

Mainstreaming Informal Financial Institutions

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Table of contents

1. Origins	1
2. Evolutionary trends	2
3. Donor options	3
3.1 Mainstreaming informal finance through networking: an incentives-driven approach	3
3.2 Financial Service Association (FSAs): an option pioneered by IFAD	4
3.3 Linkage banking	5
3.4 NGOs as promoters of good practices	5
3.5 Promoting prudential regulation and supervision	6
Annex 1: Mainstreaming informal financial institutions: objective, key results and outputs	8
References	9

Abstract

Informal financial institutions (IFIs), among them the ubiquitous rotating savings and credit associations, are of ancient origin. Owned and self-managed by local people, poor and non-poor, they are **self-help organizations which mobilize their own resources, cover their costs and finance their growth from their profits**. With the expansion of the money economy, they have spread into new areas and grown in numbers, size and diversity; but ultimately, most have remained restricted in size, outreach and duration. Are they best left alone, or should they be helped to upgrade their operations and integrate into the wider financial market? Under conducive policy conditions, some have spontaneously taken the opportunity of evolving into semiformal or formal microfinance institutions (MFIs). This has usually yielded great benefits in terms of financial deepening, sustainability and outreach. Donors may build on these indigenous foundations and provide support for various options of institutional development, among them: incentives-driven mainstreaming through networking; encouraging the establishment of new IFIs in areas devoid of financial services; linking IFIs/MFIs to banks; strengthening NGOs as promoters of good practices; and, in a nonrepressive policy environment, promoting appropriate legal forms, prudential regulation and delegated supervision.

1. Origins

Labor, rice and money

In March 1967, on one of my first field trips in Liberia, I had the opportunity to observe a group of a dozen Mano peasants cutting trees in a field belonging to one of them. Before they started their work, they placed hoe-shaped masks in a small circle, chanted words and - turned into animals. One turned into a lion, another one into a bush hog, and so on, and they continued to imitate those animals throughout the whole day, as they worked hard on their land.. I realized I was onto something serious, and at the end of the day, when they had put the masks into a bag and changed back into humans, I started asking questions. I learned that they worked as a group, tackling the fields of each one in turn, carrying out all the tasks performed by men. For the activities attributed to the female sex, the women organized their own group. (Seibel 1967) During subsequent visits to each of the 17 ethnic groups in Liberia over extensive periods in the two years that followed, I continued to ask questions. The study started with group work; it ended with informal finance.

All over Liberia, I found people forming self-help groups in which each person regularly contributed equal amounts of something valuable: labour, rice, money or other items. Among the Gbandi, Loma and Kissi in the north-east, you could still find masses of twisted iron rods, with one flat and one round end – the so-called Kissi pennies, which was once the local currency before the Americo-Liberians introduced the US dollar. In all of these groups, one participant at a time received the accumulated total which he could use for his own individual benefit: to fell trees with the help of a rotating work group, to feed a wedding party with the rice accumulated by a rice savings group, or as microenterprise working capital provided by a rotating savings group. A cycle was considered to be complete when each member had received the total once over. A new cycle could then start with the same or a different membership.

Accumulating and reallocating labour, rice or money are three seemingly different forms of economic cooperation. Yet in the eyes of a peasant whom I met in the Ivory Coast in 1985, they are all about financial intermediation: "Le travail, c'est notre argent!" In Ghana, in 1979, I saw groups of women jointly producing palm-oil which they sold on the market, allocating the proceeds to one member of the group at a time. Most of these groups also provided social insurance by allocating scarce resources, out of turn, to members in emergency situations. In the early days this consisted mainly of food items whereas nowadays it is usually money.

Indigenous origins, world-wide diffusion

The institution of rotating savings is ancient, dating back at least to the 16th century, when Yoruba slaves carried it to the Caribbean, as part of their institutional luggage – or social capital. Both the term `esusu` and the practice have persisted to this day, as *esu* in the Bahamas, *susu* in Tobago or *sou* in Trinidad. Among the Yoruba in Nigeria today, there is hardly a single adult who is not a member in one or even several esusu, numbering anything between two and several dozen or even hundreds of members. The institution exists all over West Africa as well as in many other parts of the world, where it is an integral part of the local microeconomy and referred to with its own vernacular term (*arisan* in Indonesia, *paluwagan* in the Philippines, *gameya* in Egypt, *ekub* in Ethiopia, and *cuchubal* in Guatemala - Seibel & Damachi 1982).

