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SPOTLIGHT

PROSPECTS AND CHALLENGES OF INFORMAL MONEY LENDING IN PAPUA NEW GUINEA

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Key Points

- Informal finance or money lending is flourishing in Papua New Guinea (PNG), it is driven by the absence of access to affordable formal microcredit services.
- The emergence of informal finance from the borrower's perspective in PNG is that the process is quick, and it does not require a lot of paperwork.
- Money lending business activities often occur out of necessity to meet both the lender and borrower's needs.
- Informal money lenders face a greater risk of losing part or all their money due to the nature of informality, lack of security or collateral.
- Informal money lending businesses have the potential to transition to formal SMEs in PNG.
- Demand for informal lending can decrease with easy access to cheaper credit from formal financial institutions.

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By Joseph Kaile

More than 80 percent of Papua New Guinea (PNG) population depend on informal semi-subsistence sources of food and incomes for livelihood (Wang, 2014). According to Kopel, Au, Iwong and Tukne (2021), the informal economy plays a vital role in sustaining the livelihood of Papua New Guineans. Most informal economic activities occur out of necessity and to meet unmet demand for specific products and services and cover every sector of the economy including technical and financial services. Financial exclusion remains very high in PNG at 75 per cent (Kopel, 2020). Informal finance or money lending has become a common and lucrative business activity because of the unmet demand for easy access to credit. This article briefly outlines the nature of informal lending and the factors that contribute to thriving informal money lending businesses in PNG. It also highlights the challenges and opportunities of informal finance for lenders and borrowers and concludes with a way forward.

What is informal finance?

Informal finance can be defined as small, unsecured, and short-in-maturity funding sourced from private money lenders, relatives, and friends (Nguyen and Canh, 2021). By definition, informal financial transactions are done outside the formal financial system. It is a common type of informal economic activity in PNG, though some are registered with the Investment Promotion Authority (IPA) and are formalised SMEs. It involves a money lender providing funds to a borrower with an agreed interest rate to be repaid after a defined period of time.

Nature of informal finance

Informal finance arrangements include the following:

- The money lender provides funds to the borrower at extremely high interest rates of 30 percent, 40 percent, or 50 percent and the principal and interest is paid over a short period, usually at the end of a fortnight. The borrower will have to agree to the terms of lending before the lender releases the funds to him or her. The agreement is often made verbally between the two parties. The same interest rate is applied to those that are willing to borrow money and repay in a week or a month or even two months.
- As this type of arrangement is highly risky with greater chances of default, the lender provides funds to only highly trusted borrowers based on relational grounds, that is, people known to them. At other times, a broker who is known to both the borrower and lender acts as the go between person for a commission usually paid by the lender upon repayment of the loan.

What factors contribute to the emergence of informal finance?

The growth of informal finance is determined by supply and demand for financial services. Nguyen et al. (2019) noted that informal finance is a manifestation of weaknesses in formal financial services, and to a less extent, a product of personal resources and local institutional and market factors. This is particularly the case in some developing countries including PNG where the formal financial institutional frameworks remain underdeveloped.

The financial industry is marked by an underdeveloped microfinance sector and formal financial institutions have stringent collateral requirements with lengthy processes of application and credit worthy checks for loan applications. These practices exclude the majority of people, and they are highly dependent on informal sources of finance (Kopel, 2020).

Only 25 percent of PNG's population have access to formal financial services (Kopel, 2020). Even those who have bank accounts often use accounts only for depositing and withdrawing their own savings and do not access additional services, especially credit and micro insurance products (Kopel, 2020).

Challenges and opportunities

There are both challenges and opportunities for both informal lenders and borrowers. This is summarised in the matrix on the other page.

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Stakeholder	Challenges	Opportunities
Borrower	Extremely high interest rates. Risk of being subjected to physical, verbal, and emotional abuse from money lenders in case of delay in payments or default.	No collateral, no paperwork, quick access to loans
Lender	Highly risky, without collateral no guarantee to recover loans.	Highly profitable from high interest rates
Middleperson	Highly risky, if borrower does not repay, lender puts pressure on middleperson to recover funds.	Profit from earning commission

Borrower Opportunities: The absence of paperwork and fast processing time makes this an attractive option and borrowers have the opportunity to access quick loans. This leads many borrowers to prefer the use of informal money lenders, despite the high interest rates.

