Crossfire: Formal vs. informal sector savings

ELISABETH RHYNE and PAUL RIPPEY

In our regular debate between two experts, Crossfire invites Beth Rhyne and Paul Rippey to argue the case surrounding the following: 'The overall benefits of formal sector savings are much greater than saving in the informal sector'.

Would you hand your savings over to a group of your friends or a trusted money-keeper?

Savers who use formal methods are much less likely to have their savings lost or stolen

Dear Paul,

Do you keep your savings in a roll of cash stuffed in a jar in a secret place in your home? I didn't think so. Do you hand your savings over to a group of your friends or a trusted money-keeper, expecting to get it back in a couple of months? No? Why not?

I can tell you that I use a bank. It's much safer. Who knows what might happen to a jar of cash? Money in a bank is also easier to keep track of and more likely to hold its purchasing power. And with ATMs around every corner and plastic payment cards accepted at stores and restaurants, I can access the money whenever and wherever I need it.

Okay, okay. We both have solid incomes and live in big, rich cities full of banks, ATMs and merchants that take VISA and MasterCard. But although a small farmer in the altiplano of Peru or a market vendor in Dar es Salaam may have different environments and smaller savings, their needs for savings services share important similarities with yours and mine. And that's why savings in financial institutions makes sense for them, too.

First, there's safety. Savers who use formal methods are much less likely to have their savings lost or stolen. In a path-breaking study, Microsave Africa interviewed 1,500 people in Uganda (a country you know better than I) who saved in formal, semi-formal and informal forms (Wright and Mutesasira, 2001). Microsave asked whether respondents had lost any of their savings during the past year. While 15 per cent of formal savers and 26 per cent of semi-formal savers had lost some money, a whopping 99 per cent of informal savers had lost money. And their rate of loss was much higher. While the percentage of savings lost in the formal and semi-formal sectors were 3 and 9 per cent, respectively, the average percentage loss among informal savers was 26 per cent

Elisabeth Rhyne is the Managing Director of the Center for Financial Inclusion at ACCIONis and Paul Rippey is an independent consultant specializing in bringing clean energy and other value-added services to savings groups. He is a founder of Savings-Revolution.org

doi: 10.3362/1755-1986.2011.011, ISSN: 1755-1978 (print) 1755-1986 (online)

of the amount saved. Any move toward formality – including small savings and credit cooperatives – appears to increase safety relative to informal mechanisms.

Any move toward formality appears to increase safety

If we believe these findings, financial inclusion that makes formal savings services available should clearly become a priority. Microsave has used this study to advocate with central banks in Uganda (successfully) and India (unsuccessfully) to create regulations supportive of microfinance institutions as deposit-takers.

The question then becomes whether it is cost-effective to offer formal savings services to very poor people and people living in remote areas. The good news is the revolution in availability of basic banking services aided by the cell phone and the point-of-sale device. The point-of-sale device underpins the banking agent model, pioneered in Brazil, in which banks contract with retail stores to handle payments, deposits and withdrawals. Transactions through agents are so much cheaper than through bank branches that banks can now serve very small towns and poor urban neighbourhoods.

Transactions through agents are so much cheaper than through bank branches

Five years after the launch of banking agent regulations, every municipality in Brazil had at least one banking outlet. The cell phone goes further, reducing the cost of transactions to a small fraction of the cost at a regular branch. In Kenya, M-Pesa started with money transfers, but is rapidly becoming the gateway to a savings account. Although cell phone banking is yet to take off in many other countries, I see signs that it soon will, such is the eagerness of bank regulators to learn from Kenya. These transformations will put formal savings services within the reach of millions of people who couldn't have them before.

Best wishes,
Beth

Dear Beth,

Poor people are rushing to join modern informal groups because of their convenience, their flexibility, their transparency, the high returns on savings, and the savings discipline they bring to their members.