Financial deepening

With the expansion of the money economy, these informal financial institutions (IFIs) have not lost their vigor. Quite to the contrary, they have multiplied, both in number and diversity. Banks, with their inappropriate products and practices, have not prevented the IFIs from spreading. In many instances, even the staff of commercial and central banks (as in the case of Bank Indonesia) have been found to participate. Some banks have even adopted the financial technologies used, such as daily deposit collection adopted by Bank Dagang Bali in Indonesia and by the Northern Mindanao Development Bank in the Philippines.

2. Evolutionary trends

From labour to credit...

Substantial changes have occurred in recent decades. Although with no predetermined pattern, these changes have tended to be in the following directions:

- from labour, kind or premonetary currency, to cash,
- from non-financial to financial groups,
- from rotating to nonrotating patterns,
- from short-lived to permanent groups,
- from savings only to savings-driven credit.

Groups and processes of change have been open and flexible, adapting to varying circumstances, as appropriate. For example, *in a first phase*, a rotating work group may offer its services for a wage and allocate the total to one member at a time. *In a second phase*, it may abandon the rotating pattern by keeping the income in a joint savings fund for emergencies, joint activities or distribution at the end of the year. *In a third phase*, it may turn itself into a credit association, using the savings as a permanent fund for providing loans to members. *In a fourth phase*, as the financial volume increases, the lending becomes commercialized as indicated by high interest rates and insistence on collateral. In this phase, income interest payments become the main form of internal savings mobilization.

... and from traditional organizations to microfinance

My first studies in the 1960s were devoted to *traditional organizations* (Seibel & Massing 1974), a term which – at best - evoked the interest of anthropologists. During the 1970s, technical assistance agencies rediscovered these organizations under an old name used by Raiffeisen a hundred years earlier: *self-help groups* (Seibel & Damachi 1982) In the mid-1980s, they changed into *informal financial institutions* (Seibel & Marx 1987). Finally, in 1990, inspired by the 1989 World Bank Conference on Microenterprises, I proposed to the Economics Institute in Boulder, CO, that it offer part of its program in *World Banking and Finance* under the heading of *Microfinance*, comprising both microsavings and microcredit (Seibel 1996). This new term reflects the fact that it becomes increasingly difficult to clearly distinguish between formal and nonformal origins and practices.

Local monetization and institutional innovation

The most important innovation has been the evolution from a *non-rotating group* - saving in labour, livestock, commodities, premonetary means of payment or hard cash - to a *non-rotating credit institution* which mobilizes its own savings for the purpose of building up a credit fund. In Liberia, for example, this process started with the opening of the Firestone plantations in the 1930s and reached virtually all ethnic groups towards the end of the 1960s (Seibel 1970; Seibel & Massing 1974). The

single most important factor which led to the emergence of IFIs, their transformation into nonrotating microfinance institutions and their continuous growth, appears to have been the monetization of a local economy. In severely undermonetized economies, as, for example, in rural Laos (Kunkel & Seibel 1997), IFIs are virtually absent.

Daily deposit collection

Institutional innovation also pertains to the local emergence of entirely new informal financial institutions. Daily deposit collection is a financial institution on West African markets and we can trace this back to about about fifty years ago. It is called *ajo* among the Yoruba of Nigeria, *anago susu* in Ghana, *nago* in Ivory Coast (*nago* or *anago* = Nigerian), *yesyes* in Southern Togo, *jojuma* among the Kotokoli in central Togo. The deposit collector may serve anything between 200 and 600 clients a day. From each he collects a fixed amount which is then registered on a printed card. By the end of the month he returns the total, keeping the amount of one daily deposit as a collector's fee. The efficiency of the *anago susu* is far beyond the possibilities of even the most advanced modern bank. On one of the markets in Accra I measured the time it took on average to make a deposit including the walking time from one client to the next: 17 seconds. Making a microloan took just under one minute. In the mid-1980s, the deposit collectors in Accra formed the Greater Accra Susu Collectors Association, which was registered and planned to set up its own bank, but the authorities were not favorable (Seibel & Marx 1987). Today (February 2000), the Ghana Cooperative Susu Collectors Association, with 397 members out of an estimated total of 1040 susu collectors, covers all of Ghana. The World Bank, together with IFAD and the African Development Bank, is in the process of supporting linkages of susu collectors with rural banks and other formal institutions and the establishment of a national risk fund by the association.

