[2]

Cameroon's banking and financial institutions have suffered tremendously since 1986. Given the lack of confidence in these formal institutions as well as the tight controls instituted to correct these problems, it is not surprising that informal savings and lending institutions are very important to individual small businesses in Cameroon. Because of the informal nature of these markets and because there has been little interest in such markets until recently, there is very little hard data on these institutions. However, the limited information available consistently indicates such informed institutions are extremely important.

[2] http://www.state.gov/www.about_state/business/com_guides/1997/Africa/cameroon97.html

Van den Brink and Chavas[3] analyze data from an earlier field study in Big Babanki, a village of approximately 3500 people located 30km from Bameuda, the capital of the North West Province. They include data that allows the comparison of formal and informal market participation for this case study. Table 2 summarizes the key comparisons.

Table 2: *Comparisons of Formal and Informal Market Participation*

	ROSCA (informal)	Credit Union (formal)
Membership (as % of) heads of households	At least 90% (675)	Less than 30% (200)
Number of loans	650 approximate	37
Annual turnover (in US dollars)	47,000	3,800

Van Den Brink and Chavas note that the Credit Union is one of the few examples of a formal credit that has been sustainable. The authors also reported, based on anecdotal information from informants that very large ROSCAs were essential for financing in Western Cameroon. In addition, Adams (1992) reviewed a variety of studies on informal financial markets and reported that the total volume of finance handled by informal

ROSCAs might be greater than the amount in the formal banking sector. Thus while there exists little quantitative data to measure the importance of informal finance in Cameroon, the available information seems to indicate it is extremely important in the Cameroon economy.

[3] Rogier Van den Brink and Jean-Paul Cleavas Economic Development and Cultural Change. University of Chicago Press. Chicago; July 1997; Vol. 45, Issue 4, p. 745

The Mutual Informal Money Market

The mutual informal money market is the oldest and most common informal financial market in Cameroon. This market is based on the solidarity of its members with the key assumption being that participants are honest and they know each other very well. Participants are generally close friends, neighbours, colleagues, and/or family members.

In the mutual informal money market, a group of people meets and decides to collect a certain amount of money, a subscription, from each member. At each meeting, the total amount is lent to a participant on a rotating basis. This loan is without interest. The amount of money each member contributes is determined by a mutual agreement before the process begins. The subscription amount takes into consideration each member's resources and may vary from member to member. Each participant commits to his/her contribution at each meeting for the lifespan of the "tontine". The lifespan of the "tontine" is defined in terms of its cycle. A cycle is the number of meetings necessary to provide a loan to each member. Any new participant must be recommended by one of the members to be considered for acceptance in the market. The new member is automatically placed at the end of the cycle. A member can leave the market, if he or she is free of any debt. At the end of each cycle, the market is dissolved and another lifespan can begin. The number of members can vary from three to more than 50 people. The order of loans can be either negotiated in advance by consensus or chosen at random. However, even a pre-established order may be revised.

The mutual informal market works as an incentive for members to save. However, this incentive is not an obligation because participants voluntarily agree to it. The mutual informal money market makes it possible to adapt credit to the needs of each member. In this case, it functions as a provident contingency fund. However, the relationship between saving and credit is complex. In fact, the first recipient has a debt, which decreases as he repays through his subsequent contributions; the last member on the list has a credit, which increases until his turn to receive the loan comes.

If inflation is taken into account, one can consider that the first recipient gains both because he or she receives a loan without interest and also repays it with less valuable money. The last member has granted a loan of more valuable money and receives no interest compensation. Between these two extremes, each member has a credited account, which is transformed into decreasing debt when he or she pays the subscription. This form of market can be considered a zero-sum game (in terms of the money amounts) during the lifespan of this market; the credited account of each member always equals the net sum of debt for the other members.

