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From Informal to Formal: Why Small Merchants Avoid Banking Systems and What Changes Their Minds

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Abstract
The transition of small traders from the informal economy to the formal financial sector is still a core issue in global economic development strategies. In spite of all the technological advances, a large proportion of micro-enterprises and street vendors around the world remain unbanked, preferring to stick to cash transactions and informal financial safety nets. This peer-reviewed analysis investigates the complex barriers that prevent small merchants from entering formal banking systems, and categorises these barriers into structural, financial and psychological factors. We draw on literature and data generated specifically between 2016 and 2017 to explore the fundamental disconnect between the rigid architecture of traditional banking and the high-frequency low-denomination reality of informal commerce. In contrast, this paper identifies the main drivers that actually promote formalisation through the use of mobile money, targeted field interventions and innovative microfinance approaches. Empirical evidence from Sub-Saharan Africa and South Asia in this period shows that removing the barriers to initial access and taking advantage of mobile telecommunications can radically change the financial behaviour of a merchant. This paper provides a solid foundation for creating financial inclusion policies that support sustainable microenterprise growth by understanding both the rational resistance to traditional banks and the successful uptake of digital financial services.

Keywords: *small merchants, microenterprises, traditional banking, microfinance strategies, digital financial services etc.*

I. Introduction

The informal economy is not a marginal phenomenon: in many developing countries it underpins employment and daily economic activity. The sector is dominated by small traders, operating largely in cash – market vendors, kiosk owners, street hawkers and micro-entrepreneurs. A striking characteristic of these economic actors is their consistent refusal to utilise formal banking systems. The explanation has historically been either a lack of financial literacy or just geographic isolation. More nuanced pictures are, however, revealed by comprehensive research carried out between 2016 and 2017 that avoiding the formal banking system is largely a rational economic choice driven by structural frictions, high costs and the fact that bank product designs are so mismatched with the daily cash flow realities of the poor (Williams, Shahid and Martínez, 2016).

In the 2016-2017 time frame, the discussion about financial inclusion evolved from just offering 'access' to 'active usage' and 'impact' (Morduch, 2016). The global unbanked population remained staggeringly high, with hundreds of millions of micro-entrepreneurs relying solely on informal mechanisms such as Rotating Savings and Credit Associations (ROSCAs), moneylenders and cash hidden at home. These methods are easily accessible but they come with risks such as theft, group default and the 'kinship tax' – social pressure to share liquid cash to extended family members.

This paper seeks to rigorously investigate why small merchants avoid traditional banks and, more importantly, what interventions change their behaviour. We investigate the barriers to entry, from documentation to withdrawal fees, that effectively exclude small merchants from the formal sector. We also unpick the drivers of change, especially the exponential rise of mobile money and digitally enabled financial services which took off at an unprecedented pace around 2016 and 2017. As seminal research in this period has shown, when financial products are developed to reflect the flexibility of cash but bring the security of a digital ledger, merchants show a great willingness to formalise their savings (Suri & Jack, 2016; Somville& Vandewalle, 2017).

The next sections are structured as follows: In Section 2 we discuss the specific barriers that deter merchants from going to formal banks. In Section 3 we examine the informal alternatives they employ. Section 4 discusses the technological and structural drivers of formalisation based on field data from 2016–2017. Section 5 discusses the effect of these transitions on microenterprise development. Section 6 concludes.

II. The Architecture of Exclusion: Why Merchants Reject Formal Banks

Small merchants' reluctance to open and utilise formal bank accounts arises from a fundamental mismatch between the business models of conventional commercial banks and the economic realities of informal microenterprises. Research published in 2016 and 2017 identifies a number of overlapping structural barriers that together constitute a 'architecture of exclusion' (Research ICT Africa, 2017). These barriers fall into three broad categories: financial costs, regulatory friction, and product inflexibility.

2.1 Transaction Frictions and Negative Return

"The biggest deterrent for a small merchant with razor-thin margins is the cost of banking. Traditional banking models rely on account opening fees, minimum balance requirements and flat-rate withdrawal fees. For example, in Ethiopia, tight collateral requirements and high transaction costs are significant supply-side constraints that constrain microenterprises' access to formal credit and savings (Nega & Hussein, 2016; Tarfasa et al., 2016). If a street vendor saves a little money every day, and pays a fee to withdraw that money a few days later to buy inventory, the effective interest rate on that deposit becomes very negative. This economic reality makes formal banking irrational for short term working capital management.

2.2 Challenges in Regulation and Documentation

Stringent 'Know Your Customer' (KYC) requirements present another major challenge. In the informal sector, small merchants operate without formal business registration, tax identification numbers, and often without formal property deeds, utility bills, or other proof of residential addresses. Therefore, they are routinely refused the ability to open accounts. The 2017 After Access Informal Business Survey across several African countries shows that 76% of informal businesses did not have a bank account primarily because they could not meet the formal requirements for documentation and funding (Research ICT Africa, 2017).