Dhikuti, the small businessman's self-help finance company

There are numerous other forms of institutional upgrading to be found worldwide. In Nepal, institutional upgrading has taken a different route. Until the 1950s, the *dikur* or *dhikuti* was a simple rotating savings association among Thakali traders. Since then, it has spread throughout all towns and most ethnicities in Nepal and become *the small businessman's self-help bank* (Seibel & Shrestha 1988). As business opportunities grew and money became scarce, secret bidding (widespread also in the Chinese *hui* and the Vietnamese *ho*) replaced allocation by lottery. For example, at the first turn, the lowest bidder may accept a pot of \$1000 for \$600, reducing individual contributions by 40% or putting the balance of \$400 into an emerging loan fund. In response to a new law permitting the establishment of finance companies, the first dhikuti have now started to register as finance companies and this has substantially altered the traditional pattern of rotating savings and credit. The most prominent of these is the Himalaya Finance and Savings Company, which offers various savings and credit products to the poor and near-poor throughout Nepal, including contractual savings and term finance. At some point, up to 600 daily savings collectors collected deposits of US\$ 0.15 per day, before new central bank regulations led to a reduction in the number of collectors and an increase in deposit amounts. (Seibel & Schrader 1999)

3. Donor options

3.1 Mainstreaming informal finance through networking: an incentives-driven approach

Given the prevalence of the informal financial sector and its capacity for adaptation and innovation, special support may be given to informal financial institutions (IFIs), among them financial self-help groups in particular. This may entail: (a) enhancing management skills and operational practices; (b) transforming rotating and nonrotating savings and credit associations, funeral societies, deposit collectors, also moneylenders, and similar informal institutions – many of indigenous or traditional

origin - into financial intermediaries with a permanent loan fund; (c) availing of opportunities for upgrading to regulated financial institutions and mainstreaming into the formal financial sector; and (d) entering into linkages with commercial banks. A particular strategy to be supported by donors, in partnership with an NGO, might be ***upgrading & mainstreaming through networking among informal IFIs as an incentives-driven option***. IFIs may be offered assistance to establish networks and enlist as members. The network may be registered under a suitable legal form: as an association, a foundation, a cooperative, a company and eventually perhaps, at a higher evolutionary stage, a formal financial apex institution. In a stepwise order, the network may offer services as an incentive to join: training, consultancy, book-keeping tools, legal assistance, exchange of experience, interest representation, dialogues with local and national authorities, auditing & supervision services, liquidity exchange, and commercial bank linkages. As members of the network, IFIs are free to choose whether they remain informal network members or, with network assistance, seek a semiformal or formal status for themselves. Incentives for mainstreaming are listed in Box 1; a basic LogFrame for donor intervention is given in Annex 1.

Box 1: Stepwise incentives for mainstreaming as a service to IFIs	
<i>Mainstreaming</i>	<i>Incentive</i>
1. Registration	Basic training (accounting)
2. Reporting	Financial management training
3. Legal status	Consultancy services in good practices
4. Prudential norms	Liquidity exchange and refinancing
5. Supervision	Accreditation with a seal of quality

3.2 Financial Service Associations (FSAs): an option pioneered by IFAD

The concept and development of Financial Service Associations (FSAs) are an IFAD innovations built on the principles of indigenous nonrotating savings and credit associations: proximity, local financial intermediation, ownership and self-management by the poor, self-reliance, and sustainability. With a view to promoting cost-effective delivery of financial services at the village level in areas devoid of banking facilities, IFAD first introduced this model in the Republic of South Africa in 1994, followed by the Republic of Congo in 1996, and in the Republics of Guinea and Benin in 1997. Introduction of the model in Ghana, particularly in the northern regions with sparse rural banking facilities, is under preparation. The FSA model avoids use of external funds by mobilizing local savings in the form of equity and transforming them into small loans to shareholders for quick turn-around activities. The salient features of the FSA model are as follows:

