RETHINKING RURAL FINANCE: A SYNTHESIS OF THE *PAVING THE WAY FORWARD FOR RURAL FINANCE* CONFERENCE*

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EXECUTIVE SUMMARY

The conference *Paving the Way Forward for Rural Finance*, held in Washington DC, June 2003, brought together academics, donors, practitioners, and development professionals to discuss successes and failures from past involvement in rural finance, and to explore creative solutions to the problems that constrain rural financial market development. This conference was meant to encourage a reengagement and a rethinking by donors and practitioners in the field of rural and agricultural finance. This paper represents a synthesis of ideas that emerged from the conference. The ideas here are not intended as a comprehensive list of either the constraints or possible programming options. Instead, this synthesis puts forward a way of thinking about rural finance and proposes concrete programming options that flow from this conceptualization of the rural finance problem. Conclusions and recommendations presented here do not necessarily reflect USAID policy.

The steady withdrawal of USAID and other donors from rural finance over the 1980s was the result of hard-learned lessons about the failures of subsidized credit and the consequent dependency on external sources of funding. Yet the entry of private, unsubsidized institutions has been slow, and rural financial markets remain thin. In this environment, the productivity of the rural economy is dampened by three forces: (i) liquidity constraints, (ii) risk constraints, and (iii) savings constraints. While growth and poverty reduction are sometimes discussed as separate goals and addressed with different policies, relaxation of these constraints holds out the promise of an interlinked approach to both growth and poverty reduction. A deep and broadly-based rural financial system can boost growth by enhancing the productivity of agricultural enterprises, address poverty by improving the financial access of low-wealth households, and relink growth with poverty reduction by assuring that small-scale producers and low-wealth households are positioned to participate in new markets and growth opportunities.

Now is a propitious time for USAID and other donors to rethink rural finance with the goal of enabling the deep and broadly-based rural financial markets needed to achieve these growth and poverty reduction goals. Given the unique challenges of the agricultural economy, and the diversity of rural clients, it is unlikely that any single institution can achieve these goals. For example, microfinance has a role to play in expanding the reach of the financial system to clients with needs for small loans and lacking collateralizable assets. At the same time, there is space and need for financial institutions that can lend on the conventional collateral of agricultural and other rural enterprises. The key is to find a set of policies and programs that will induce the entry, assure the sustainability and facilitate interlinkages along a continuum of rural financial institutions poised to provide credit, savings, insurance and other financial services.

While a number of the specific interventions discussed in this document have been implemented as elements in other development programs, one of the key points raised by many at the conference is the need to utilize effective programming approaches, whether proven or innovative, with the conscious objective of promoting rural financial markets as part of broader financial sector strengthening. Unlike earlier generations of rural finance programming, the approaches here are *indirect*—they do not directly provide financial services. Instead, they create an enabling environment and strengthen institutional capacity in a way that will induce the entry and evolution of competitive providers of rural financial services. The result should be a stable yet dynamic financial sector, capable of operating without subsidy, and freed of the sustainability limitations that plagued earlier rural finance efforts.

The ideas presented here are organized into five strategic programming areas that address the liquidity, risk and savings constraints to economic growth in the agricultural sector and rural areas. Mitigating these constraints could reshape the rural economy, opening the way for vibrant rural financial markets poised to service agricultural enterprises and rural households. The five strategic areas are:

1. Mitigating Risk

Correlated risk and sectoral uncertainty limit the entry of new financial institutions into the rural market. Creating instruments that protect financial institutions from some of this risk can stimulate lending in rural financial markets, especially for agriculture. Such policies will have a multiplied effect as they open the space for the entry of new and more affordably priced financial intermediation services and help liberate rural households from risk constraints that suppress their own entrepreneurial activity.

2. Improving Information Access and Management

Rural financial institutions have a difficult time gathering sufficient information about potential clients and managing that information efficiently. Improving the infrastructure for collecting, processing and sharing information will make smaller rural institutions more efficient and lower lending costs. Improving informational systems will help these institutions move along the path to financial sustainability.

3. Diversifying Products and Services

To help reduce poverty and stimulate economic growth in rural areas, effective rural financial markets would provide a wide range of services and products including lending, savings, leasing, insurance and transfers (e.g., of remittances). While various conference papers touched on a number of these products and services, the need for expansion of savings services was highlighted as an element critical to both building institutional sustainability and meeting client needs. Innovative savings products for rural areas give local families reliable ways of making their savings more productive and help them cope with shocks. Savings instruments can relax aggregate liquidity constraints by capturing and intermediating the substantial inflow of remittances. Achieving these goals will require well sequenced efforts to enhance institutional capacity, extend the reach of effective regulation and supervision, and intermediate remittance flows.

4. Strengthening the Legal Environment

A well-functioning policy and legal framework is key to the development and sustainability of the financial sector. The nature of laws that govern the financial sector, as well as the quality of the institutions that enforce those laws, will also largely determine the shape and depth of the financial sector. Of particular importance are the laws and institutions that either facilitate or inhibit secured lending by influencing the ease with which agricultural and other rural assets can be used as collateral. The legal environment for secured lending can be strengthened through collateral widening measures that codify land rights, promote legal reform for institutions, cooperatives and NGOs, and expand borrowing laws to increase the participation of poor. Improving the systems through which collateral can be provided and collected will open the door to a larger client base, while still protecting the interests of lenders.

5. Enhancing Value-chain Financing

Input suppliers, processing firms, warehouses and other commercial actors in the agricultural and rural sectors provide critical financial services to small and medium rural producers. Enhancing existing, interlinked rural finance activities and facilitating new services by these actors can expand access and ensure competitively-priced financial services.

These five strategic programming areas are intended to open the way to greater entry and sustainability of private financial institutions along the continuum that stretches from microfinance providers to conventional, collateral-based lenders who operate without extensive monitoring and supervision of their clients (so-called "arm's length" lenders). Given the importance of microfinance in assuring a financial system that reaches out to provide services to a broad range of rural residents, it is worth stressing that programming ideas put forward here should provide the foundation for more effective rural microfinance institutions that will serve the needs of low wealth households. Correlated risk and other constraining features of the rural economy make effective microfinance particularly challenging in rural areas. Programming innovations proposed here would relax those constraints, creating the foundations for a rural microfinance revolution.