2.3. Geographical and Psychological Distance

While branch networks have grown, formal banks are often concentrated in urban commercial areas far from peri-urban slums and rural markets where many informal merchants operate. The opportunity cost of going to a branch and waiting in queue is directly converted into lost sales (Menkir, 2016; 2017). There is also a profound psychological barrier. The traditional banks are often seen as scary places, made for rich people and those who have formal jobs. This lack of trust is compounded by low levels of financial literacy and fear of being exposed to unwanted taxation or seizure of assets by the state through engaging with formal institutions.

Table 1: Typology of Barriers to Formal Banking for Small Merchants (2016-2017 Context)

Barrier Classification	Specific Constraint	Impact on Microenterprise Behavior
Economic / Financial	High transaction fees and minimum balances	Erodes already narrow profit margins; capital is locked away from daily use.
Regulatory	Strict KYC and anti-money laundering documentation	Prevents account opening due to lack of formal ID, business registration, or utility bills.
Geographic	Branches located far from informal markets	High opportunity cost of time; traveling to banks means lost sales and revenue.
Psychological	Mistrust of formal institutions and intimidation	Fear of hidden charges, state taxation, and perception that banks are "not for the poor."
Product Fit	Inflexible product structures designed for salaries	Fails to accommodate the highly volatile, daily cash flow needs of small vendors.

III. The Informal Financial Ecosystem: Survival and Coping Mechanisms

Where formal banking does not exist, small merchants depend on informal financial networks that are well embedded. They are very much adapted to the local context and give the necessary liquidity but with them come considerable vulnerabilities. Understanding baseline systems is critical to understanding what drives a merchant's migration to formal platforms.

3.1 Rotating Savings and Credit Associations (ROSCAs)

ROSCAs are still a common way to accumulate capital in the informal economy. Merchants form trusted groups and each contributes a fixed amount of cash daily or weekly into a common pool. At every interval the pot is awarded in its entirety to one member. ROSCAs can be effective at solving the behavioural problem of savings discipline through the harnessing of peer pressure but are inherently inflexible (Karlan, McConnell, Mullainathan, & Zinman, 2016). A merchant can not draw on funds in an emergency unless it is their turn. The system always runs the risk of group default.

3.2 Stashing Cash and Money Guards

Physical cash is the most common means to managing daily liquidity. But cash is also very vulnerable to theft, fire, and the temptation to spend it immediately. Further, informal traders face tremendous social pressures to provide liquid assets to family members in emergencies. To shield their working capital from these demands, merchants sometimes hire 'money guards' - trusted local shopkeepers to keep cash in return for a small fee or for nothing. The fact that the money guard accepts negative or zero interest rates suggests that the merchant has an urgent need for a safe and illiquid storage mechanism to protect the business capital from household dissipation (Dupas, Welch, & Geray, 2016).

3.3 Unregistered Moneylenders

Merchants frequently turn to informal moneylenders in the event of a sudden liquidity crisis or a time-sensitive inventory purchase opportunity. But these lenders provide instant, collateral-free loans, based on personal links, at exorbitant interest. This predatory pricing often traps microenterprises into a cycle of debt, greatly restricting long-term enterprise development and accumulation of capital (Rossi, Biffignandi, & Shirley, 2016).

IV. Catalysts for Change: What Drives Formalization?

If traditional banks are structurally misaligned with merchant needs, what forces compel a shift toward formalisation? The literature of 2016 and 2017 indicates that merchants are not short of desire to save securely; what they need are products that fit their operational constraints. The two main catalysts identified during this period were the removal of arbitrary access barriers and the rapid growth of mobile money ecosystems.

4.1 Particular Measures to Overcome the Savings Constraint

In a landmark field experiment in Kenya, offering unbanked market vendors fee-free basic savings accounts had a profound impact on their financial behaviour (Dupas, Welch, & Geray, 2016). Removing the initial frictions of account opening (e.g., high minimum balances, complex paperwork) led to a large share of female market vendors actively using formal accounts. And importantly they used these accounts even with withdrawal fees. The study showed that the vendors appreciated the psychological and physical distance that the bank created between their business capital and their everyday household needs.

In a similar vein, Somville and Vandewalle (2017) implemented a randomised controlled trial in rural India whereby villagers were granted access to formal bank accounts. They found that treated individuals maintained significant savings in their new accounts, substituting away from riskier informal saving mechanisms. They changed their mind about banking because of a simple, accessible formal ledger, and it revealed to us an unmet, latent demand for secure savings vehicles. When formal institutions customise interventions with behavioural nudges, such as SMS reminders, they raise savings rates amongst these newly banked populations even further (Karlan et al., 2016).

4.2 The Mobile Money Revolutions

Mobile money was the most transformative catalyst for small merchant formalisation in 2016-2017 period. Services such as M-Pesa in Kenya and MTN Mobile Money in Uganda rewired the economics of financial inclusion fundamentally. Mobile money overcame the geographic barrier by turning the merchant's basic feature phone into a bank branch and leveraging a decentralised network of local agents for cash-in/cash-out services.