- (a) *Proximity*. An FSA is a joint stock company with a variable capital that is owned and operated by shareholders, who are local residents.
- (b) *Savings*. Mobilization of local savings is as equity or stock, rather than demand deposits. Local resource accumulation and security of savings are major incentives for buying shares.
- (c) *Accounting*. Record keeping, including the annual closing of accounts, is done locally by the FSA itself. Accounting and administrative procedures are simplified and transparent and are based on local practices and experience.
- (d) *Management Autonomy*. All decisions are taken and carried out by shareholders themselves including creditworthiness examinations. There is no ceiling on the number of shares held by a member; but no shareholder can have more than 10 votes in the General Assembly where all major management decisions are taken.
- (e) *Controls*. The mechanisms for internal and external controls constitute a coherent whole that facilitates the rapid attainment of autonomy and self-regulation.
- (f) *Profitability*. The shareholders themselves define the FSA's strategy for profit generation; concern for profitability is an integral part of all decision-making.
- (g) *Lending Operations*. FSA mobilizes financial resources in the form of equity from within its area of operations for investment back into the area. The main financial product of the FSA is represented by small very short-term loans that can foster the socio-economic promotion of at least

80% of the membership. Its offer of financial services may be expanded but only after participatory analysis both of the costs of credit and of ways to attain an acceptable trade-off between the financial health of the FSA and the profitability to borrowers.

- (h) *Sustainability*. The members define their own strategies for risk management, for constituting reserves, for remunerating capital and for making allocations for operating costs, bad debt provisioning and the preservation of the value of capital against inflation.
- (i) *Networking*. The creation of FSAs is able to stimulate the emergence of local institutions and networks providing central services to the FSAs. As intermediaries, FSAs are able to facilitate access by formal financial institutions to the rural markets.

Thus, the FSA concept is a flexible microfinance model for delivery of low-cost financial services to rural areas by establishing village-level financial structures that are initiated, owned, and operated by villagers themselves. It represents yet another solution to the lack of interaction between formal and informal financial entities. (The World Bank & IFAD 2000, Working Paper I, Part C, pp. 8-9)

3.3 Linkage banking

At their own initiative (and sometimes aided by consultancy proposals), informal financial institutions have entered into numerous linkages, mostly depositing savings in cooperatives and banks. But being informal, these institutions had great difficulty in accessing credit from those banks or cooperatives. This is where APRACA, a Bangkok-based association of central and rural-agricultural banks in Asia and the Pacific, intervened. An increasing number of member institutions, such as Bank Indonesia, Landbank in the Philippines, NABARD in India and BAAC in Thailand, have encouraged banks and NGOs to cooperate on the commercial terms of existing financial self-help groups (Ghate 1992; Kropp et al. 1989; Seibel & Parhusip 1992; Seibel 1996), thereby reducing the transaction costs of lenders and borrowers as well as deposit takers and depositors. This has worked well in Asian countries where policy frameworks have favored financial innovations, cost-covering interest rates and institutional viability. In Africa, where policy environments are unfavorable - or less stable, as in Nigeria, APRACA's sister organization AFRACA found it more difficult to promote linkage banking. However, some of its member institutions, such as CNCA in Burkina Faso, AFC in Zimbabwe, and the Central Bank of Nigeria, have taken promising initiatives. In Ghana, the World Bank, IFAD and the African Development Bank are preparing a new initiative of linking indigenous savings and credit associations, the so-called susu clubs, and daily deposit collectors to banks.

3.4 NGOs as promoters of good practices

NGOs can have a special role to play in the promotion of sound microfinancial institutions. They can disseminate information and organize exposure training programs such as the one provided by the Grameen Bank in Bangladesh. Through training, they can assist small institutions to improve their viability and upgrade their legal status, as required. They can also initiate financial operations which, in many countries, precludes deposit collection. But if they are seriously interested in financial operations, they should register as a rural or commercial bank, finance company or savings and credit cooperative. Among those that have successfully embarked on this road are, to name but a few: BancoSol in Bolivia, Bank Purba Danarta and numerous other NGO banks in Indonesia, and CARD Rural Bank in the Philippines (Seibel & Torres 1999).