These programming ideas proposed here should also help link institutions along the rural finance continuum, creating the basis for a financial services ladder. As households advance economically they can climb the ladder and move from microfinance providers to arm's length lenders, who offer larger loans at potentially more favorable rates but who require large amounts of collateral and reputational assets. A return to some principles of microfinance, in combination with the interventions listed above, creates the possibility for rural finance to evolve in a way that includes as wide a range of the population as possible and helps them all move towards a more productive and profitable future. Efforts to further promote microfinance in rural areas, along with an expansion of rural and agricultural finance, should then support the financial sector strengthening needed for broad-based economic growth.

I. Why Rural Finance, Why Now?

In the 1980s, USAID and other donors disengaged from rural finance as the result of hard lessons about the failures of targeted, subsidized credit and the consequent dependency of financial institutions on external sources of funding. Policies that were widely practiced in the 1970s did not prove successful. Government involvement in the management and implementation of rural financial systems was expensive and inefficient. The often political nature of loan programs, coupled with poor record keeping, meant delinquency was often overlooked. The result was a poor repayment culture and financial instability among lending institutions. Subsidized credit programs further undermined the institutional sustainability of financial institutions, distorted financial markets, and discouraged savings mobilization. Government interventions had a tendency to crowd out development in the private sector, and many people, particularly in rural areas, did not have access to adequate financial services.

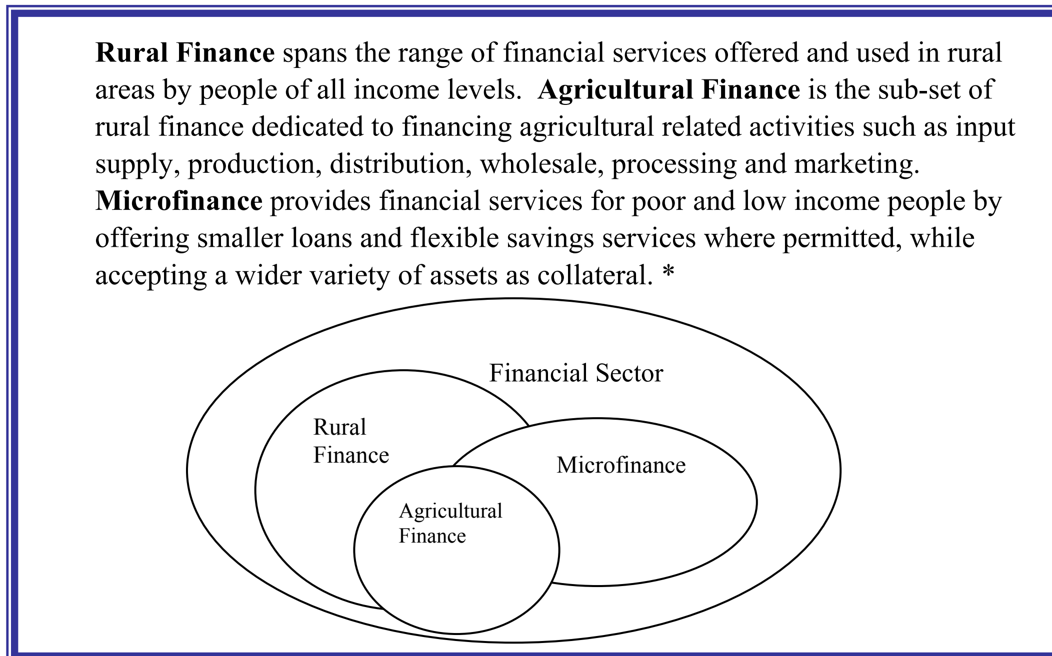
Unfortunately, the withdrawal of ill-advised state programs alone did not spur greater entry into rural financial markets. A number of factors continue to thwart the development of vibrant financial markets in the rural areas of most countries. The higher transaction costs associated with dispersed populations and inadequate infrastructure, along with the particular needs and higher risk factors inherent in agriculture result in an under-provision of financial services in rural areas. Further, where services are available, products are often designed without consideration for the needs and capacities of rural households and agricultural producers.

The inability of households and enterprises to access capital on competitive terms to undertake profitable investments, or take advantage of market opportunities, means that incomes and growth are lower than they need be. Without market instruments to insure against risk, rural households and enterprises may even retreat from profitable projects for which they have adequate liquidity. The absence of competitive savings instruments and other financial services in rural areas leads to less productive forms of savings that cut further into households' scarce liquidity and dampen local growth prospects.

Expansion of rural financial services can create a win-win scenario that will *promote growth* while also helping *reduce poverty*. Given the high proportion of poor populations that live in rural areas, the growing income inequality between urban and rural markets, and concerns for food security and population vulnerability in rural communities, many development agencies are returning their attention to rural financial deepening as part of a strategy to stimulate rural private sector development. Innovative programming, however, must be mindful of past lessons while also attending to the constraints that limit the ability of agricultural enterprises and rural households to take advantage of emerging economic opportunities.

The figure below illustrates some of the specific challenges of rural and agricultural economies that block the easy achievement of these goals. There are key differences between rural and urban areas that affect the characteristics necessary for successful rural financial institutions. The first is the prevalence of agriculture in rural areas. Agriculture is distinct from other sectors because of its seasonality, geographic limitations, price volatility, and dependence on natural conditions. Moreover, households in rural areas are often poor, and have greater difficulty managing risk, coping with shocks, and accessing consistent cash flows. In order to address the nature of borrowers and their industry in rural areas, there is a need for a

continuum of financial institutions that can provide products to a wide variety of households and enterprises. Among a wide range of services microfinance institutions can provide, they have an important role to play in expanding the reach of the financial system to clients who need small loans and lack collateralizable assets. At the same time, there is need for financial institutions that can lend on the conventional collateral of agricultural and other rural enterprises. The key is to find a set of policies and programs that will induce the entry, assure the sustainability and facilitate interlinkages along a continuum of rural financial institutions poised to provide credit, savings, insurance and other services.



