

Rural Finance Study

An inventory of policies, practices and challenges regarding support to rural (micro) finance among Netherlands' MicroNed members.





Village Bank Burundi.

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(micro) finance among Netherlands' MicroNed members

Commissioned by the Rural Finance Group of MicroNed

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Woman preparing food for sale in Mali.

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Gabrielle Athmer

EXECUTIVE SUMMARY

This study was commissioned by the Rural Finance Working Group of MicroNed, which is a network organisation of the Co-Financing Organizations (CFOs) ICCO, Oxfam-Novib, Hivos, and Cordaid. The aim of this study is to learn from each others support practices in the area of rural finance. This study is one of the activities of the Rural Finance Working Group to improve practices and enhance policy making in the field of rural finance.

The study includes a quantitative portfolio analysis of rural MFIs, an overview of CFO policies, institutional set-up and supporting instruments, and several case studies highlighting successes and challenges of different supporting approaches of the CFOs.

CFO Support approaches in rural finance

One can distinguish three support approaches; the most commonly followed approach is building financially sustainable Microfinance Institutions (MFIs), whereby MFIs are gradually prepared for semi-commercial funding. The approach targets credit-led MFIs that receive external funding for their loan funds and introduce deposit services when they have matured and have acquired the appropriate legal status.

The second approach involves support for Member-Owned Microfinance Institutions (MOMFI). The key source of funds of the MOMFIs is member equity. The member-owned institutions vary from small autonomous groups to large and sophisticated national cooperative networks. CFOs support MOMFIs both directly, and also through NGOs that promote and assist the smaller member-owned institutions.

The third approach focuses on support for the provision of financial services to the actors in the value chain, based on a rural economic development perspective. These financial services can be provided both by organisations or companies inside the chain, or by financial institutions outside the chain. Traditionally, producer organisations make the most 'natural' partners for CFOs because of their poverty focus. However, an increasing number of CFOs are engaging in strategic partnerships with companies in order to increase their leverage.

Financial instruments, roles and institutional set up

CFOs use a wide variety of instruments in all three approaches, including grants, seed capital packages, guarantees, loans, equity and technical assistance. Some CFOs provide loans and/or equity themselves, others work through specialised agencies. The CFOs have different roles, acting as providers of funds, brokers and capacity-builders.

Support to MFIs and support to value chain development are covered by different CFO staff. The Member-Owned Microfinance Institutions or promoters are either supported by Microfinance experts, or by rural (market) development specialists. Interaction between Rural Development and Microfinance staff does occur, but mostly on an ad hoc basis. Generally, no structural exchange with the aim to develop a joint rural finance practice has (as yet) been developed.

Policies and challenges

MicroNed members not only focus on new and emerging MFIs, but also support mature MFIs, mainly with regard to expansion into rural areas, product development and inclusion of specific vulnerable groups. Overall, CFOs base their policies on the CGAP good practice guidelines for funders of Microfinance. These guidelines are largely developed on the basis of experiences of credit-led MFIs (first approach), which implies that policies are specifically suited to this type of MFIs and are not (entirely) applicable to (promoters of) member owned microfinance institutions or to providers of financial services to actors in the value chain.

The main challenge for MFIs falling into the first approach is to keep down costs, while serving clients in low-density population areas. The challenge relating to the second approach – support to MOMFIs - is not so much to recover costs but much more to build institutional sustainability; governance and management need specific attention, especially in the MOMFIs that have grown too large for peer control.

The challenge for the third approach is how to build on existing relationships in the value chain and link producer groups to financial services. The role of the CFOs in this approach is complex since it requires a lot of knowledge of the actors in the chain and of the local circumstances. The funding agency can play a brokering role, linking up different parties, including MFIs, companies and producers. No policies are yet in place with regard to this approach, but there are many interesting experiments implemented by CFOs on the ground, linking producers organisations to different sources of finance.

Quantitative portfolio analysis

A quantitative portfolio analysis was conducted, which included mainly credit-led MFIs. Interestingly, the outcomes showed that MFIs operating predominately in urban areas achieve virtually the same levels of sustainability as MFIs that have an almost completely rural clientele. As expected, the – few- cooperative MFIs in the sample had relatively larger rural outreach.

Case studies from partner organisations

Case studies relating to the three approaches mentioned above are presented. Three Rural MFIs were analysed with regard to the first approach, comprising a small rural MFI with an exclusively rural outreach and a considerable agricultural portfolio, and two MFIs with both a rural and an urban outreach. The former case highlighted that, with appropriate policies in place, it is possible for a rural microfinance institution to focus completely on rural areas, and even to concentrate on credit for agriculture and livestock and still be profitable. Risk mitigating strategies used by the MFIs include selection of clients with different income sources, flexible products matching income streams of clients, portfolio diversification over different climate zones and – for two of the MFIs analysed – operations in both rural as urban areas.

One of the cost reduction strategies applied by the MFIs is cooperation with NGOs developing market linkages and strengthening farmers' organisations; this type of cooperation substantially reduces costs for the MFIs as these NGOs provide market information as well as linkages with potential clients, eliminating the need for specific market research.

The case study relating to the second approach deals with support for a promoter of rural SACCOs. The case illustrates both the potential for considerable outreach of these SACCOs in remote rural areas as well as the challenges in the field of governance and management. Intensive monitoring by the promoting agency is important to build capacity and improve transparency and also to limit mismanagement and abuse of power by influential leaders.

Cases illustrating the third approach include different types of companies: a trading company set up by a NGO implementing a market development programme together with farmers; a trading company set up by business people; and a trading company created by individuals linked to producers' cooperatives. In these cases, producers were linked to the financial services of an MFI, to rural banks and to trading companies. CFOs deal with multiple stakeholders and have to consider what kind of support to which actors in the value chain will generate the most impact for farmers against the lowest costs. The cases show that loans provided by a trading or processing company can be a valuable option to provide access to credit to small farmers. However, loans to trading companies for on-lending to producers entail an accumulation of risks for the company (risks of lack of supply due to crop failure, price risks, and risks of non repayment of loans). The involvement of an urban MFI proved to be not successful because the MFI did not have sufficient expertise to operate in rural areas.