Suri and Jack (2016) provide compelling evidence that access to mobile money significantly reduced extreme poverty in Kenya, mostly by allowing users, particularly those in female-headed households, to save more efficiently, smooth consumption during economic shocks, and transition their main occupations from subsistence agriculture to retail and microenterprise. Mobile money had a secure digital ledger, secured with a PIN, that replicated cash liquidity without the risk of theft and involuntary sharing. Similarly, Munyegera and Matsumoto (2016) in Uganda showed that mobile money adoption increased household consumption and welfare through cheaper and faster remittances that merchants used to buffer business volatility. Moreover, the FinScope (2016) survey for Rwanda acknowledged that digital financial services was the main driver of the financially excluded into the formal sector without ever going through traditional brick-and-mortar banks.

Table 2: Comparative Analysis of Financial Mechanisms for Small Merchants

Financial Attribute	Informal (Cash/Mattress)	Informal (ROSCAs)	Digital/Mobile Money (2016-2017)
Liquidity	Extremely High	Very Low (only on payout turn)	High (via local agent network)
Security Risk	High (Theft, fire, kin pressure)	Moderate (Group default risk)	Low (Digital ledger, PIN protection)

Cost Structure	Inflation depreciation	Zero explicit cost, high social cost	Per-transaction fees, no maintenance fees
Enterprise Impact	Capital easily depleted by consumption	Allows sporadic bulk inventory purchases	Enables daily consumption smoothing and sustained growth
Documentation	None required	Social capital and trust required	Tiered KYC (often just a mobile SIM registration)

V. The Impact of Formalization on Microenterprise Development

Often, the trajectory of a microenterprise changes effectively when a small merchant is incentivised to use formal or quasi-formal digital financial services. There is enough evidence in the literature from 2016-2017 about the microeconomic effects of this transition, in particular that of access to credit, capital accumulation and institutional constraints.

5.1 Expansion of Assets and Accumulation of Capital

Merchants will be able to more efficiently build up capital by offering a safe way to save digitally. The daily profits are kept safe to safeguard the business's working capital against the high frequency demands of the informal economy. That way merchants can buy inventory later on in bulk which gives them access to wholesale discounts and therefore much better profit margins. This phenomenon is strongly related to the pecking order hypothesis (POH) in microenterprise financing, which suggests that small firms prefer internal finance (retained earnings and savings) over external debt in highly constrained financial markets (Kuruppu & Azeez, 2016).

5.2 The path to formal credit

The transition to mobile money also creates a record of digital transactions. Until 2016, credit bureaus had no clue about informal merchants. As merchants started using mobile money to pay suppliers and get paid by customers, fintech companies and forward-thinking microfinance institutions began using these digital footprints to underwrite unsecured micro-loans. But not without obstacles. Although microfinance institutions exist in Ethiopia, a large share of small enterprises still faced challenges in accessing external credit due to institutional rigidities and the absence of adapted loan products (Abara & Banti, 2017; Mersha & Ayenew, 2017). Statistics affecting microfinance of this period indicated that institutions had to provide more than just loans; they had to provide comprehensive and flexible financial portfolios that were truly aligned with the cash flow dynamics of the poor (Morduch, 2016).

5.3. Coping with External Shocks

Finally, the formalisation greatly increases the durability of the microenterprise. The informal sector is highly vulnerable to systemic and idiosyncratic shocks. An entrepreneur who has no formal savings or insurance may be required to sell off business assets at a steep loss in the event of a health crisis or natural disaster. Mobile money and formal savings accounts allowed merchants to generate financial cushions so that the enterprise could survive periods of economic volatility without falling back into extreme poverty.

VI. Conclusion

The durability of the unbanked small merchant is not irrationality but a conscious response to a formal banking system that was not designed for the informal economy. Evidence that emerged during the critical period of 2016-2017 reveals how traditional banking architectures create an insurmountable architecture of exclusion, characterisedby high fees, stringent documentation, and geographic centralisation. In response, small merchants construct complex informal financial lives, based on cash, ROSCAs and moneylenders, despite the risks involved.

What changes the mind of a merchant is the arrival of financial products that respect their economic reality. The literature shows there is huge latent demand for safe savings when structural barriers are reduced. The rapid adoption of mobile money, as shown by Suri and Jack (2016) and Munyegera and Matsumoto (2016), revealed that technology could combine the informal flexibility and formal security. By providing cheap, highly accessible and secure digital ledgers, mobile money platforms have managed to pull millions of merchants out of the cash economy. Ultimately, increasing financial inclusion for microenterprises means facilitating the ability of financial institutions rather than small merchants to adapt. To fully harness the economic engine of the informal sector, the global financial system must develop products that match the speed and flexibility of informal cash.

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