Rural Finance spans the range of financial services offered and used in rural areas by people of all income levels. **Agricultural Finance** is the sub-set of rural finance dedicated to financing agricultural related activities such as input supply, production, distribution, wholesale, processing and marketing. **Microfinance** provides financial services for poor and low income people by offering smaller loans and flexible savings services where permitted, while accepting a wider variety of assets as collateral. *

*Adapted from CGAP Donor Brief No. 15, October 2003.

The strategies for rural financial market development presented in this document are designed to alleviate some of the principal constraints that limit the expansion of financial services in rural areas. Addressing these constraints should open the way for an increase in the variety of services provided by existing institutions and induce the entry of other providers into the market. A stronger rural financial sector will bolster the productivity of agricultural enterprises. In addition, improving access to liquidity and other services can help households improve their production processes, build assets over time, and deal more effectively with economic shocks. In short, the development of rural financial markets can promote economic growth and help a wider range of households take advantage of that growth.

This document summarizes some of the principal constraints, best practices and new ideas that emerged from the USAID-sponsored conference on rural finance in June 2003. None of the programming options are presented as a silver bullet to solve the problems of rural finance. Instead, the ideas and recommendations included in this synthesis are possible components of an approach to induce the creation of an efficient

financial market that services the needs of agricultural enterprises, non-farm rural enterprises and both poor and non-poor rural households.

II. Rethinking Rural Finance: Constraints and Programming Options

The rural finance programming options that emerged from the conference cluster into five strategic areas designed to reshape the rural economy by opening the way for vibrant rural financial markets that are poised to serve the needs of rural households and agricultural enterprises. The next five sections organize these programming areas around the specific objectives each has been designed to achieve. A list of further readings on each of these programming areas is provided at the end of the document.

1. Mitigating Risk

Risk is a major factor limiting the development of enterprises and restricting the livelihood options of rural households. Households and enterprises must routinely make investment decisions based upon their assessment of vulnerability and likelihood of return. Moreover, their investment decisions will be shaped by which risk mitigation mechanisms are available to them. Without alternative risk mitigation mechanisms, households will resort to informal, autarchic savings and low-risk/low-return livelihood strategies. Micro insurance, flexible savings and other financial services to help poorer households smooth consumption and protect themselves against shocks can help minimize potentially devastating asset loss and facilitate shifts toward adoption of livelihood strategies with potentially higher returns.

At the *Paving the Way Forward for Rural Finance* Conference, the discussion of risk focused on the constraints to the provision of rural financial services in the agricultural sector. The reluctance of many lenders to operate in rural areas can be traced to the greater risk, both real and perceived, that they associate with agriculture. Vagaries of weather and market price make agriculture inherently more risky than many other economic activities. However, lenders are often disinclined to lend in rural areas and to the agricultural sectors simply due to a lack of familiarity with the sector or clients within that sector. If agricultural producers were able to decrease the risk of default in the face of a catastrophe, or if lenders could protect themselves, at least partially, in the case of loan loss, this would increase the likelihood of entry by private sector financial institutions to rural areas and the agricultural sector. To reduce this critical constraint, two broad types of risk must be addressed: correlated risk and sectoral uncertainty.

Constraints

Correlated risk occurs when the economic fortunes of a large segment of the borrowing pool are tied to the outcome of the same random forces. Lenders can generally manage risk within their loan portfolio if their borrowers are not all exposed to the same risk at the same time. However, if the majority of the loans in a lender's portfolio are vulnerable to simultaneous catastrophe, the lender cannot internally manage the risk. In agriculture, correlated risk is almost always a problem because changes in commodity prices, imperfect weather and natural disasters generally impact large groups of borrowers in the same way. Either everyone will be positioned to repay loans in a favorable year of good rains, or no one will be able to repay in the

wake of a drought or other occurrence that destroys crops and undermines incomes. Correlated risk can wreak havoc on an agricultural loan portfolio.

The predictable result is the under-provision of loans to the rural sector, especially for agricultural activities, and to lower-wealth rural borrowers who may lack assets or be unwilling to risk them as collateral. In many developed countries, crop insurance protects lenders from impact of correlated risk. However, the large subsidies or direct cost for such coverage make these programs impractical for developing countries.

Compounding this problem of correlated risk is the general lack of knowledge that financial institutions have about the rural sector. This sectoral uncertainty makes lenders reluctant to enter rural markets, where rural borrowers and agricultural enterprises are perceived as high risk. As a result, if they are willing to lend to agricultural enterprises at all, lenders require large amounts of collateral to secure loans, and the loan products offered are often not designed to fit the needs and income flows of these enterprises. Without incentives to cover the perceived risk to lenders and additional training in how to select rural borrowers and make lending to them profitable, it will be very difficult to entice new agricultural lenders into the market.

Programming Options

Both programming interventions discussed below shift some of the risk away from financial institutions, thus minimizing a major disincentive to their lending to rural households and agricultural enterprises. Neither intervention increases rural or agricultural lending directly, yet both can be used to promote the expansion and deepening of financial intermediation in rural areas and to the agricultural sector.

Index-based Insurance

Unlike traditional (multi-peril) crop insurance, index-based insurance pays out only when a designated, observable event takes place. For example, a farmer's crop can be insured against drought using objective measures of rainfall within the farmer's geographic area. If the rainfall drops below the target level, payments are made whether or not the insured farmer actually experiences crop loss. While index-based insurance offers more narrowly focused coverage, it protects against the type of correlated risk that dampens entry by competitive rural lenders. Because payouts are based on events that are observable to all and are beyond the control of the farmer, index-based insurance does not suffer from the so-called moral hazard problems that undermine the viability of standard crop insurance programs.