Conclusions and next steps

CFOs are in an outstanding position to play a key role in developing good practices with regard to rural finance, given their substantial rural portfolio, their expertise in both microfinance and rural development and the wide range of instruments they have at their disposal. Through an interaction between microfinance and rural development specialists, innovative and technically sound solutions for rural finance can be further developed. Further testing of different supporting policies is necessary.

Staff members of CFOs attach great importance to the development of rural finance policies.

Some of the elements that emerged from this study as needing to be part of such policies are listed below.

First approach

- CFOs must take into account the livelihoods of their clients and the markets in which these clients or potential clients are involved. This means that CFOs must actively promote possible linkages of MFIs with actors in value chains and/or market development organisations.
- Good practices in rural and specifically agricultural microfinance are emerging and it is important that CFOs actively promote these among their partner MFIs.
- CFOs ought to consider differentiating their grant policies for urban and rural microfinance institutions.

Second approach

- Given the importance of member-owned MFIs for rural outreach and for providing basic financial services, including savings services, to the rural population, it is important to adapt funding policies to this type of MFIs

Third approach

It is important to elaborate policy guidelines to promote financial services embedded in market transactions as part of rural finance policy. These policy guidelines must include definitions of the possible roles of CFOs with regard to different type of value chain products such as trade credits and contract farming. An area for special attention is grant funding to companies (provided by CFOs for extension services) which helps improve their market position and allows profits to increase. To reduce the risk of market distortion, CFOs should work on defining the conditions in which grants to companies are justified.



Rural Finance Facility Buusa Gonofaa. Client pays savings to officer.

ACRONYMS

| | |
|-----------------|--|
| ACDEP: | Association of Church Development Projects |
| ASCA: | Accumulating Savings and Credit Association |
| AMCS: | Agricultural Marketing Coopartive Societies |
| BG: | Buusaa Gonofaa MFI |
| CFO: | Co-financing Agency |
| CGAP: | Consultative Group to Assist the Poor |
| FBO: | Farmer Based Organisation |
| FSS: | Financial Self Sufficiency |
| FSU: | Financial Services Unit |
| HIVOS: | Humanistic Institute for Cooperation with Developing Countries |
| HTF: | Hivos Triodos Fund |
| ICCO: | Inter-church Organisation for Development Cooperation. |
| KADERES: | Karagwe Development and Relief Services |
| MFI: | Microfinance Institution |
| MIS: | Management Information System |
| MOMFI: | Member-Owned Microfinance Institution |
| NGO: | Non Governmental Organisation |
| NBFI: | Non-Bank Financial Institution |
| OSS: | Operational Self Sufficiency |
| PAR: | Portfolio at Risk |
| RFS | Rural Finance Scheme |
| ROSCA: | Rotating Savings and Credit Association |
| SACCO: | Savings and Credit Cooperative Society |
| SED: | Sustainable Economic Development |
| SEEP: | Small Enterprise Education and Promotion |
| SFMC: | Savanah Farmer Marketing Company |
| SHG: | Self-help Group |
| SNV: | Netherlands' Development Organisation |
| VSLA: | Village Savings and Loan Association |



Female trader Rwanda.

MicroNed is a network created by Cordaid, Hivos, ICCO and Oxfam Novib. Its mission is to strengthen and coordinate the joint members' contribution to the microfinance sector, in order to improve the quality of services provided, increase efficiency and effectiveness of operations and facilitate the synergy with other finance modalities by investment funds, banks and other financial institutions. The MicroNed members use various instruments to support their partners, including grants, loans & guarantees. Coordination through MicroNed network focuses on grant-supported activities.

An important objective for MicroNed is strengthening member expertise on different aspects of microfinance. One of the thematic areas selected for concerted expertise development is Rural Financial Services. A rural Rural Finance Group was formed, comprising representatives of the four member CFOs and led by ICCO/ Terrafina Microfinance.

The Rural Finance Group commissioned a study about the rural finance policies and support mechanisms used by its member organisations. The main aim of the study was to learn from each other support practises.

The resulting objectives of the study are:

- a) To compile an inventory of current MicroNed members' policies and partners involved in rural financial services, using an accepted working definition for rural finance;
- b) To put together an inventory of particular challenges encountered by these rural microfinance providers and the actions taken to overcome such challenges.
- c) To compile an inventory of MicroNed member support mechanisms to rural financial services partners in terms of financial and technical support and assess the appropriateness and adequacy of the support mechanisms.

The study was conducted by two master students from the Erasmus University: Casper Havinga and Jurjan Mol. The outcomes of their research were presented and discussed during the MicroNed rural finance learning event on December 13 in 2007.

The students carried out the following tasks:

- Interviews with program officers of the 4 Co-financing Organisations (CFOs) and analysis of their business plans and policy documents. Description of the microfinance policy of each CFO, the rural finance policy (if available) and the financial instruments used;
- Analysis of data available in the project files of 154 randomly selected partner MFIs (of which 21 were supported exclusively with grants);
- Information collection from selected MFIs on their levels of satisfaction with donor organisations;
- Case studies of strategies of rural Microfinance Institutions and of financial services to actors in the value chain. The cases were proposed by the CFOs.

The students' research activities were carried out under supervision of the Rural Finance Working Group.

The limitations of this study are the following:

- Lack of information in the project files on the performance of the MFIs, especially the young, grant-funded MFIs. CFOs are organisations involved in a wide range of development activities and their management information systems (MIS) are generally not or only partly adapted to Microfinance.
- Lack of information on the performance of financial services providers in cases where these were supported in the context of a rural (market) development programme.
- Limited variety of case studies: no case studies on sector support and only one case study relating to member-owned microfinance institutions.

