Why do Rural Community of Sri Lanka prefer for Informal Sources of Financing?

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ABSTRACT

The aim of this paper is to examine the factors that affect the preference of informal financing sources by the rural community of Sri Lanka. Data were gathered from 300 rural respondents in Uwa, Sabaragmuwa and Western Provinces of Sri Lanka using stratified sampling method. The main research instrument used was a questionnaire based on seven point Likert scale. Descriptive Analysis, Multiple Linear Regression Analysis and Stepwise Regression Models were used to analyse data. Research findings revealed that previous experience with informal borrowings, relationship with the lender, loan size, repayment flexibility and less collateral requirements significantly and positively affected the preference of informal financial sources by the rural community of Sri Lanka. Interest rates charge by the informal lenders have a significant and negative impact on the preference to use informal financing which reveals that interest rate is the core factor to make the informal financing unpopular. Legal requirement did not affect preference of informal sources of financing by rural community of Sri Lanka significantly.

Keywords: Informal Finance, Rural Community, Sri Lanka

Introduction and research problem/issue

Financial sector of Sri Lanka has been developed up to a greater extent and consist of a well-developed banking system. In 1960s informal financing sector represented 64% of total financial sector of Sri Lanka, and it was reported only 35% in 2003. (Central Bank Report,2004). In 2007, it was highlighted that approximately 20% of households use informal sources of finance in Sri Lanka (GTZ,2007). Further, it was heighted that informal credit has utilized 18.5%, in rural households, 20.8% in estate based households, and 16.6%. by urban households just (GTZ,2007). Government owned banks fairly represent covering entire county and substantial amount of privately owned commercial banks and formal financial institutes also actively participate to provide formal financial facilities for the rural community. A greater proportion of the poor in the country are still unbanked in Sri Lanka (Colabage,2012). Karunagoda (2007) noted that Informal financing sector of Sri Lanka represents non-institutional or unorganized financial sources such as friends and relatives, moneylenders, traders, pawnbrokers, and landlords engage in lending activities and borrowings. Further, he has stated that these informal activities operate in clusters throughout the country where the operations related to a particular cluster is limited to a particular geographical area or group of people most of the time. ''Poorer households are generally excluded from formal financial institutions and still rely on such informal sources to borrow money in Sri Lanka''. (Colombage,2012). Central Bank of Sri Lanka also highlighted in several times that the usage of informal financing sources by the community is risky and at the same time it is a threat for the formal financing sector or less value addition for the entire economy and hinders the accelerated economic development. Even though

informal financing supports economic progress of the nations and the counties, it adds far below to the economic value addition over formal financing sources. Formalization of financing sources is a vital factor for sustainable economic development in any country. Informal Financial sector in Sri Lanka is substantial as per the reported and unreported statistics and rural community fulfil their financial needs via informal financing modes. Even though formal financial sources are reported as providing cheaper, lower risky financing than informal financing sources, still rural community tends to prefer informal financial sources to fulfil their financial needs.

Research Problem

Government owned commercial and other banks are fairly representing entire county by providing formal financial services. Substantial amount of privately owned commercial banks and formal financial institutes also actively participate to provide formal financial facilities for the rural community. Formal financial sector has been growing rapidly in the rural areas and formal financial institutions have introduced many customized packages to meet needs of the rural community. Further, financial experts of Sri Lanka are often recommending and communicate customers to use formal financiering sources while highlighting draw backs of using informal sources of financing. Evidences show that still informal financial sector is popular among rural community. According to the research findings of the Central Bank of Sri Lanka and literature highlights, informal financing represents considerable percentage in Sri Lanka. The research problem of this study was

''what are the factors that impact on preference for informal sources of finance by the rural community of Sri Lanka''.

Research Methodology

Sample of the study consisted of 300 individuals from rural areas in the Western, Uua and Sabaragamuwa Provinces of Sri Lanka. In Uwa Province 18.2% households and in Sabaragamuwa Province, 23% of households use informal financing (GTZ, 2007). Primary data were gathered though a survey based on stratified random sampling and a questioner was used as research instrument which consists of seven point Likert scale. Pearson Correlation Analysis, Multiple Linear Regression Models and Stepwise