The World Bank has been one of the leading agents of this type of intervention, often helping create the knowledge base needed to value the risk and price the insurance products within target countries and regions. Where appropriate, USAID and other donors can contribute to the effectiveness of such programs by strengthening the institutional, infrastructural and human capacity to ensure a reliable and objective source of data and will enable developing country policymakers and practitioners to engage with private sector insurance providers. These discrete programming interventions can, in turn, leverage private sector financial resources to supply the needed insurance instruments. The use of index-based insurance programs in developing countries is still in the early stages of development. While it will not be appropriate in all contexts, it is worthy of further examination for application to a range of situations. Mechanisms should be put in place to carefully monitor impacts of any interventions in this area.

Loan Guarantees to Stimulate Private Rural Lending

Banks in developing countries generally prefer to pursue more conservative investments like low-risk government bonds or making loans to established clients. If these banks do make other loans, they will often require collateral of 100-200% of the loan amount. Donor-supported guarantees can encourage private-sector lenders to engage in rural financing activities. While the portion covered by the loan guarantee can vary, the donor organization shares the risk of the loan(s) by agreeing to reimburse a certain percentage of the losses. Portfolio guarantees under USAID's Development Credit Authority cover up to 50% of the loan against loss, ensuring that banks have significant investment in making good loans, but expanding the range of activities and clients to which they lend. By sharing the risk, loan guarantees not only encourage the circulation of available investment capital, but also demonstrate the soundness of lending to sectors that may not otherwise have access to capital. In conjunction with the loan guarantee, technical assistance and training provided to the lending institutions can help improve the quality of the bank's loan portfolio and the financial services and products offered to clients.

2. Improving Information Access and Management

Reliable client information is a key to successful financial operations, and therefore a critical component of strategies for financial sector development. Currently, a lack of cost-effective information collection, management, and sharing challenges existing rural financial institutions and discourages entry by potential market participants. Improvements in information systems would lower intermediation costs and induce new institutions to enter, creating the possibility for lower cost financial services. Further, improved information systems can enhance the viability of rural financial institutions by improving both the quality of their lending portfolio and the overall efficiency of operations. However, there are large fixed costs associated with establishing information systems and certain components that would require public investment.

A number of papers at the conference addressed the problems associated with financial institutions' access to information. Several pointed to the need for institutional development in the area of information systems and elements of desirable information systems. Others explored mechanisms to facilitate financial sector information sharing.

Constraints

The cost of lending in rural areas is relatively high as a result of low population densities combined with low loan volume. For many larger financial institutions, which often operate through arm's-length contracting, it is not worth the substantial investment required to move into rural areas. For this reason, in many countries, the providers of rural finance are smaller, locally-based institutions. While these enjoy some cost advantages in information collection because of their familiarity with the community they serve, they can still face problems in client assessment and monitoring.

Their first challenge is collecting and managing reliable client information. Geographic dispersion of households and enterprises means that collecting and verifying information about new clients is time consuming and labor intensive. Once institutions have the necessary information, there is the problem of

managing it in an efficient manner. Many institutions have only basic information management technology, which decreases the capacity of credit officers and the reliability of records.

These problems are especially significant for the smaller rural institutions that make up a large part of the market. In an effort to make their services more accessible to a larger population, many are willing to forgo or minimize collateral requirements, relying instead on increased monitoring. Information collection and client monitoring come at a high cost, however, and these costs generally result in higher interest rates.

Information problems are perhaps most problematic in the case of tracking borrower histories. If institutions do not have records about prior borrowing and repayment behavior, more costly research is required to determine whether or not clients are creditworthy. Often the financial institution simply forgoes lending to those clients. These problems, which have their roots in the geographical dispersion of rural populations, are exacerbated if confidentiality regulations, other legal limitations, or general mistrust prevent information sharing between lenders.

The end result is an institutionally thin, high-cost rural financial sector. Breaking out of this self-perpetuating state of high costs and few market participants will require proactive programming that improves the collection, management and sharing of information.

Programming Options

Mechanisms that help lenders collect and manage information could help them improve efficiency and reduce costs. The two programming options below address managing information about clients both within an institution and across lenders. While neither approach would be appropriate for all areas, they each offer possible solutions for exploration. Moreover, each of these mechanisms have substantial fixed cost and public good components, making it unlikely that financial institutions by themselves will find it profitable to adopt the needed changes. By helping to cover some of the new fixed costs incurred, donors can help institutions lower their variable costs, improve efficiency and ultimately create incentives for greater entry and density of financial service providers in rural areas.

Information Technology

Effectively managing information about many borrowers is critical to sustainable financial service operations. Many rural lending institutions have small staffs that must keep track of the details of many accounts with only very basic computerized systems. The manual methods they employ to transfer data from the field into the central records significantly increase the cost of lending. If financial institutions had the hardware and software to help them manage their records more efficiently, they could expand the number of loans managed by each loan officer and improve the quality of their loan portfolio through better tracking. Relevant additions would include computer systems for institutions that lack them, or more advanced technologies like handheld PCs, smart cards, and other innovations that can improve information collection by credit officials, and access to accounts by end borrowers.

The upfront costs of investing in new technology are high. Donors could help cover the cost of technology and provide staff training in the usage of new systems. Training is important not only so current staff can adjust to new systems, but also so that understanding can be passed on and the technology used sustainably. Lenders and clients could benefit immediately, since they both would be able to access account information more easily.

Credit Bureaus and Credit Scoring

Credit bureaus provide large historical databases containing the credit repayment history of individuals and firms. These histories are used by lenders to assess loan applications and reduce the possibility of lending to a person who has a history of delinquency or default. By making delinquency or lack of repayment public information, credit bureaus increase the incentive to repay all loans. Some bureaus also allow clients to establish a *good* reputation that can be transferred to new institutions. This mobility can be especially valuable for low-wealth borrowers, whose initial entry point into the loan market is through locally-based microfinance institutions. Credit bureaus could help these clients graduate to lenders that may offer larger loan sizes or lower interest rates than those that they had access to when they first entered the market. The related tool of credit scoring provides a statistical method for analyzing repayment probability for different types of borrowers. It consists of the assessment of which client characteristics affect the likelihood of repayment and the construction and use of a decision-oriented model to predict the future performance of borrowers. The score that is assigned to an individual is based on their financial status and history, and allows them to be more easily compared to other potential clients.