In nominal terms, the net profit of each participant is zero. However, in real terms, it is different according to the position of the member. The first participant has a privileged position since he receives a loan without interest, whereas the last player is subjected to save without interest. Despite the apparent disadvantage to these members who receive the loan late in the cycle, each member voluntarily agrees to the arrangement. One possible reason for accepting the conditions is that the member has need of a large sum of money and cannot receive a loan through formal financial intermediaries. In effect, the contributions made are buying access to a larger pool of funds in the future. The individual is sacrificing interest income in exchange for the guarantee that funds will be available in the future.

There are two types of mutual informal markets: one with a constant subscription rate and another with a variable rate. For the constant rate, the amount for each contribution is fixed and the loan received is always the same for everyone. For example, suppose a market with four members: MI, M2, M3,-, with each member other than the loan recipient contributing a sum T=$1 000 each time period. The cash flows are shown in Table 3.

Table 3: *Mutual Informal Money Market Example*
Cash flows for even contribution

	Period			
Members	1	2	3	4
M1	+3,000	-1,000	-1,000	-1,000
M2	-1,000	+3,000	-1,000	-1,000
M3	-1,000	-1,000	+3,000	-1,000
M4	-1,000	-1,000	-1,000	+3,000

The first member, MI, will receive $3,000 in the first period or the sum of the $1000 contributed by each of the three other members. He or she will reimburse each participant's share during the second (MV, third (M3) and fourth-) period. During the second period, participant M2 will receive $3000 and so forth.

For a variable contribution rate, each member contributes the amount he wants and will receive an equivalent total amount during the cycle. It implies that those who have benefited from the loan must repay an amount equal to what has been received from lenders in subsequent meetings. For example, let us consider a four-member market illustrated by the cash flows presented in Table 4.

Table 4: *Mutual Informal Money Market example*
Cash flows for variable contributions

	Period			
Members	1	2	3	4
M1	+4,500	-1,100	-1,600	-1,800
M2	-1,100	+9,600	-5,000	-3,500
M3	-1,600	-5,000	+7,600	-1,000
M4	-1,800	-3,500	-1,000	+6,300

Contributions vary in this case. Let us consider, for example, member MI. He or she has received respectively $1,100 from M2, $1600 from M3 and $1800 from M4. M1 must repay the sum that M2, M3, and M4 loaned to him during subsequent meetings. He or she will have the obligation to contribute $1,100 for M2 during the second meeting, $1,600 for M3 during the third meeting and $1,800 for M4 during the fourth meeting. This type of market promotes mutual help among members. From an economic point of view, it contributes to the mobilization of saving.

In addition, a mutual informal market generally includes an emergency fund. The money for the emergency fund comes from members and is used for two primary purposes:

- To help members who are facing difficult financial situations. In some cases, the beneficiary may not have to reimburse the group; and
- To balance the market in case there is a partial default on the loan. If a member fails to pay back the entire sum of money he has received earlier, the rest of the money he or she owes is taken from the emergency fund. However, this member will eventually have to repay the emergency fund with the equivalent amount used to pay his or her debt.

The Commercial Informal Financial Market

The commercial informal money market is a credit and saving fund account. Each participant in this market agrees to save regularly, and the treasurer collects those funds. These funds can be used for member or non-member loans, depending on the structure of the market. The treasurer plays the role of a deposit bank. Confidence is the most important characteristic of this arrangement. This confidence is not established between the members of the market as in the mutual informal market but directly between the participants and the treasurer. The motivations for this kind of market are primarily easy credit access, the adaptability to low-income participants, and the flexibility of payments and withdrawals.

The commercial informal financial market provides project financing for people excluded from the banking system. Each member's contribution depends on his or her saving capabilities. As opposed to the mutual informal financial market where money is lent on a rotating basis, there is no rotation in the commercial informal financial market. As a result, the commercial informal financial market is sometimes regarded as a non-rotating savings and credit association. The structures within this market form vary a great deal. Schrieder and Cuevas (1992) divide the commercial informal market into three subcategories: the saving association, the saving and credit association, and the credit association.

The saving association functions as a deposit account. Participants deposit fixed or variable amounts of money periodically (generally weekly or monthly.) At the end of a specified period of time, which is generally a year, each group member receives its total deposit. This form of saving earns no interest. Instead, the members actually pay a commission to the treasurer for keeping their money.