As a follow-up of the MicroNed learning event on rural finance in December 2007, the report was rewritten by microfinance consultant Gabrielle Athmer.



Market women in Rwanda.

This chapter defines the concepts 'rural' and 'rural finance' and summarises key constraints in rural finance. In addition, a description is given of, the rural finance approaches applied by CFOs.

2.1 Definition of rural financial services

In order to investigate rural financial services it is important to define what is included when considering 'rural' financial services. How to define a 'rural population' or a 'rural area'? While figures on rural versus urban populations are being monitored throughout the world, it remains problematic to identify a clear definition of what constitutes a rural area that can be used uniformly across countries.

2.1.1 Definition of rural

Although 'rural' areas have been analysed in many countries for decades, there is no single commonly accepted definition. Some organizations use population density as the main distinguishing factor. For example, the OECD¹ classifies a community as 'rural' when it has less than 150 inhabitants per square kilometre. The International Fund for Agricultural Development (IFAD) defines 'rural' in terms of two main characteristics. Firstly, rural people generally live on farmsteads or in groups of houses containing perhaps 5.000 – 10.000 persons, separated by farmland, pasture, trees or scrublands. Secondly, the majority of rural people spend most of their time on farms.

According to the Small Enterprise Education and Promotion (SEEP network), a rural area is defined as: "an area in which the primary economic activities are small-scale agriculture and livestock rearing, although it also includes small-scale trade, service, and manufacturing activities. It is also characterized, in relative terms, by geographic isolation, low population densities, poorly developed infrastructure, underdeveloped market for goods and services, and high poverty concentration²".

In developing countries in particular it is very hard to formulate an exact, objective measure to define 'rural areas': population density can vary from 1 per square kilometre in some Sahel regions, to over 1000 per square kilometre in rural Java, Indonesia. The authors decided on the definition of the SEEP network as the most comprehensive and useful in the context of rural finance.

¹ The OECD is the "Organization for Economic Co-operation and Development", an international organization of thirty countries that accept the principles of representative democracy and a free market economy.

² SEEP network 2006: Social Performance Glossary www.seepnetwork.org/files/4728_file_Soical_Performance_Glossary.pdf

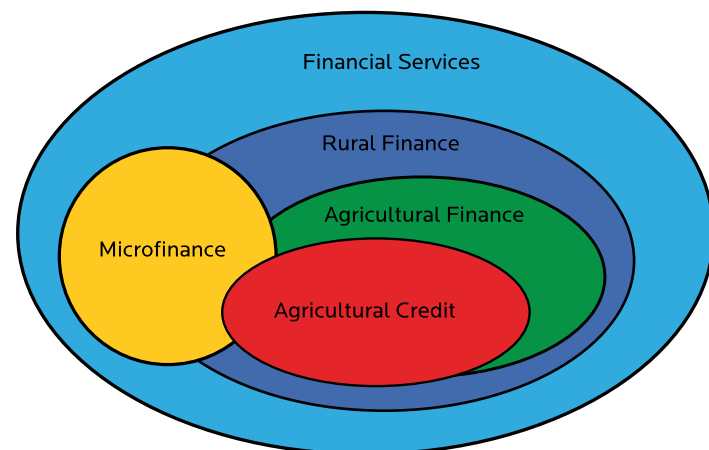
2.1.2 Definition of Rural finance

Another important issue when discussing rural financial services is which financial services are included. The definition of rural finance as developed by Nagarajan & Meyer³ provides a useful guideline:

“The provision of financial services to a heterogeneous, rural, farm and non-farm population at all income levels through a variety of formal, informal, and semiformal institutional arrangements and diverse types of products and services, such as loans, deposits, insurance, and remittances.”

Figure 1⁴ puts rural finance in perspective. It shows that Microfinance is only a small component of Rural Finance; Microfinance Institutions provide financial services in rural areas and also provide financial services specifically for agricultural activities.

Figure 1 Rural finance in perspective



³ Nagarajan, G. and Meyer, R.L. (2005) 'Rural Finance: Recent Advances and Emerging Lessons, Debates, and Opportunities'. Reformatted version of Working Paper AEDE-WP-0041-05. Department of Agricultural, Environmental, and Development Economics, The Ohio State University.

⁴ Miller, C. (2005) page 4. "Global Perspectives in Rural Finance and Poverty Alleviation". FAO, Rome. Presented at the 4th AFRACA Microfinance Forum : Lessons Learned in Micro and Rural Finance Service Provision in Africa.

2.2. Constraints in rural microfinance

Generally it is recognized that supplying rural microfinance is more difficult than supplying urban microfinance. Difficulties relating to the development of the financial sector in rural areas are listed in a paper on challenges in rural finance by C. Miller⁵. Miller describes 12 constraints which are classified into four groups: vulnerability constraints, operational constraints, capacity constraints and political and regulatory constraints.

These are summarised in the box below:

Vulnerability constraints

1. **Systemic or covariant risk. Same risk at same time**
2. **Market risk. Fluctuation of prices**
3. **Credit risk. Lack of collateral**

Operational constraints

4. **Investment returns. Seasonality gives non-constant cash flow**
5. **Low investment and assets. Weak safety net**
6. **Geographical dispersion. High dispersion and low population densities**

Capacity Constraints

7. **Infrastructural capacity**
8. **Technical capacity and training Rural population is less skilled**
9. **Social Exclusion. Cultural, linguistic, etc constraints affect market and financial integration**
10. **Institutional capacity**

Political and regulatory constraints

11. **Political and social interference. Subsidized and/or directed credit from state-owned banks**
12. **Regulatory constraints. Regulations and/or lack of enforcement rural environments**

For more details on each of these 12 constraints, please refer to annex 1.