Both of these approaches are still rather new in the developing country context and appropriate intervention and application are still in debate. One debate revolves around the locus of control of credit information—i.e., whether credit reporting bureaus should be public or private. Best practice suggests that credit bureaus need to be independent private entities. Lenders might be shareholders but ideally the bureau is a freestanding entity serving as much of the market as possible.

There are various areas of potential donor support for establishment of credit bureaus or scoring systems. First, these systems require large amounts of data. Where lending has been deeply constrained and data simply doesn't exist, application of these approaches will be limited. In areas where they could be used effectively, the costs of initiating either bureaus or scoring tools are high and lenders themselves generally do not have sufficient resources to cover those costs. Donors can partner with existing lending institutions to help cover the costs of the initial collection and centralization of information about borrowers. Donors could also help establish rules for how information would be submitted into the bureaus and provide training to lenders that want to participate. Standardization of information is an important component of any centralized system. Further, development of guidelines regarding how information will be handled would provide greater assurance to borrowers that their financial information won't be misused. Any system should have privacy measures in place before being allowed to collect or transfer information about individuals.

3. DIVERSIFYING PRODUCTS AND SERVICES

A narrow focus on credit provision has been one of the underlying weaknesses of many financial institutions seeking to operate in rural areas. Narrow geographic range (i.e., just in rural areas), or narrow client base (i.e., targeted lending to poorer populations or to women exclusively) can further undermine the long-term sustainability of financial institutions. While this imbalance can result from policy restrictions, donor programs have sometimes exacerbated this imbalance by setting targets or restrictions on institutional support.

From the client's perspective, effective rural financial markets would provide a wide range of services and products including lending, savings, leasing, insurance and transfers (e.g., of remittances). While various conference papers touched on a number of these products and services, the need for expansion of savings services was highlighted as an element critical to both building institutional sustainability and meeting client needs.

The absence of safe, convenient savings services in many rural areas forces many households to rely on autarchic savings strategies, typically through accumulation of grain stores, livestock and other commodities that often offer low or even negative real rates of return. Such in-kind or commodity-based savings strategies can have negative consequences for both the savers and local economy. Safe and accessible savings instruments would permit rural households to fulfill their precautionary savings goals with fewer funds, allowing the option of increased investment in productive activities. In addition, the intermediation of those savings through financial institutions would permit other households and businesses to tap into household savings as a source of investible funds. This latter effect has become even more important with the growth of remittances into rural areas. Intermediation of the remittances that are in excess of the receiver's immediate consumption needs can have substantial local economic development effects.

Constraints

The paucity of deposit-taking institutions and savings options in rural areas results primarily from two interlinked problems. Many larger commercial banks do not find it profitable to operate in rural areas because of the transactions and informational costs of offering services. While there are some notable exceptions, financial institutions serving rural areas often do not accept savings, and in many countries are restricted from doing so. While these legal restrictions may be prudent, breaking the savings constraints will require a creative approach to (i) ensuring that rural financial institutions can serve as reliable custodians of savings deposits; and, (ii) modifying the legal and regulatory structure to permit them to take deposits and require them to protect deposits. If successful, this approach will not only expand the financial services provided in rural areas but enhance the sustainability of rural financial institutions by lowering their cost of funds.

Programming Options

There are several ways that donor intervention can support the diversification of financial services and products in rural areas with safer savings and improved financial intermediation.

Institutional Strengthening

Many financial institutions are prohibited by law from accepting deposits because of a lack of either regulatory agency capacity to adequately oversee them or of government confidence in their ability to protect their clients' investments. Standard accounting practices and effective documentation by all financial institutions would facilitate oversight mechanisms and better self-regulation through great transparency and efficiency. Institutions could be required to increase their equity or loan loss provisions in order to maintain the security of deposits. Donors can help build financial management capacity within non-regulated financial institutions through training in standardized accounting practices, documentation, and

financial disciplines. In addition, assistance/training on product/service design, portfolio management and outreach strategies can further enable institutions to sustainably expand their services.

Institutional capacity alone, however, is not sufficient where policy restrictions prevent rural financial institutions from accepting savings. Beyond assisting institutions in gaining the capacity for sound financial management, donors can become an advocate for expanding the number and type of institutions that are allowed to accept deposits. As part of this effort, donors could invest in expanded regulatory capacity, support appropriate adjustment of laws and regulations, educate policymakers on the ways in which financial integrity and security can be ensured without direct regulation and government oversight, and illustrate the potential contribution to economic growth that expansion of savings services can bring.

Deposit Insurance

Deposit insurance was one program intervention that was discussed at the conference as an innovative approach to smoothing some of the risk that is often associated with savings. While it won't be feasible in all countries, a workable deposit insurance program could further rural financial institutions' efforts to mobilize savings by increasing the confidence that potential clients have in these institutions. Moral hazard is a potential problem with deposit insurance, making it vital that it be used by strong institutions that follow standardized procedures, and can be effectively monitored and regulated.

Developed countries have well-functioning programs for deposit insurance with different schemes that are adapted for different participating financial institutions. For example, in the United States, deposit insurance mechanisms are modified depending on whether the participating financial institution is a bank or a credit union. While unilateral capitalization of a deposit insurance scheme may not be possible or even desirable, donor programming could support the design and piloting of a deposit insurance scheme that would then leverage public and/or private sector funds for full implementation. Considering the limited regulatory and oversight capacity in many countries, training and assistance on deposit insurance may also be necessary for government officials, regulators and representatives of central banks.