Regression Analysis were used to find degrees of impact from each individual factor on of Preference of using informal financial sources by the rural community of Sri Lanka. The linear regression formula was built to test the impact from dependent variables on independent variable as given bellow:

$$PF = b_1 INT + b_2 LCO + b_3 RE + b_4 RF + b_5 SZ + b_6 EXP + b_7 LR + e$$

PF	=	Preference of using informal financial sources
$b_1 INT$	=	Interest rate charge by informal lenders
$b_2 LCO$	=	lesscollateral requirements
$b_3 RE$	=	relationship with the lender
$b_4 RF$	=	repayment flexibility
$b_5 SZ$	=	loan size
$b_6 EXP$	=	Previous experience with informal borrowings

b_7LR = Legal Requirements e =

error term

Based on the empirical findings, the hypotheses given below were developed and tested;

H1- interest rate charge by informal lender impact on preference for informal financial sources by the rural community of Sri Lanka

H2- legal requirement impact on preference of informal financial sources by the rural community of Sri Lanka

H3- less collateral requirements impact on preference of informal financial sources by the rural community of Sri Lanka

H4- Relationship with the lender impacts on preference of informal financial sources by the rural community of Sri Lanka

H5- Repayment flexibility impacts on preference of informal financial sources by the rural community of Sri Lanka

H6- Previous experience of informal borrowing impacts on preference of informal financial sources by the rural community of Sri Lanka

H7- loan size impacts on preference of informal financial sources by the rural community of Sri Lanka

Results and Findings

Descriptive Analysis

300 respondents represented the sample of this study: 60% of males and 40 % females;

20% of the sample was represented by 20-30 age category; 40%, 30-40 years; 20%, 4050 age group and 20%, over 50 years of age.

Radiality?????

The Cronbach's Alpha values reported for the independent and depended variables were as follows: less Collateral = 0.788, size = 0.711, previous experience = 0.700, interest rate = 0.714, repayment flexibility = 0.702, relationship with the lender = 822, legal requirement = 0.744 and preference = 0.754, those values which satisfied the decision criteria of internal consistency of the questionnaire of Cronbach Alpha value are closer to 0.7. The results of Bartlett's test of Sphericity indicated that all the factors are at 0 0.05.

Based on the results of KMO test, those results can be interpreted that factor analysis was appropriate. The results of multiple linear regression coefficient were reported as follows: Table 01: Coefficients of Liner Multiple Regression Model

Model	Non-standardized Coefficients B	Sig.
(Constant)	.026	.901
SZ	.163	.000
PE	.357	.000
RF	.102	0.007
RL	.311	0.000
LR	-.024	.462
INT	-.113	.001
LCO	.217	0.001
Dependent Variable: PRF		

R Square value was 0.545, and it revealed that independence variables explain 54% of the total variability of the dependent variable and the model was significant at 0.05% confidence level. Stepwise regression analysis revealed that the key factor which impacts on the popularity of informal financing is previous experience with informal borrowing and the second was the relationship with the lender. The next important factor was less collateral requirement.

Test of Hypotheses

H1-interest rate charges by informal lender, H3-less collateral requirements H4- Relationship with the lender, H5-Repayment flexibility, H6-Previous experience with informal borrowing, H7- loan size impact on preference for informal financial sources by the rural community of Sri Lanka by accepting hypotheses at 0.05 level of confidence.

H2- legal requirement was rejected under confidence level of 0.05.

Findings of the research

Research findings revealed that previous experience with informal borrowings, relationship with the lender, loan size, repayment flexibility and less collateral significantly and positively affected the preference of informal financial sources by the rural community of Sri Lanka. Interest rates charge by informal lenders has a significant and negative impact on the preference to use informal financing which reveals that interest rate charges by informal lenders was a factor to that makes the informal financing unpopular. Legal requirement did not affect significantly the preference of informal financial sources by rural community of Sri Lanka. The research findings demonstrate how formal financial sources need to adjust their products and process to match with the needs of rural community by referring to the factors which make the informal sources of financing popular.

Conclusions, Implications and Significance

Previous experience with informal borrowing, relationship with the lender, loan size, repayment flexibility, and less collateral requirements were affecting popular informal sources of financial among the rural community of Sri Lanka. The interest rates charges by the informal lenders were reported as a factor which leads to the unpopularity of informal sources of finance among the rural community of Sri Lanka. The research findings demonstrate how formal financial sources needs to adjust their products and process as to match the needs of rural community and need to have special attention on relationship marketing strategies. Further, Formal Financing institutions need to rethink as to how to reduce collateral requirements by articulating sophisticated risk reduction methodologies.

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