Modern informal savings groups are convenient, their flexible, and transparent

When I say 'modern' savings groups, I'm talking about time-bound, distributing ASCAs (accumulating savings and credit associations) following the approaches used by agencies such as CARE, Oxfam, Plan, CRS and the Aga Khan Foundation. They have tested and refined approaches that have reached about four and a half million people, at a cost per member, in the most efficient projects, of under ten dollars. Their approaches have different names – village savings and loan associations, saving for change, savings and internal lending communities, and community based savings groups – but they all have

M-Pesa and Equity are hardly putting the informal groups out of business

In Kenya, membership of informal groups is rising

We should compare the best the informal sector can offer, that is modern savings groups, to the best the formal sector can offer

in common transparency (conducting all transactions in front of all members), simplified bookkeeping (no elites needed!) and the annual distribution of assets – which helps to meet members' needs for lump sum amounts. And they know their savings are safe.

People are voting with their feet. Kenya's FinAccess surveys in 2006 and 2009 showed that despite the steady growth of Equity Bank and M-Pesa, membership in informal groups actually rose between the two studies, from 37.5 to 38.7 per cent. Surprisingly, the growth was highest among urban people: from 26.2 per cent in 2006 to 32.7 per cent in 2009. These are the same people who have the best access to formal providers.

There is a complex relationship between the formal and informal sectors we need to understand better: FSD Kenya reports that one woman recently interviewed had closed her Equity account in favour of her two CARE savings groups, which satisfy all her savings needs and loan requirements. At the end of the day, the interest she pays on her loans from the savings groups comes back to her through the annual distribution. Her husband on the other hand still uses his Equity account and has been able to access a much larger loan to capitalize his business.

Many kinds of financial service provider can find a market, but M-Pesa and Equity, with their huge advertising budgets and well-heeled investors, are hardly putting the informal groups out of business.

Oh my. I have been going on so long I've run out of space and did not even get to talk about social capital! Maybe next time. But before I end, I'd like to ask a favour, Beth. You brought up the ten-year-old Uganda MicroSave study. Let's retire that once and for all. It was written pre-cell phone and pre-Equity, so it does not represent the best formal institutions well. Worse, it lumps everything from moneylenders, to ASCAs and ROSCAs (rotating savings and credit associations), to burying money in a jar behind the house all together and calls it the 'informal sector'. Let us be more precise and compare the best the informal sector can offer, that is modern savings groups, to the best the formal sector can offer.

Best regards,
Paul

Dear Paul,
I just knew you would have something to say about that MicroSave study. Yes, the study is old, but that is not a reason to simply discount it. It is a reason to have a fresh look at the important question it asks. The frequency and amount of loss of savings in formal and informal institutions deserves several more studies in several more countries. Meanwhile,

> Over time, when offered a choice, people will gravitate toward greater use of formal services

its powerful message stands as a significant caution for those prone to get too enthusiastic about informal savings.

You cite growing numbers of members of savings groups in Africa promoted by international organizations. Of course in India, the self-help group programme claims to be the biggest ‘microfinance’ programme in the world, with over 45 million members. But just as traditional microfinance programmes tend to get carried away with the numbers game, so have the promoters of savings groups. It is a lot easier to count savings group members when they first sign up, but what happens later? How long do the groups remain active, and do they meet their member needs? I believe, and have heard from researchers in India, that if there were an accurate count of active members of active groups who are using savings groups as a significant part of their ongoing financial management strategy, the claims of the promoters would shrink dramatically.

> It is a lot easier to count savings group members when they first sign up, but what happens later?

That said, I agree with you that many people will find it convenient to use both formal and informal savings mechanisms. *Portfolios of the Poor* (Collins et al., 2009) showed that most economically active low income people are continually piecing together a complicated array of financial arrangements, often using every variety of service available to them. My point is that over time, when offered a choice, people will gravitate toward greater use of formal services. The informal savings groups you are so enthusiastic about serve the wonderful function of assisting people to create stronger informal services, in places where formal services are either unavailable or of poor quality. That is why they are mainly aimed at people in remote rural locations and people who have not yet been offered affordable savings accounts (e.g. because banks charge too many fees or because minimum balance requirements are too high).