Enhancing Remittance services

Global remittance flows in 2003 are estimated to be over $90 billion. It is further estimated that in many countries, nearly 50% of remittances flow to rural areas (Orozco 2003). Remittances are an important source of income for many households and in many cases exceed their immediate consumption needs. By offering savings services, financial institutions not only provide households a more secure and flexible mechanism to save excess funds but also increase the capital available for investment by other entrepreneurs.

In addition to expansion of savings services, there are a number of other programming interventions that can enhance services to remitters and remittance receivers. A number of donor organizations are partnering with private sector entities to pilot new innovations, such as smart cards, aimed at lowering costs and improving convenience and transparency of transfer mechanisms. Donors can also work with government counterparts to promote beneficial taxation and other policies that facilitate remittance flows rather than driving them toward informal, non-transparent transmission mechanisms.

4. STRENGTHENING THE LEGAL ENVIRONMENT

A well-functioning policy and legal framework is key to the development and sustainability of the financial sector. Macro-level policies governing such things as interest and exchange rates and repatriation of funds can have significant impact on liquidity within the financial sector and provision of services. The nature of laws that govern the financial sector, as well as the quality of the institutions that enforce those laws, will also largely determine the shape and depth of the financial sector. Of particular importance are the laws and institutions that either facilitate or inhibit secured lending by influencing the ease with which agricultural and other rural assets can be used as collateral. These laws and institutions, together with the limited legal literacy in rural areas, are two issues of particular concern for the development of rural financial markets.

Constraints

Without the ability to turn existing assets into capital, rural households and enterprises cannot borrow to finance productive activities. This lack of collateralizable wealth discourages entry by financial institutions resulting in thin markets. If households and enterprises cannot clearly lay claim to their property, then it is highly unlikely that financial institutions will accept it as collateral for loans. This is frequently the case for land. While land is likely to be a household's most valuable asset, lack of clear title may prevent its use as collateral. Even where titles are granted and publicly registered, additional factors could limit the use of property as collateral. In countries where there are not clear mortgage laws, or land markets do not function well, then even clear title to land may be insufficient for its use as collateral. Lack of knowledge about establishing ownership and registering collateral may further prevent households and enterprises from making better use of their existing assets.

The use of movable assets, such as tractors, standing crops and even television sets, has been suggested as an option in cases where land is not useable as collateral. However, many countries have laws that prevent or severely limit the use of movable property as collateral. In addition, the lack of registries for movable property makes ownership of these assets difficult to prove, thus limiting their use even in the presence of enabling policy. Thus, households and enterprises may have assets of value but are unable to use them to secure a loan.

Where lending is taking place, and where there are multiple lenders, the priority of claims needs to be well defined in order for lenders to value the risk when accepting collateral. If a client has, for example, used the same collateral to secure more than one loan, and if the priority of claims is not well defined by the legal system, then at least one of the lenders will be left out if the client defaults. The legal system should not only establish the rules for prioritizing the claim but set up rules for the enforcement of a claim on collateral, including how assets will be seized and liquidated. If the terms were more clearly defined for both parties, then lenders could feel more secure in their ability to make claims in the case of loss, and borrowers could clearly understand the process of repossession in the case of default.

Programming Options

Enabling Collateralized Lending

While non-collateral lending plays an important function in the deepening of financial services and the development of the "lending ladder," the ability to collateralize loans increases exponentially the borrowing

power of enterprises and households. For lenders to be able to accept assets as collateral, they must be able to:

- establish clear ownership of property,
- expand the types of assets that can be used to secure loans,
- define the priority of claims over mortgaged property, and
- rely on the judicial system to enforce contract disputes.

Programming interventions to support the development of mortgage laws, property registries, titling schemes, collateral definitions, and priority of claims could help improve the environment for secured lending. There often are many layers of laws—including pledge, mortgage, and property laws—that figure into secured transactions. No two legal frameworks are exactly alike, so understanding which component is the greatest barrier in a given context will help policy interventions have maximum impact. Recommendations should take into account the available assets in rural areas and make sure that reform will allow these assets to be used as collateral.

Beyond support for legislative reform, support may be needed to strengthen the institutions that manage information such as property ownership and liens against property. Finally, property only has value and use as collateral in an environment where property laws are enforced. Interventions to strengthen the human and institutional capacity to enforce contracts and other laws will often be necessary. With support for legislative and institutional reforms that enable secured lending, rural households and enterprises will be better able to turn existing assets into capital and borrow to finance productive activities.

Legal Literacy and Advocacy

The establishment of an appropriate enabling environment does not guarantee that people will use their assets as collateral or use them wisely. Oftentimes in rural areas, people's understanding of their rights to property is not adequate for them to utilize opportunities that their ownership makes possible. Efforts to educate potential borrowers as to the rights and responsibilities associated with property ownership help them leverage their assets while understanding the risks in doing so. Legal assistance centers can further enable small enterprises and rural households in their attempts to understand legal and commercial processes such as contract enforcement, mediation and foreclosure.

In cases of nascent property rights systems, excessive bureaucracy or other problematic environments, better information on processes for utilizing collateral may also be necessary to induce lenders to enter the market. Clarity in the claims process for different types of collateral in the case of default could further widen the range of assets lenders are willing to accept as collateral.

5. ENHANCING VALUE-CHAIN FINANCING

In many places, input suppliers and other non-financial enterprises are an important source of rural finance. Input suppliers, processors and other product traders often provide credit or in-kind inputs to farmers at time of planting, repayable upon harvest. In some cases, the intermediary accepts a portion of the producer's output, often at a price agreed to when the credit is issued. While significant price fluctuation can make these contractual relationships less advantageous to the producer at times, they are still

generally preferable in the absence of more conventional financial services. Often these relationships are an important source of information, as well as access to input and output markets. Several papers at the conference explored mechanisms that promote mutually beneficial relationships between non-financial entities and agricultural producers that improve the latter's access to credit. Opportunities to expand these market chain relationships through the engagement of financial institutions were also explored.