⁵ Miller, C. (2004). "Twelve key challenges in Rural Finance". Unpublished paper presented at the FAO rural Finance Workshop, SEEP Pre event in Washington D.C., Oct 28 2004 http://www.seepnetwork.org/section/programs_workinggroups/action_research/working_groups/ids/agm2004

2.3. Rural finance approaches of MicroNed members

Although the challenges are numerous, there are many examples of successful experiments using innovative models to reach the remote rural poor and to provide financial services required by farmers and rural households in general. Some of these successful examples will be presented in this study.

As mentioned above in the definition of rural finance, rural finance services can be provided by a large range of institutions. These include microfinance institutions, banks, NGOs, producer organisations, buyers of produce, agro-processing firms, input suppliers, informal savings and lending groups.

MicroNed members support microfinance institutions as well as producer organisations and commercial companies to meet the needs for finance of actors in the value chain. Increasingly, a need is felt for 'thinking out of the microfinance box' where meeting the demand for finance in rural areas is concerned.

Three main methods deployed by CFOs can be distinguished. The first – and most common - approach focuses on building financially sustainable MF institutions, whereby MFIs are gradually prepared for semi-commercial funding. Support focuses on the MFIs' financial and operational sustainability. This approach targets credit-led MFIs that receive external funds for their loan funds and that introduce deposit services when they have matured and have acquired the appropriate legal status. The MFIs' performance is assessed on the basis of financial performance indicators and ratios. Over the last few years, there was increasing attention for the development of social performance indicators, to allow assessment of the extent to which MFIs are realising their social mission. Most mainstream MFIs flourish best in urban environments with a high population density and the products provided by these MFIs (short-term, regular repayments) are best suited to commercial activities. The challenge of this approach in a rural context is to adapt products and delivery mechanisms to meet the need of rural populations and to keep costs low while serving clients in low-density population areas.

The second approach, which is not explicitly mentioned in CFOs' policy papers but is being applied in practice, entails support to Member-Owned Microfinance Institutions (MOMFI). Members of these institutions are both users and owners of the institution; members are involved in decision making⁶. They are distinguishable from mainstream MFIs in that member equity (shares, savings) constitutes the key source of funds. The member-owned institutions vary from small autonomous self help groups (SHG) and village savings and credit associations (VSLA) to Credit Unions and sophisticated national cooperative networks. CFOs support these MOMFIs both directly and through NGOs that promote and assist member-owned institutions. The promoting NGOs support the creation of e.g. SACCOs and VSLAs and provide training and technical assistance.

⁶ FINCA type of village banks are not included in this definition, as it is the FINCA MFI taking the decisions, the participants of the banks are FINCA's clients. The definition for member owned financial institutions is derived from the following study: Coady Institute 2008: Reaching the hard to Reach: Comparative study of Member-Owned Financial Institutions in Remote Rural Areas

This second approach is attractive in the context of rural finance because Member-Owned Microfinance Institutions have a strong presence in rural areas. In many countries, MOMFIs are the most important source of financial services for the rural population. Because their cost structures differ from those of mainstream credit-led MFIs, cost recovery is not the main bottleneck. The key challenge relates to governance and management capacities, especially for those MOMFIs who have grown too large to be monitored by their peers⁷. With an aim to ensuring long-lasting financial services to the institutions' members, CFOs therefore focus their support on the MOMFIs' institutional sustainability.

The third approach involves financing of actors in the value chain, based on a rural economic development perspective. A value chain can be defined as 'the full range of activities that are required to bring a product from its conception to its end use'⁸. The value chain consists of enterprises that collaborate in various degrees; the chain is defined by its raw material and market segment⁹. The enterprises, or actors, in the chain can provide (financial) services to other actors in the chain, mostly to secure supply of produce. Financial services can also be provided by actors outside the chain, such as a bank or MFI. The lenders rely on the strength of the value chain to reduce risks. CFOs are increasingly interested in 'value chain development'; this means that CFOs actively promote – sustainable - inclusion of CFO target groups into value chains or potential value chains (developed by the private sector), so that their participation and benefits are improved. In addition, other developmental concerns (environment) are also incorporated¹⁰.

The role of funding agencies in this approach is multiple and complex, since it requires extensive knowledge of both the actors in the chain and the local circumstances. Funding agencies can provide assistance by linking up different parties including MFIs, companies and producers.

⁷ M. Hirschland et al. 2008: "Financial Services in Remote Rural Areas. Findings from 7 case studies in remote rural areas." Coady International Institute:

⁸ Downing et al. in Tilman Altenburg, 2006; "Donor approaches to supporting pro-poor value chains" Report prepared for the donor committee for Enterprise Development.

⁹ HPC: value chain course material

¹⁰ Adapted from HPC value chain ppt



In the table below, the different approaches associated with support to financial services are presented:

Table 1: CFOs' three main approaches to support the provision of financial services

| APPROACH | 1. Support to Credit-led Microfinance Institutions | 2. Support to member Owned Microfinance institutions | 3. Support for the provision of financial services to actors in the Value Chain |
|-----------------------|--|---|---|
| Focus | Building financially and operationally sustainable microfinance institutions that provide financial services tailored to their clients | Building institutional sustainability –directly or through an NGO - of MOMFIs to provide financial services tailored to their members | Include or strengthen the position of CFO target groups in (potential) value chains |
| Partner organisations | MFIs, MFI networks, microfinance service providers | SACCOs / Credit Unions, Promoters of VLSA /Self-help groups, Networks of MOMFIs, TA providers to MOMFIs | NGOs, MFIs, trading companies, farmer organisations |

Support to MFIs and support to value chain development are generally covered by different CFO staff. This may involve personnel from one department, from different departments and/or partly from other specialised organisations linked to the CFOs. The Member-Owned Microfinance Institutions or promoters are supported either by the Microfinance experts of the CFOs, or by their rural (market) development specialists. Interaction between the microfinance and the rural development specialists can promote innovative and technically sound approaches in rural finance. Not surprisingly, one of the key CGAP recommendations to donor agencies with regard to rural finance advises to encourage interaction between microfinance/finance staff and rural development/agricultural staff.