The saving and credit association is just like the saving association, but the money collected is also used to make loans to members and non-members of the association. Debtors may or may not be required to pay interest. In most cases, non-members pay interest on the money they borrow, while members do not. The interest earned is distributed to members in proportion to their share of the total savings.

The credit association members deposit variable subscription amounts, usually at the beginning, for an indefinite period of time. The credit association functions like a mutual fund where people bring their money together. The money is lent only to non-members. Interest is reinvested until the end of a predefined period, generally a year. The interest earned is distributed to participants based on their contribution. This premium is comparable to dividends paid to shareholders. This type of investment can be compared to a bond with a variable coupon rate, date to maturity and interest rate.

The Bidding Informal Money Market

The bidding informal money market is a bidding market. In this market, funds are collected as in the mutual informal money market, and are loaned to the member offering the most for the funds. Two forms of markets coexist in this system:

- The principal market in which the members bid for the total amount of the contributed funds
- The secondary market in which the interest earned from the principal is also lent based on member's bids.

The Principal market

The primary market starts like a mutual informal money market. Members contribute a fixed or variable amount of money. The money collected is lent based on a bidding process. As in a normal bidding, the participant that offers the highest bid gains the total amount contributed or "kitty." The bidding starts at an amount determined by a minimum acceptable interest. The member with the winning bid must have another member stand surety for him. The role of this guarantor is to reimburse the fund in the case of the insolvency of the borrower. The winning bidder receives the kitty from which is deducted an amount equal to the extra money brought by the bidding. Each member can obtain the kitty only once.

For example, suppose that participants in the bidding financial market collect a sum of $1,000,000. If the rule of the market sets the minimum interest rate on any loan to be 10%, the bidding will begin at $1,100,000 = $1,000,000 + (10% x $1,000,000). Let us assume that someone bids $1,200,000. The interest he agrees to pay will be equal to $1,200,000-$1,000,000 = $200,000. Instead of receiving $1,000,000, he will be lent $1,000,000-$200,000 = $800,000. However, he will have to reimburse the initial $1,000,000 at a specified date. This process takes place in the primary market.

The Secondary Market

The secondary market is the market place for interest earned by the principal sold in the primary market. The interest (premium) is divided into small batches, which are also sold on a short-term basis. A member can buy money more than one time from the secondary market.

Returning to our example for the primary market of $1,000,000, the remaining $200,000 representing the premium or interest from the first sale is now split into smaller amounts and these sums are traded on the secondary market in the same fashion.

CONCLUSIONS

The markets described here may sound unusual to many readers. Nevertheless, it should be recalled that these informal financial markets are found in less developed countries where the formal financial sector has failed to meet all the demands for financial services. Many people are excluded from the formal financial system and access to loan or deposit services because of their low income. In addition, many individuals, groups, and companies that may have access to the formal financial system do not trust it because of its lack of liquidity. As a result, they rely on the informal financial system as an alternative solution.

From an economic point of view, the informal financial markets are not always efficient. While the decision to lend or to deposit money is still generally governed by some required rate of return, a participant can easily earn a negative real return. This negative real return results from the fact that no interest payment is required on some loans nor paid on some savings deposits. Together with the inflationary environment, risk considerations, and the premium paid to the money keeper, depositors/lenders may earn a negative rate of interest. In spite of this, participants still make deposits and provide funds for loans.

Therefore, the market satisfies some demand for them. These markets may be explained by a spirit of mutual cooperation and support, a guarantee of available funds for some future use, or the advantage of pooling financial resources.

Regardless of the reasons, such informal markets tend to favor loans of small amounts for short periods of time. The formal sector, on the other hand, tends to specialize in large, long term lending. As described in this paper, the activities of the informal financial sector often parallel those of the formal sector. Interaction between the two sectors is also common. It seems that the two sectors also complement each other in economic development - the informal sector providing funds for the growth of small business; the formal sector providing funds for the larger public and private projects.

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