Constraints

While trader-supplied credit and contractual arrangements with processors may be the best option a producer has for financing production, traders or processors may enjoy spatial monopoly and the resulting credit contracts may not be competitive or fair. Depending on the region and crop, the terms of the contract may place the producers at a serious disadvantage. At a minimum, price differences for product sold can hide the actual cost of the loan extended by the trader. Many farmers cannot access larger markets where they might receive a better price for their product and therefore are dependent on the price offered by the traders operating in their region. Limited competition among traders and a lack of transparency in formation of contracts can lead to higher credit costs for producers.

Even when supplier/trader credit is functioning with a reasonable degree of transparency and efficiency, the limited liquidity of non-financial agents limits their ability to support economic growth in the agricultural sector through these arrangements. Most input suppliers, processors and other trading intermediaries are not in the business of financial intermediation and have limited liquidity. Without access to additional funds, they often have to limit the number of contractual relationships they form. Moreover, when traders do not have established relationships with producers, they may be more reluctant to provide credit even on a contractual basis. It is often particularly difficult for small producers to gain access to these business networks. The transactions costs associated with a large number of small producers, make working with low-volume producers a less attractive investment for traders than working with larger operations.

Finally, the liquidity problems that producers experience as a result of the seasonality of production can be smoothed by non-financial mechanisms. Prices for most commodities are often lowest at harvest time when the supply is very high, and are higher later in the season. This price fluctuation can be problematic for farmers who often need to sell their product at harvest in order to repay the loans that financed production. Without a means to store their output for sale when prices are more optimal, and to cover loan or working capital expenses until later in the season, many farmers get locked into low-input, low-return production strategies.

Programming Options

Linking non-financial institutions with financial markets is key to expanding economic growth in rural areas, since so many different types of institutions provide financial services to agricultural producers. There are several ways to expand these services to benefit these producers and help them make better use of these markets.

Producer Associations

One of the problems facing small farmers is that, as individuals, they do not have bargaining power relative to the market. By forming producer associations to jointly market their product, they have more influence on output prices and trade relationships. Associations can also help their members to meet higher quality and

production standards and thus demand higher prices on the market. There are excellent examples of associations adding value for members through product branding and quality “seals of assurance.” Associations can help lower transactions costs for traders as well, since they can deal with a single, larger entity rather than dealing individually with many farmers. Associations may also help farmers make use of warehouse receipt systems (see discussion below), since many storage facilities have quantity minimums that exceed the capacity of individual small producers.

Donors can help in the formation of associations, including both legal formation of the association and the institutional strengthening as they expand operations. In some countries, producers may need to be educated as to the potential benefits of associations. In addition, they could work on educating traders and others to help them understand the potential benefits of working with associations, including higher quality and lower transactions costs. Donors can also help associations link up with larger corporations, including export businesses, to increase the market for their product.

Building Market Linkages with Financial Institution Participation

While non-financial institutions may have access to more information about clients and be better able to provide technical services to clients, they often have limited liquidity with which to finance producers. Financial institutions have greater liquidity and can offer a wider range of services. Linking financial and non-financial institutions in the provision of financial services through supplier/trader credit or contractual arrangements can “harness the respective advantages of both” (Pearce, p.9). The non-financial partner is able to expand activities by tapping into the financial institution’s funds while the financial institution benefits from the lower selection and monitoring costs. The producers also benefit since they can access a wider range of products, and potentially larger loan sizes, through the financial institution than they could through non-financial entities.

These linkages can be facilitated through the creation of intermediaries that jointly offer technical assistance and help farmers access finance and trader relationships. Donors can help fund the start up of these institutions, which could operate either as a business or an NGO. These institutions can help farmers access financing sources, requiring that farmers use their technical assistance program in order to improve their productivity and increase chances of repayment. This is similar to the model practiced by Fintrac in Honduras and elsewhere. Building capacity in these linking institutions could help farmers access new services, improve productivity, increase competition among traders, and strengthen market networks in rural areas.

Warehouse Receipt Lending

Warehouse receipt lending enables producers to use stored product as collateral. Thus, producers are able to secure cash at the time of harvest and sell their product at a more favorable price. While fees paid to the storage facility increase the “cost” of obtaining a loan, depending on the crop and context, the difference in price that farmers can get waiting several months after harvest can often exceed this additional cost. Since farmers remain dependent on the future sale of their stored product to repay loans, it is critical that storage facilities ensure the quality and security of stored product.

Donor programs to establish the legal and regulatory frameworks and certification policies for storage facilities can enable the use of this financial access mechanism. Often, legal frameworks in developing countries need to be amended to allow for the use of stored product as collateral. Additionally, training

provided to warehouse administrators in proper storage techniques provides greater certainty to both the lender and the producer who has taken the loan secured by stored product.

III. Foundations for More Effective Rural Microfinance

Reducing risk, improving the informational environment, facilitating the intermediation of savings and enhancing the collateral value of rural assets—these efforts can enhance the entry and sustainability of conventional rural financial service providers. Yet, many poor rural households lack the resources and assets to take advantage of the services offered by these providers who rely heavily on standard, easily marketable collateral assets. For these households, microfinance institutions—which typically employ either collateral substitutes (*e.g.*, peer monitoring and joint liability) accept more flexible collateral or augment clients' limited conventional collateral with intensive screening, management and supervision—have an important role to play.

The microfinance revolution of the 1980s and 1990s significantly expanded poor people's access to financial services. However, while there have been some successful efforts to expand the outreach to rural areas, microfinance has admittedly had more impact in urban areas. Underlying the constraints to rural microfinance is the correlated risk that typifies agriculturally-dependent, less diversified rural economies. Correlated risk undercuts the very logic of joint liability lending, which requires one individual to be able to cover the loan payments of another individual who suffers an economic downturn. The system fails when all individuals simultaneously suffer income losses.