The next chapter will provide a brief description of the CFOs institutional set-up, policies and financial instruments¹¹.

¹¹ CGAP 2006: "Good practice guidelines for funders of microfinance. Microfinance consensus Guidelines". Pg. 29.

MICRONED MEMBERS: POLICIES, FINANCIAL INSTRUMENTS, INSTITUTIONAL SET-UP

This chapter summarises CFO policies with regard to microfinance and rural economic development and explains the support instruments deployed by CFOs. It also looks at their institutional set-up. An important distinguishing feature is whether CFOs provide loans themselves or through a specialised agency. The chapter concludes with a tentative comparison of the CFOs' areas of expertise. The CFOs' main institutional features are presented in a table at the end of this chapter.

3.1. Policies

The Microfinance policies of the four agencies do not differ substantially, except in their emphasis on 'rural'. While ICCO (and Terrafina Microfinance) have the most pronounced policy for working in rural areas, all are active in rural areas and support considerable rural portfolios, since many poor live in rural areas and poverty alleviation remains the driving force of the CFOs.

The CFOs' microfinance policies are aimed at improving the livelihoods of poor people. While the CFOs focus on new and emerging MFIs, they also support mature MFIs, mainly with regard to their expansion into rural areas, product development and inclusion of specific vulnerable groups. The CFOs do not only support individual MFIs (micro-level), but also aim to improve the infrastructure for microfinance as a whole (meso level) and to promote a conducive policy environment. At the meso level, CFOs support, for example, national or regional networks of MFIs and provide training to local consultants. At the macro level, CFOs support local organisations that lobby on behalf of MFIs for a better regulatory framework for microfinance. Overall, CFOs adhere to the CGAP good practice guidelines for funders of Microfinance¹². These guidelines are developed in large part on the basis of the experiences of credit-led MFIs, which implies that policies are in line with the CFOs' first approach - "building financially sustainable MF institutions".

None of the CFOs operate from a comprehensive rural finance policy which combines all aspects of intervention in rural finance (micro, meso and macro) and which is distinct from the overall microfinance policy. All the CFOs are engaged in activities relating to both Microfinance and Rural Economic Development. Among their partner organisations, the CFOs include producer organisations and local NGOs working with farmer organisations, but they also support other actors in the value chain, such as trading companies (both owned and not owned by producers) or processors.

MFI Client Ethiopia.

¹² CGAP Consultative Group to Assist the Poor) 2006: "Good Practice Guidelines for Funders of Microfinance." Washington DC

3.2. Support instruments and roles

CFOs have a wide range of supporting instruments to their disposal: grants, seed capital package, loans, guarantees and equity investments. Moreover, CFOs do not limit their role to funding, but also act as brokers and capacity-builders.

The broker role is the most prominent role in the economic rural development programmes. CFOs facilitate cooperation and synergies between different stakeholders, including financial services providers. This is most explicit in Cordaid's programme Small Producers in the Market, Hivos' programme Support to Producers in Multi-Stakeholder Arrangements and in ICCO's programmes Local Market Development and International Market Development. Oxfam Novib's theme programme Right to Sustainable Livelihood covers microfinance as well as producer organisations and trading companies. Oxfam Novib is currently working on its rural finance policy in the context of this theme.

The financial support instruments of CFOs are summarised below. The MicroNed members make use of all these instruments in their microfinance and rural economic development programmes, although the extent to which each instrument is deployed may differ (more grants than loans, e.g.).

Grants

Grants are provided to starting MFIs that are not yet operationally sustainable, as well as to mature MFIs, mainly for technical assistance (e.g. for business planning), product development or social performance management. Grants are also provided to support the (rural) microfinance sector at the meso and macro level. For example, microfinance networks, branch organisations and lobby organisations are supported with grants.

Grants are also provided to actors in the value chain, such as trading companies (e.g. for extension services for farmers). In addition, grants are also made available to NGOs engaged in supporting and organising producers.

Seed capital package

Hivos was the first CFO to develop a seed capital grant policy for new MFIs that did not qualify for loans. Recently, MicroNed members developed a joint policy framework for a seed capital package. According to this framework, the minimum seed capital package contains a grant or loan for portfolio growth as well as a grant for fixed assets and/or operational losses and possibly technical assistance. The MicroNed seed capital policy was developed for MFIs, but is also available to producers' organisations and trading companies. The objective of the seed capital package is to assist (re-)starting MFIs and producers/trading companies in developing into commercially viable businesses. Newly starting MFIs are not yet able to repay loans. In general, applicable policies currently allow for different interpretations as to when either a grant or a loan is most appropriate. Although there will always remain a grey area and each MFI should be judged individually, some CFO staff feel that a clearer policy is needed.

Loans

In many countries, organisations are not able to access loans from the formal financial sector at affordable rates. CFOs step in by providing loans directly (in the case of Cordaid) or by linking with social investors, until the organisations concerned are in a position to take out loans from the local financial sector or from more commercial investment funds.

Loans are provided to MFIs, as well as to producer organisations and trading companies. Overall, more loans are provided to the former than to the latter. Loans to MFIs tend to perform better.

Trade and producer credit is more risky.

Guarantees

Donors also guarantee loans provided by local financial institutions or by social investors. Such guarantees give MFIs and producer organisations / trading companies access to loans, including loans in local currency, which they would otherwise not receive. Donor agencies usually do not provide guarantees for the loan amount in full and thereby leverage their capital. Guarantees are intended to enable MFIs to build up a track record to increase their access to loans without guarantees¹³.

Equity Participations

By engaging in equity investments, donors become co-owners of MFIs or producer organisation /trading companies. Equity investments are in high demand, as the capital base of small and emerging MFIs is too limited for accessing loans. On the other hand, it is questionable whether co-ownership is compatible with the role of donor agencies.