The important question on the supply side is whether the pricing of savings accounts will fall to a level that makes such accounts a viable choice for the people who are now clients of savings groups. Providers are certainly seeing a dramatic drop in costs per transaction as a result of mobile banking and other technology-assisted models. But it is not yet clear that, even with those technologies, mainstream providers are ready to offer the kind of low minimum balance, low-fee savings accounts that would attract poor clients. Very few banks, including microfinance-oriented banks, appear to be convinced that offering savings to the poor is worth the effort. The few that have done so, such as Bank Rakyat Indonesia, Equity Bank in Kenya and a handful of others, have been rewarded with

I believe that conditions are ripe for a rapid expansion of the offer of low-balance savings accounts

Mutual trust and reciprocal relationships are present in savings groups and conspicuously absent from most formal financial institutions

An important benefit of group membership is social capital

millions of loyal customers. I believe that conditions are ripe for a rapid expansion of the offer of low balance savings accounts. It is only a matter of time – and I do not mean a generation, but a few years – before today's picture changes dramatically. If this happens, the role of savings groups will recede increasingly toward the periphery.

Best wishes,
Beth

Dear Beth,

I am worried that we are going to end this discussion in general agreement – how disappointing! You have refrained from dismissing savings groups out of hand, and I have held back from trashing MFIs. Not only that, we agree about important things: we don't know as much as we would like about the relative safety of saving in different types of institution, and we agree on the need for more research. Finally, we concur that people are best served by having access to multiple types of service.

But let's come back to the proposition we started with: the net benefits of formal and informal savings. As I hinted in my previous note to you, an important benefit of group membership – in addition to proximity, return on savings, access to small loans, flexibility, transparency and incentive to save – is social capital, the value that people find in the mutual trust and the reciprocal relationships that are so strongly present in savings groups, and so conspicuously absent from most formal financial institutions. Successful banks are aware of this, and carefully craft their advertising to present themselves as benevolent partners. Their smiling greeters welcome people to branches, they call their clients 'members', and they have done a remarkable job of reducing fees and simplifying procedures. Do not get me wrong – I applaud all this.

But when the baby is sick, the breadwinner is laid off, or the rains do not come, and the members turn to each other, then you see the value of the social capital in groups, relative to banks.

A few years ago I was sitting in a focus group in eastern Uganda, talking to some farmers about the different financial services they used. I asked who had lost money saving with different institutions, and a retired teacher told me that he had lost money in his Stanbic account. That surprised me, because Stanbic is a modern, profitable, regulated institution, where savings are insured. I asked how that could have happened. 'They take money out of my account every month', he replied with outrage, 'and it's not even theirs!'

His remark seemed touchingly naïve, based on a fundamental misunderstanding of the nature of businesses. Of course for-profit companies have a big role to play in making his life better, from the village shop up to the phone company and beyond. But is it just me who finds it worrisome when banks hold the resources of the poor? I admit it: living through the sub-prime mortgage debacle, with its opaque derivatives and collateralized debt obligations, has coloured my opinion of banks. Nothing wrong with the bankers; rather, it is the incentive structures, the temptation of making fabulous sums, and the cosy relationships among financial institutions, regulators, auditors and raters that make me nervous.

You talked a bit about where this is all going. You predict that when no-fee affordable savings accounts become available, people will sign up for them in droves. I agree, but I note that savings groups are not only for the rural isolated populations; in fact, they are growing fast in urban and semi-urban areas in Kenya, where there is a no-fee bank seemingly on every corner. And savings groups are not just for savings; credit and insurance are also provided, as well as the social capital I described above. Many people will stay in their savings group but maintain a bank account as well, just as you and I each have more than one financial service provider and require multiple financial services.

> Savings groups are growing fast in urban and semi-urban areas in Kenya

People are drawn to banks for their very real virtues (as well as by all those darn billboards). But they come to savings groups for their virtues also. Hopefully, in the future, technology will help us find ways to offer financial services that combine the predictability and precision of regulated institutions with the solidarity, low cost, social safety net, proximity, empowerment and incentive to save we find in savings groups.

Until then, let us let people keep voting with their feet. Right now, they are voting strongly for savings groups – the savings group population is well over 4 million – and the groups are growing without benefit of advertising, and at a very affordable cost per member. These people are making their own calculations of the benefits of saving in the informal sector, and it looks to me like they are making good decisions.

It has been a pleasure.

Paul

References

Collins, Daryl, Morduch, Jonathan, Rutherford, and Ruthven, Orlanda (2009) *Portfolios of the Poor: How the World's Poor Live on $2 a Day,* Princeton University Press.

Wright, G.A.N. and Mutesasira, L.K. (2001) 'The relative risks to the savings of poor people', *Small Enterprise Development* 12(3), pp. 33–45.