The programming options laid out above offer some solutions to some of the issues that have constrained the expansion of rural microfinance. Effective mitigation of correlated risk through index-based insurance should immediately open the door to more sustainable rural programs of joint liability lending and other forms of rural microfinance. Similarly, enhanced savings instruments that provide greater security and flexibility to rural households will stabilize the value of household savings and simultaneously contribute to the sustainability of rural micro-financial institutions. Finally, a stronger informational environment will provide steps up a financial services ladder, in which low wealth households with proven records of credit-worthiness can capitalize on their good reputations and obtain services from institutions that do not rely expensive forms of client supervision that are necessary for microfinance institutions.

Creating a foundation for more effective rural microfinance will address poverty alleviation goals while also relaxing the financial constraints (risk and liquidity) that often block the participation of low-wealth households in the agricultural and rural economic growth process. Besides laying the groundwork for a broadly-based process of agricultural growth, this strategy should also deepen the financial sector itself by linking microfinance to other providers of rural financial services.

IV. Challenges and Learning Opportunities

While all of the possible programming elements above hold promise, designing effective programming and achieving desired results will be challenging. Obviously, programming interventions should be tailored to the specific environment and level of institutional development of the country in which they are being applied. Beyond this, there are four challenges that could undermine programming and inhibit the growth of rural financial sectors. These should be should be kept in mind during program design and implementation.

First, the programming options presented here are designed to more *indirectly* enhance rural financial intermediation. It is not automatic that addressing identified constraints will suffice to induce entry or contribute to institutional development and the effectiveness of this approach deserves monitoring. This will be the case with all types of financial intermediaries. While lessons of the past do support movement away from more direct interventions, the successful outcome of most programming options listed here require actions on the part of private agents — borrowers lenders, and/or others — and there is, therefore, no guarantee that they will have the anticipated outcome.

A second challenge is the complexity of legal reform. Improving the legal and regulatory environment to enable the expansion of rural financial services may necessitate changes to laws or development of new laws. This can be a difficult process, best served when there is strong support for reform within the policymaker community. However, if the benefits of rural finance development are not clear to policymakers, it can be difficult to identify a champion or muster the political will for reform.

A third issue is the willingness of rural populations to take advantage of additional financial services. In many rural areas, people distrust banks and are reluctant to turn over their savings and risk their assets. While many households do take small, uncollateralized loans for productive purposes, fewer of them are willing to risk their assets for longer-term loans that would allow them to invest in production-enhancing technologies. While in some places, the rural population makes good use of the services that are available to them, some populations are hesitant to use savings services, buy insurance or take advantage of other financial services, even when these are available. Therefore, in addition to promoting the development of new rural financial services, it may be necessary to simultaneously educate rural households and businesses as to the benefit of using these new services to improve production, overcome shocks, and improve welfare over time.

Finally, many changes will require the cooperation of financial institutions themselves. Donors alone cannot implement the majority of changes detailed in this document. Innovation should be accompanied by public education, training, and technical assistance. Institutions will have to be able to see the potential benefit to their business before they will be willing to enter in the rural realm and increase their service offerings.

All activities should be preceded by a careful assessment of the needs and limitations of a particular case, and interventions should be tailored accordingly. This will be a learning process for all parties, but initial challenges should not serve as a deterrent to action.

FURTHER READING

For more information on **Mitigating Risk** *see*:

Bryla, Erin et al. “The Use of Price and Weather Risk Management Instruments with Examples from Tanzania and Morocco.” Case study presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Buchenau, Juan. “Innovative Products and Adaptations for Rural Finance.” Presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Skees, Jerry. “Risk Management Challenges in Rural Financial Markets: Blending Risk Management Innovations with Rural Finance.” Presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Wasielewski, John and Stavely Lord. “Guarantees for Rural Financing: A Guide to USAID's New Mechanism.” Presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Wenner, Mark and Diego Arias. “Agricultural Insurance in Latin America: Where are we?” Case study presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

For more information on **Improving Information Access and Management** *see:*

Buchenau, Juan. “Innovative Products and Adaptations for Rural Finance.” Presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

de Janvry, Alain, et al. 2003. “Up the Lending Ladder: Extending Financial Services for the Rural Poor through Credit-Reporting Bureaus.” BASIS Brief No. 16. Madison: BASIS Management Entity, Department of Agricultural and Applied Economics, University of Wisconsin. Online at http://www.basis.wisc.edu/live/basbrief16.pdf.

For more information on **Diversifying Products and Services** *see:*

Branch, Brian and Janette Klaehn. 2002. *Striking the Balance in Microfinance: A Practical Guide to Mobilizing Savings*. Washington, DC: Pact Publications.

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Hirschland, Madeline. “Serving Small Rural Depositors: Proximity, Innovations and Trade-offs” Case study presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

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Zeller, Manfred. “Models of Rural Financial Institutions.” Prepared and presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

For more information on **Strengthening the Legal Environment** *see:*

Fleisig, Heywood and Nuria de la Peña “Legal and Regulatory Requirements for Effective Rural Financial Markets.” Prepared and presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Gonzalez-Vega, Claudio. “Deepening Rural Financial Markets: Macroeconomic, Policy and Political Dimensions.” Prepared and presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

For more information on **Enhancing Value-chain Financing** *see:*

Buchenau, Juan. "Innovative Products and Adaptations for Rural Finance." Presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Fraslin, Jean-Herve. "CECAM: A Cooperative Agricultural Financial Institution Providing Credit Adapted to Farmers' Demand in Madagascar." Case study presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Onumah, Gideon. "Improving Access to Rural Finance through Regulated Warehouse Receipt Systems in Africa". Case study presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Pearce, Douglas. "Buyer and Supplier Credit to Farmers: Do Donors Have a Role to Play?" Prepared and presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Weiland, Robert and Curtis Slover. "A Comparative Study of Fertilizer Credit in Bangladesh". Case study presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

For more information on **Rural Microfinance** *see:*

Von Pischke, J.D. "The Evolution of Institutional Issues in Rural Finance Outreach, Risk Management and Sustainability." Presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.

Zeller, Manfred. "Models of Rural Financial Institutions." Prepared and presented at *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* held June 2-4, 2003.