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The impacts of financial linkage on sustainability of less-formal financial institutions: Experience of savings and credit co-operative societies in Tanzania

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ABSTRACT

The developing economies are experiencing a growing trend of financial Linkage between formal and less-formal financial institutions. Normally, less-formal financial institutions receive loanable funds from formal financial institutions as an approach to meet their financing deficit, while formal financial institutions engage in linkage as a mean to expand business. The main concern of stakeholders regarding this practice is how such linkage can affect the performance of the less-formal financial institutions. In Tanzania, the Savings and Credit Co-operative Societies (SACCOS) are the most used less-formal financial institutions which are also highly involved in financial linkage. In this study therefore, we used Tanzania SACCOS' financial statement data, for the period of 2004–2011, and panel data regression model to examine the relationship between financial linkage (measured as financial dependency ratio) and sustainability (measured as Operational Self Sufficiency) of less-formal financial institutions. The findings suggest that the higher the level of financial linkage the more the SACCOS become unsustainable. Implying that, to be sustainable institutions, the SACCOS should try keep away from the use of external funds in their loan portfolio.

1. Introduction

Both formal and less-formal[2] financial institutions are vital and required in the economic development of the Low Income Countries (LICs) (Aryeetey, 2008). In Tanzania, the National Financial Inclusion Framework (2014–2016) which was released in 2014 reveals that, both formal and less-formal institutions have played an important role in the National Financial Landscape. Also it shows that the impacts of formal and less-formal institutions in financial inclusion have been growing. For instance, the formal financial institutions services reached 16% and less-formal institutions services reached 27% of the population in 2009. Consequently, they have a mutual role in financial system development and economic growth (Kaleshu & Temu, 2012; Qin & Ndiege, 2013). In this situation therefore, the growth and survival of formal as well as less-formal financial institutions in Tanzania is important and thus is the focus of this study.

Despite the recent fair improvements made in financial sector of Tanzania, which are mentioned in literature to be the outcome of financial reforms that started by the enactment of the Banking and Financial Institutions Act of 1991 (Kaleshu & Temu, 2012; Satta, 1999; Simpasa, 2011), both formal and less-formal financial institutions have challenges that seems to limit their individual ability to expand financial services (Kaleshu & Temu, 2012; Randhawa & Gallardo, 2003) as should have been. For example, while the immediate effects of financial reforms were the development of the formal sector (Satta, 1999; Simpasa, 2011) it has not reached reasonable population (Bee, 2009; Kaleshu & Temu, 2012). In general, poor majority who are residing in rural settings are the most excluded in formal financial system (Kessy & Urio, 2006).

Perhaps there are various reasons for these and here we just describe the main two. Firstly, most of the formal financial

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[1] The Moshi University College of Co-operative and Business Studies has recently changed the name and now it is known as Moshi Co-operatives University.

[2] The less-formal financial institutions are all semiformal and informal financial institutions most of which are rural financial institutions and serve the poor. So in some explanation the word is synonymy to microfinance. Moreover, contrary to the formal financial institutions like commercial banks, less-formal financial institutions are not regulated by the Bank of Tanzania.

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institutions are located in urban areas, hence inaccessible among the majority of population (more than 70%) who are in rural areas (Kessy & Urio, 2006). In this case, literature states that in the absence of less-formal financial institutions, there is more liquidity in urban than in rural areas because formal institutions like commercial banks fear rural financial market due to high financial risks (Kaleshu & Temu, 2012; Sebhatu, 2012). Secondly, commercial banks demand for the worth collaterals from their clients as a way to minimize financial risks (Bee, 2009), which in most cases poor people do not afford as a result of widespread poverty and informal ownership of the assets like land. Again in this case less-formal institutions are superior because they can work without physical collaterals as they have other means to reduce financial risks for example using group lending methods (Okura and Zhang, 2012).

In fact it appears that, inability of formal financial institutions to serve properly the rural financial markets has been the strengths of less-formal financial institutions, because less-formal institutions appears to be the solutions to most of the formal financial institutions' challenges. On the other hand, the main challenge of the less-formal financial institutions is inadequate finance and poor managerial ability (Kaleshu & Temu, 2012). That means even with their ability to reach many people at one time, they have less to give to meet the real demand for financial services especially loans. As such the solution is to get commercial loans from formal financial institutions. So, less-formal and formal financial institutions seem to require each another to improve their financing activities (Kaleshu & Temu, 2012; Randhawa & Gallardo, 2003), the phenomenon which is referred as financial linkage[3] in this paper.