3.3. Institutional set-up

An important distinction between CFOs when it comes to rural finance is whether loans and/or equity are provided directly by the CFO or by a specialised agency. Cordaid directly deploys the entire range of financial instruments. ICCO provides guarantees on loans by Oikocredit and maintains the option to either provide directly or through Oikocredit; Hivos provides guarantees on loans provided by the Hivos Triodos Fund and managed by Triodos Investment Management Ltd.. Oxfam Novib supplies grants; loans and guarantees are provided by Triple Jump.

¹³ See CGAP Focus Note 40: guaranteed loans to microfinance institutions, how do they add value?

3.3.1. Oxfam Novib

Oxfam Novib is the only CFO organised along regional lines. The other CFOs are organised along thematic lines. Oxfam Novib has 8 regional bureaus, with responsibilities divided among staff members according to defined thematic areas. The above-mentioned Right to Sustainable Livelihood is one out of five. The Right to Sustainable Livelihood covers both Microfinance and the support to producer organisations. In addition to the experts with the regional bureaus, Oxfam Novib's Research & Development department also employs a policy advisor on microfinance, who is responsible for monitoring the seed capital activities of the regional bureaus.

Triple Jump

Up until 2006, Oxfam Novib managed its loan and guarantee fund through a Financial Services Unit (FSU). While the regional bureaus were leading in the selection of projects, the FSU was responsible for the assessment, approval and monitoring of the quality of projects financed through loans or guarantees, as well as for the management of the loan and guarantee portfolio.

In 2006, Oxfam Novib effectuated a spin-off of the Financial Services Unit, which re-established as a new fund management company: Triple Jump. The objective behind this move was to establish an organization capable of responding to the needs of microfinance institutions at all stages of their development. Triple Jump not only manages the Oxfam Novib fund - which focuses on provision of loans to emerging MFIs - , but also three other funds targeting more mature MFIs¹⁴. The Oxfam Novib Fund is mainly used for the provision of loans; guarantees are only issued in countries which disallow loans from foreign organisations. Oxfam's regional bureaus always have the final vote in the selection of candidates.

Oxfam Novib does not engage in equity participation, as it considers co-ownership to be in compatible with the more distant role of a donor agency. Oxfam Novib did hold equity in two institutions, but policy has changed since 2004. Loans are issued primarily to MFIs; 90% of the portfolio is invested in microfinance.

Triple Jump Advisory Services was set up at the same time as Triple Jump Fund Management as an independent foundation, to support the institutional development of MFIs through consulting services and technical assistance.

3.3.2 Cordaid

Cordaid's Entrepreneurship department covers both microfinance and rural economic development via its Small Producers in the Market and Access to Financial Services programmes.

Cordaid is a unique actor among the four MicroNed members, as it has no external partner to conduct loan analyses and issue loans. From 2000, loans were supplied by a separate Financial Services Unit; since 2007, Cordaid's loan and grant activities have been combined in the Entrepreneurship department. A fund manager monitors the quality of the loan portfolio; loan proposals are submitted to a credit committee consisting of external credit experts for approval.

Microfinance

The Access to Financial Services programme issues loans primarily to MFIs. According to its 2007-2010 business plan, Cordaid plans to provide fewer direct loans and to facilitate the involvement of other investors, preferably local banks, through its guarantees and equity investments. Until now, neither the guarantees, nor the equity investment instrument have been deployed much. Subordinated loans (quasi equity) are used on occasion. In addition to its assistance for MFIs, Cordaid also provides support to self-help groups (through NGOs) in India.

Small Producers in the Market

With its Small Producers in the Market programme, Cordaid aims to "reinforce the strength of small-scale producers and strive for better access to markets through building more structured relationships between small producers on the one hand and processing companies, local traders, retailers and exporters on the other."¹⁵ Cordaid has acquired considerable expertise in supporting producer groups, facilitating synergies between different stakeholders and in financing different actors in the value chain.

The small producers programme makes use of grants rather than loans. Often grants are provided to NGOs working with producer cooperatives and farmer associations. Loans or guarantees are used to support financial services provision by producer cooperatives and companies, often linked to commodity chains. These financial services can be divided into two different types:

- Trade finance: financial services linked to commodity chains, preferably the fair trade chains. Often organised producer groups are involved which received prior support through NGOs.
- Contract farmer schemes¹⁶: loans are provided to companies to on-lend to farmers to finance their inputs. Loans are redeemed when the farmers sell their produce. Loans are often complemented by grants for technical assistance to farmers to improve the quality of their produce and their level of organisation. Cordaid implemented a number of pilot projects to link up MFIs to contract farming programmes. One of these pilots is presented in chapter 7.

¹⁴ The Calvert Investment Fund, ASN- Novib Fund, NOTS fund, SNS institutional Microfinance Fund

¹⁵ Source: Cordaid's website <http://www.cordaid.nl/English/Entrepreneurship/Index.aspx?mId=10797>

¹⁶ Contract farming can be defined as agricultural production carried out according to an agreement between a buyer and farmers.

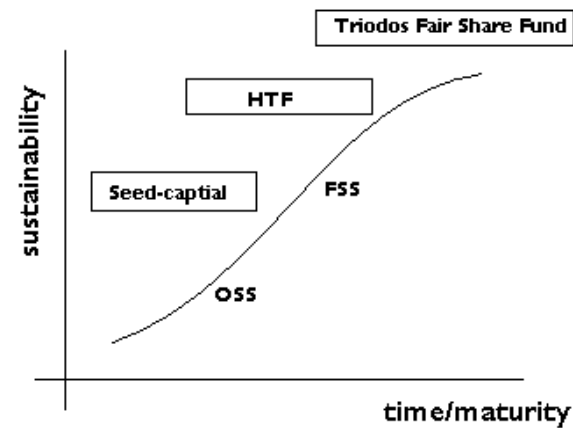
3.3.4. Hivos

Hivos is subdivided in three main departments, each related to a specific thematic area. The Sustainable Economic Development (SED) department covers both microfinance and rural economic development. This department is responsible for the implementation of Hivos' "Access to Opportunities" programme that covers microfinance, enterprise development, sustainable trade finance and support to small producers in the area of sustainable production, quality management and access to markets.