NGOs may propagate good microfinance practices (but not *best* practices, which evokes notions of universally valid optimal solutions). Good practices are crucial to the sustainability of microfinance services. They may comprise:

- the mobilization of internal resources for institutional self-reliance through savings collection, higher interest rates on loans, share capital, profits and insurance premiums;
- the promotion of microsavings as a source of microenterprise or farm household self-financing, including voluntary withdrawable savings, time deposits, mandatory regular savings, lottery savings, and daily savings collection on doorsteps;
- appropriate microcredit products with small loan sizes growing according to repayment performance and absorptive capacity, mostly short maturities and installments according to customer capacity, insistence on timely repayment, and market rates of interest covering the costs of each product;
- microinsurance products contributing to loan security, such as life, health, cattle insurance;
- product reciprocity, tying credit to savings and insurance to enhance financial discipline and bankability;
- collection reciprocity as a means of arrears prevention, combining savings and loan installment collection or financial and commodity transactions;
- customer-oriented microfinance procedures and services set by financial institutions rather than government, including sound financial management, convenient collection and deposit facilities, appropriate loan processing, adequate risk management, timely repayment collection, monitoring and effective information gathering;
- terms and conditions which benefit from the experience of formal and nonformal institutions and serve the interests of both the institution and its customers.

3.5 Promoting prudential regulation and supervision

Indigenous selfregulation

The evolution from rotating savings groups to non-rotating credit groups has been accompanied by a shift from oral rules and regulations to written bye-laws. In their simplest form, they may read like the rules of a so-called *money company* found in a small Mano village in the Liberian hinterland in 1967:

"All members should agree upon one sum of money to be paid every Sunday. And one late to pay that Sunday five cents interest will be added to the sum he suppose to pay. Members should always put in the income; No matter how hard money business might be; you will have to put in the income. The five officers should agree before the money should be loaned to someone."
 "Any money missing from the bank the Treasurer is responsible to pay for what is missing."
 "Time for the income: Every Sunday." (*Literal transcription*) (Seibel & Massing 1974:76)

Prudential regulation and supervision

Under conditions of a repressive policy environment, IFIs and other unregulated MFIs have a competitive advantage as they are free to set their own interest rates and other contract terms. Many IFIs remain informal simply because there is no suitable legal form available, or at least no legal form with sufficiently low minimum equity capital requirements, or with capital adequacy ratios instead. However, once the policy environment is deregulated and entrance barriers are removed, much may be gained from prudential regulation and supervision. Three reform measures are of crucial importance for the upgrading of IFIs into regulated MFIs:

- (1) *the deregulation of interest rates on deposits and loans:*
 permitting each institution to adjust its interest rates to its effective costs, including those of serving marginal areas and of collecting microsavings and microinstalments at doorsteps.

- (2) *a revision of the banking law:*
permitting local people to establish their own small financial institutions with moderate minimum capital requirements, or else capital adequacy ratios (higher than those for commercial banks). In addition, the legal system should provide for alienable land-use or ownership rights as a basis for collateral and for the efficient processing of claims arising from bad debts.
- (3) *the provision of effective bank supervision:*
providing guidance and supervision to institutions with microfinancial services in the interest of both the MFIs and their clients. In the case of a multitude of small local microfinance institutions, such supervision may be provided by separate, second-tier regulatory authorities within a delegated system of regulation and supervision, i.e., through self-organized networks of MFIs which in turn are supervised by the financial authorities.

Do MFIs benefit from banking status?

Or should they remain hidden within a nonformal financial sector? The answer is an unequivocal 'yes', they should stay informal if the policy environment is repressive, enforcing interest rate regulation, submitting institutions to inappropriate supervisory agencies, or simply barring institutions from sound practices. In many countries, equity capital requirements are such that banking status is beyond the reach of local MFIs; and the only way for IFIs to register and thereby turn into semiformal MFIs is under the Societies Act, as non-stock, non-profit corporations, private or public trusts, or cooperatives. Upgrading to some legal status may enable the institutions to substantially increase their assets and continue building them up instead of redistributing them periodically among the members, as is done by most IFIs.