SACCOS[4], which are co-operative based microfinance institutions are the most used less-formal institutions in Tanzania (Bee, 2009; Maghimbi, 2010; Wangwe & Lwakatare, 2004). SACCOS (also known as credit unions in other countries) are principally developed to meet financial services specifically savings and credit to support the lower and middle class income earners so as to be economically active (McKillop & Wilson, 2011). They are owned by members and serve the same. SACCOS reach many people because they are easily formed basing on the field of membership like same occupational, residential or religion (Fried, Knox Lovell, & Eeckaut, 1993). Due to their deep ability to reach poor majority that formal institutions have failed to serve, SACCOS have become attractive to the commercial banks and other formal financial institutions to make linkage with, as a way to exploit rural market at a low cost. Thus, formal institutions engage in this relationship by providing commercial loans to the SACCOS which disbursed to the members. In general, through linkage with SACCOS formal financial institutions greatly increase the volume of small loans which is useful to increase financial inclusion in rural areas (Aryeetey, 2008; Jones, Sakyi-Dawson, Harford, & Sey, 2000; Piprek, 2007) and improves liquidity balances between rural and urban areas (Sebhatu, 2012). Also through linkage formal financial institutions enjoy high repayment rates and high profit. For instance, Kaleshu and Temu (2012) found that the bank loan portfolio to the SACCOS has zero rate delinquency.

On the other side, in SACCOS the main source of loan portfolio is members' savings (Qin, Ndiege, & Pastory, 2013) which is usually less than loan demanded (Ndiege, Haule, & Kazungu, 2013). For instance, according to the SACCOS statistical reports published by Ministry of Agriculture Food Security and Co-operatives through the department of Co-operative development, in 2011 the total savings was 447,664.73 million Tanzania shillings and credit was 741,049.64 million Tanzania shillings, which indicates that demand for funds from SACCOS was exceeding the members' savings. As a solution to this problem therefore, in most cases the limited supply of funds from internal sources is covered by means of commercial loans especially from commercial banks (Ndiege & Pastory, 2012). As such, due to the inability to meet the loan demands of their members, SACCOS have found an access to loanable funds from formal financial institutions to be a solution for financial deficit (Ndiege et al., 2013). Consequently, for the reason of gains from both sides, there has been a growing financial linkage between SACCOS and other financial institutions especially commercial banks (Kaleshu & Temu, 2012; Ndiege et al., 2013; Ndiege & Pastory, 2012; Temu & Ishengoma, 2010).

Thus the co-operation between formal financial institutions and SACCOS might be a good practice particularly in intensifying financial inclusion. However this practice need good understanding and control depending on the traits of SACCOS which are co-operative based less-formal financial institutions. The issue here is that, while linkage is appearing as the solutions for the challenges of both the SACCOS (as a less-formal) and formal institutions, the available literature appears to have no worry about the fact that linkage is useful on the side of formal financial institutions. However, some problems have been noted in the case of the less-formal institutions performances. For instance, the expansions of formal credits worsen the terms faced by less-formal borrowers (Floro & Ray, 1997), weaken the operations of SACCOS (Fiorillo, 2006) and also while the SACCOS philosophy is "savings and credit" linkage reduces the savings behavior among members (Ndiege et al., 2013). Consequently, while linkage has been considered as a potential practice for the financial inclusion development, no doubt it will be meaningful if it is sustainable practice that encourages the growth and survival of the institutions involved. But from these previous observations already there are indications that linkage may have also negative effects on the growth and survival of SACCOS, thus more studies are required to give broad understanding on the impacts of linkage on the performance of SACCOS, thus is the focus of this study.

According to Zeller and Meyer (2002), the performance of microfinance is measured in terms of outreach, efficiency and sustainability. In attempts to understand the effects of linkage on SACCOS performance, few previous studies attempted testing the effects on outreach of SACCOS (Kaleshu & Temu, 2012; Ndiege et al., 2013; Temu & Ishengoma, 2010). No empirical analyses were found testing the effects of linkages on other two elements that is, on efficiency and sustainability of SACCOS. Thus, this study is set to add knowledge on the relevance of financial linkage by examining whether financial linkage ensures greater sustainability for the SACCOS. The study used Operational Self Sufficiency (OSS) as a proxy measure for sustainability. OSS Signifies the ability of an institution to cover costs of operations through internally generated income whereby an increasing ratio is encouraged (Ledgerwood, 1998; Nawaz, 2010; Okumu, 2007; Tehulu, 2013). For the case of financial linkage the study has used the financial dependency ratio (DPR) as the proxy measure.

The study therefore, increases understanding on how linkages affect the performance of less-formal financial institutions and therefore it widens the discussion on linkage. Also the findings in this study are useful for SACCOS industry policy advocacy in Tanzania and other related country and thus are important in improvement of ongoing practices and decision making, particularly in using commercial loans in their portfolio.

[3] Normally linkage stands for financial linkage and facilitating linkage (Pagura & Kirsten, 2006), but the financial linkage is the one which is significant in SACCOS industry (Kaleshu & Temu, 2012), and is what this paper referred to. A financial linkage, is the flow of funds between formal the less-formal financial institutions (Pagura & Kirsten, 2006).

[4] According to the Bank of Tanzania (BOT) report in the national financial inclusion framework, in 2012, SACCOS contributed 5% out of 22% of the proportion of the population formally included in financial system and thus important in national financial system development as well as economic growth.