In addition to its head quarters in The Hague in the Netherlands, Hivos works through four regional offices: in Zimbabwe, India, Costa Rica and Indonesia.

Microfinance

Hivos has developed two different products to support microfinance activities, which are adapted to the stage of the MFI within the Life Cycle Curve: a seed-capital package and a loan from the Hivos Triodos Fund (HTF) (see figure).



Hivos developed its seed capital product after identifying a gap between their initial grant products and HTF. Hivos grants could only be provided for capacity-building, training and technical assistance. Many small and emerging MFIs need loan capital for on-lending purposes, in order to build up a track record and increase outreach. The Seed Capital package was developed to include a grant to MFIs' loan capital.

Partners that obtain a certain level of maturity become eligible for the Hivos Triodos Fund (HTF) that provides loans and equity investments. The HTF investment fund was created in 1994 and combines Hivos' resources and knowledge of development processes with the banking expertise of Triodos Bank. Hivos assesses the relevance in terms of development of the requests for financing, with low income groups and women as particular focus points. Hivos guarantees HTFs' loans and provides subordinated loans in order to guarantee their equity investments. Guarantees cover 50 – 90% of all loans. HTF and Hivos define country strategies to effectively concentrate support.

HTF partners who perform well graduate to Triodos Bank's Fair Share Fund. In doing so, they enter the commercial phase of the programme (its final aim).



Client Village Bank Burundi.

Support to producers in multi stakeholder arrangements

Hivos does not maintain a set policy on rural finance, but is experimenting with different approaches to rural finance, such as, for example, support to producers in multi-stakeholder arrangements. These arrangements are developed between Hivos, producer organisations, buyers, local NGOs, and financial institutions, with the particular intention to scale up financial services in rural areas.

Hivos supports producer organisations with grants to attain better quality standards and to improve their market position. Hivos also seeks partnerships with buyers operating on international markets. Producer organisations are given assistance to acquire the necessary certification to supply export markets. Hivos combines its finance instruments (HTF loans and Hivos grants) with connecting buyers from the North with farmers in developing countries. Details of Hivos' method can be found in chapter 7, in the case study on Rainforest Trading in Peru.

3.3.4. ICCO

ICCO's microfinance programme falls under its Financial Services programme, which is part of the Fair Economic Development department. The Local Market Development, International Market Development, Cooperation with Business Sector and Climate Fund programmes also fall under this department. The financial services programme is not limited to the microfinance sector, from the understanding that other types of (providers) of financial services are needed to enhance local and international market development. By integrating the five programmes into one department, ICCO aims to promote coherence and cooperation between these programmes.

The Fair Economic Development department is subdivided into three regions: Africa and the Middle East; Latin America; Asia, Eastern Europe and Oceania. Each regional team is responsible for the implementation of the five thematic programmes in their region. Each programme is coordinated and monitored by one or two 'programme specialists'. A special status within ICCO is reserved for Terrafina Microfinance, which implements the microfinance programme in Africa. Terrafina Microfinance is a joint initiative of ICCO, Rabobank Foundation and Oikocredit International.

Within the next few years, ICCO plans to transform into an international decentralised network organisation in which organisations in the global South will play an increasingly important role. In the new organisational structure, an international council and several regional councils will be co-responsible for ICCO's development agenda and programmes.

Financial Services Programme

The financial services programme covers microfinance as well as other financial services aimed at small producers and rural micro and small enterprises. The financial services programme also includes 'fund engineering' and the facilitation of funds (risk funds, equity funds, etc). ICCO's financial services programme focuses increasingly on rural microfinance programmes aimed at farmers, rural women, rural microenterprise, small enterprise in provincial towns, in order to dovetail with the Fair Economic Development department's other programmes. ICCO targets the lower end and broad stratum of the market: MFIs that are not yet operationally or financially sustainable and which do not qualify for commercial funding.

ICCO runs five main support strategies, tailored to the context of the country concerned and the needs of rural

MFIs:

- Capacity-building for promising emerging MFIs
- Scaling up the credit portfolios of mature MFIs (to rural areas)
- Innovation, product development and Social Performance Management
- Sector Support

For more mature MFIs, ICCO supports access to the capital market. ICCO usually effectuates this by issuing guarantees for loans provided by Oikocredit. Oikocredit is part of the 'ICCO Alliance', a cooperation of six development organisations¹⁷. Oikocredit acts as a bank partner, while ICCO stands as guarantor for the loan. The guarantee's level of coverage depends on a risk analysis and varies between 30% and 100% of the loan. ICCO occasionally and only in exceptional circumstances provides loans directly to the MFIs.

The ICCO Alliance contributes to Oikocredit's Local Currency Risk Fund. Equity investments are rarely provided; however, an equity investment policy has been elaborated and the development of an Equity Fund is foreseen.

Terrafina Microfinance.

The above-mentioned Terrafina Microfinance programme for microfinance in Africa has a leading role within ICCO in the development of support mechanisms for emerging and rural MFIs in Africa. A 'tailored' approach is possible because of the combined strengths of each of the participating organisations. Oikocredit specialises in market-based loans, while the Rabobank Foundation excels in loan and grant support to cooperatives and provides banking expertise. ICCO provides capacity-building expertise and guarantees for Oikocredit loans.

Terrafina Microfinance focuses on three blind spots in the microfinance and development cooperation sectors: Africa's marginalised regions, rural areas and, finally, the lower end of the market.

¹⁷ The ICCO Alliance consists of ICCO, Oikocredit, Edukans, Kerk in Actie, Prisma and Share People.