An example are the the Lumbung Pitih Nagari (LPN) among the Minangkabau in West Sumatra, Indonesia. They have evolved from two informal institutional sources: the communal rice store, *lumbung pitih*, and the rotating savings group, *julo-julo*. As money was substituted for rice, about 500 LPN turned into semiformal financial institutions owned by their members and registered with the provincial government. With the creation of a new provincial law during the 1970s, which does not come under the national banking law, legal upgrading followed institutional evolution. The provincial government gave the LPN an equity injection, which approximately half of them used for the purpose of growing in financial strength and outreach. In 1988, with the passing of a village banking law, LPN entered into yet another phase of legal evolution, meaning that they could now register as formal village banks, Bank Perkreditan Rakyat (Seibel 1989:24 -31). An increasing number of LPN has taken advantage of this option in recent years, with substantial upscaling effects on their operations.

Towards delegated regulation and supervision

Upgrading large numbers of IFIs into formal microfinance institutions poses new supervision problems. Supervising large numbers of MFIs exceeds the capacity of most central banks or bank superintendencies in developing countries. In a number of countries - among them Indonesia, the Philippines, Vietnam, Tanzania and several Latin American countries - discussions are now under way to establish a second-tier regulatory authority as a self-regulatory and self-supervisory apex organization for MFIs. In Nigeria, such a delegated system exists already for community banks.

However, most of the discussion on institutional upgrading, regulation and supervision centers on semiformal institutions initiated and supported by NGOs and other donors. Much remains to be done, in terms of opportunities for voluntary upgrading, for the vast numbers of genuinely indigenous IFIs.

Annex 1:

Mainstreaming informal financial institutions: objective, key results and outputs

Objective: Informal financial institutions (IFIs) are upgraded and mainstreamed

1. Networking among IFIs is facilitated

- 1.1 Institutional patterns of forming financial grassroots organizations are analysed (eg, rotating and nonrotating savings & credit associations, self-help groups with financial services such as water-user associations or women's groups, deposit collectors, moneylenders)
- 1.2 Existing IFIs of the poor are identified
- 1.3 The poor are assisted in joining local IFIs owned and managed by the poor
- 1.4 Networking among IFIs is facilitated
- 1.5 Central network services are promoted as incentives to join the network (such as: training, consultancy, book-keeping tools, legal assistance, exchange of experience, interest representation, dialogues with local and national authorities, auditing & supervision, liquidity exchange, and commercial bank linkages)
- 1.6 Voluntary registration of IFIs is facilitated
- 1.7 NGOs are supported as facilitators of IFI networks and trainers of IFIs
- 1.8 Prudential norms are agreed upon

2. Mainstreaming is initiated by incentives to IFIs

- 2.1 Basic accounting training is provided as an incentive for registration with a network
- 2.2 Financial management training is provided as an incentive for financial reporting to the network
- 2.3 Consultancy services in good practices are provided as an incentive to acquire a legal status
- 2.4 Liquidity exchange and refinancing services are provided as an incentive to follow prudential norms
- 2.5 Accreditation with a seal of quality is provided as an incentive to submit to external supervision

3. Upgrading of IFIs is facilitated

- 3.1 Legal upgrading to attain a suitable legal status is facilitated
- 3.2 Human upgrading through staff and financial management training is facilitated
- 3.3 Organisational upgrading, converting rotating groups (RoSCAs, tontines), funeral societies, deposit collectors and other IFIs into permanent institutions with a loan fund built from equity, deposits and fees or premiums
- 3.4 Operational upgrading, including proper book-keeping, effective financial products, reporting to the network, is facilitated
- 3.5 Financial upgrading in terms of self-reliance (mobilizing internal resources), viability (covering costs from operating income) and sustainability & outreach (increasing earnings for expansion) is facilitated

4. Access to banks (Linkage Banking) on commercial terms is facilitated

- 4.1 Refinancing services are provided
- 4.2 Deposit services are provided
- 4.3 Payment services are provided
- 4.4 Financial consultancy services are provided

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