Lender Opportunities: Informal finance is a risky business for lenders, but many entrepreneurs still prefer to engage in this venture without hesitation due to the potential for earning high interests. This is quite an innovative industry, as Kopel et al. (2021) noted that the level of innovation in PNG is at its infancy with the majority of entrepreneurs engaging in common, non-innovative informal economic activities that are essential for meeting daily survival needs and enhancing livelihoods.

Opportunities for middleperson: A middleperson who knows both the lender and the borrower can and often connects the borrower and lender as the witness to the exchange of funds. The middleperson would collect a commission from the lender after loan repayment.

Lender challenges:

- *High Risk of default:* The informal lender faces risk of losing all or part of their money through default in the event that the borrower is unable to repay. Unfortunately, there are also people who have a habit of borrowing and do not repay the loan. Therefore, lenders have to take extra care in selecting their customers.

- *Late repayments:* When borrowers delay and make late repayments, it limits the lender's ability to create additional business by lending to other borrowers.

- *Borrowers not paying agreed interest rates:* Borrowers agree to paying a specific rate of interest before money is released and interest keeps compounding for every week that payment is delayed. Borrower failure to pay the expected amount of interest leads to anger and frustration on the part of lenders.

Borrower challenges:

- *Subject to abuse for late repayments and default:* Informal finance borrowers can be threatened and humiliated publicly in front of families, co-workers, and friends by the lenders if the repayment is not done on time or not done according to the agreed terms of lending.

- *Loss of assets and property through default:* Borrowers can lose assets to lenders if they do not pay back the borrowed money or if they take longer than the agreed repayment term. There is usually no formal written contracts for informal lending, except verbal agreements between lender and borrower, but lenders seize borrower assets such as vehicles for default.

Middleperson challenges:

If the repayment is not made on time as agreed upon, the lender will hold the middleperson accountable until this person makes sure the borrower repays the money. In instances where the borrower defaults repayment, the middle person will end up being blamed and asked to repay the borrowed funds.

Some actions taken by lenders to improve customer repayments:

- To reduce the tendency of delay in repayment of loans, lenders inform borrowers of the interest rate and loan term and how extra interest will be charged if repayment is delayed.

- Business is conducted between lenders and borrowers who are known to each other. In other instances, agents known to both parties' act as 'middlemen' and take money from lender and give it to borrower for a commission. Dealing with known parties reduces cases of default and makes it easy to follow up with delayed payments.

- Some lenders collect bank cards of borrowers to prevent borrowers form delaying loan repayment. When the fortnight or monthly salary or other payments get deposited into the borrower's account, the lender withdraws the amount owed to him/her at the Automatic Teller Machine (ATM) and returns the card to the owner.

Way forward

- Government needs to facilitate the growth of micro finance institutions to extend financial services provision as their mandate is to serve informal and low-income earners. This can serve the needs of people who are highly dependent on informal lenders.

- Setting up programs targeting the informal money lenders to make the transition from informal money lending businesses to formal Small and Medium Enterprises (SMEs) can help to reduce informal transactions. These would minimize challenges and benefit both lenders and borrowers.

- Informal finance or money lending has the potential to grow into formal finance businesses through registration with the Investment Promotion Authority (IPA) via Online Registration for SMEs. More awareness is needed to advocate for the benefits of transitioning informal lending activities to formal businesses, especially in terms of the possibility of getting access to loans to expand informal finance businesses.

- Establishing mandatory guidelines for minimum levels of documentation and registration for those engaged in informal lending and borrowing can protect both parties from each other. Basic documentation will also make it easier for law enforcement agencies to assist either party should there be conflict between them.

Conclusion

The informal lending business is fast becoming a mode of business because of its convenience to borrowers and for the profits made by the lenders. The informal money lenders are capitalising on the opportunity created by the gap in access to formal financial services through lengthy processes and the documents required to obtain a loan. Growth of the formal micro finance sector and formalisation of bigger informal finance businesses can facilitate the decrease in the demand for informal finance.

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