Local Market and International Market Development

ICCO supports partner organisations involved in international market chains and in local market programmes. The objective of its international market development programme is to facilitate access to international markets for small producers and employees active in the cotton, fruit and forest product value chains. The local market development programme aims to strengthen the position of the small producers and employees in local markets by increasing their market access and their influence within the value chain, and enhancing their competitiveness. Financial services are seen as one of the means to fuel local and international markets. In these programmes, grants, seed capital and guarantees on loans are provided.

3.4. MicroNed Members strengths in different areas

The approaches of the CFOs are similar in nature, but each places different emphasis and therefore the strengths of the organizations differ. It is clear that CFOs can learn from each other's experiences and practices. These types of comparison are always somewhat tricky, but, without any pretence of being either comprehensive or exclusive, the following areas of high level expertise can be discerned.

Cordaid has considerable experience supporting producer organizations in value chains, which often includes some form of financial services in the chain. Furthermore, the fact that both loans and grants are handled in one and the same department must be read as a strength, in particular for emerging rurally based MFIs

Hivos has developed a distinctive growth model for support to emerging MFIs, with clear exit strategies for the different phases of support. Furthermore, their recent experience with rural finance in the context of multi-party arrangements for rural economic development is an asset.

ICCO has a clear focus on rural finance and fully incorporates microfinance into the broader context of its financial services programme. ICCO makes a deliberate effort to promote synergies between its financial services and market development programmes. The Terrafina Microfinance programme was developed to support customised rural microfinance in Africa. ICCO is strong in supporting national networks. Furthermore, ICCO has relevant experience in the provision of financial services to producers in value chains.

Oxfam Novib is developing a rural finance policy which looks at rural finance within the broader context of rural livelihood development. Triple Jump's role as an independent fund manager adds a professional touch not only to the MFI loan portfolio, but also to the support offered to MFIs in different stages of their development. Furthermore, Oxfam Novib boasts significant experience with support to self-help groups and promoters of member-owned microfinance for rural outreach. Oxfam Novib is also strong in support to networks.

The table below offers an overview of these four CFOs' programmes, instruments and banking partners.

Table 2: CFO's institutional set-up and instruments used

| CFO | Microfinance support | Rural economic development support | Instruments | | Banking partner | Regional offices |
|--------------------------|---|---|--|----|-----------------|--|
| | | | | | | |
| CORDAID | Development of financial services programme | Primarily loans, but also grants, guarantees and occasionally subordinated loans or equity | No | No | | |
| | Part of the Entrepreneurship Department | | | | | |
| | Small Producers in the Market programme | | | | | |
| | Part of the Entrepreneurship Department | | | | | |
| HIVOS | Financial Services and Business Development division | Support to producers in multi stakeholder arrangements | Seed capital grants Guarantees on HTF loans Equity through HTF | | HTF | Yes: Zimbabwe, India, Costa Rica and Indonesia |
| | Part of the Sustainable Economic Development Department | | Part of the Sustainable Economic Development Department | | | |
| ICCO | Financial services sub-programme | Financial Services Programme, Local Market Development Programme, International Market Development Programme | Grants and guarantees, sometimes equity directly or through Oikocredit | | Oikocredit | No, but decentralisation is foreseen |
| | For Africa: joint initiative with Terrafina | | Support to Local Currency Risk Fund | | | |
| | Fair Economic Development Department | Part of the Fair Economic Development Department | | | | |
| Oxfam Novib Novib | 'Right to sustainable livelihood' theme | 'Right to sustainable livelihoods' theme | Grants and guarantees | | Triple Jump | Through Oxfam International network |
| | Triple Jump | | | | | |



Rural Finance Facility Buusa Gonofaa. Male board members.

4.1. Introduction

This chapter is based on a statistical analysis conducted by our two master students, using different performance indicators for MFIs.¹⁸ The majority of the MFIs included in the analysis belong to the CFOs' 'first approach' category, which focuses on credit-led MFIs. Some cooperatives fitting into the second approach (support to Member-Owned Institutions) are included in the analysis. The promoters of Member-Owned Microfinance Institutions are not included, as their performance cannot be measured according to the indicators that apply to MFIs.

It proved impossible to conduct a quantitative analysis of financial services provided to actors in the value chain (third approach), as CFOs do not always cluster financial services to partners in the chain under microfinance or rural finance. They tend to be categorised as part of their general rural economic development programmes. This means that they are difficult to locate in CFOs' MIS.

4.2. Methodology

For the portfolio analysis, data were collected on a sample of 154 MFIs out of a total of 562 microfinance organisations¹⁹ supported by the MicroNed members. MFIs were randomly selected from the partner database of the CFOs. Although MicroNeds' network activities centre on partners supported with grants, the portfolio analysis includes partners supported through different financing instruments. It is important to note that data and information on partners was often not easily accessible, in particular in the case of very young, starting MFIs. For the analysis of institutional performance and sustainability, only the larger and more mature 135 MFIs could be taken into account. It must be noted that the analysis is therefore biased towards the better performing MFIs. It is important to note that of the approximately 160 MFIs supported by the CFOs exclusively with grants, only 20 were included in the sample. Most of the MFIs in the sample (80) were supported exclusively by loans and guarantees. While taking into account the limitations of the sample, it is worthwhile to present some of the results of the portfolio analysis related to rural microfinance.

¹⁸ In this chapter, only the analysis relating to rural finance is incorporated. A detailed report on the analysis of these data can be found in 'Banking on the Poorest: microfinance in rural areas', by Casper Havinga and Jurjan Mol. This report can be obtained through MicroNed.

¹⁹ Source of number of microfinance partner organisations: Triodos Facet 2008: Partos Portfolio Analysis 2008, version 2.2.



Grain harvest of Buusaa Gonofaa client.

The table below lists the number and type of MFIs included in the analysis.

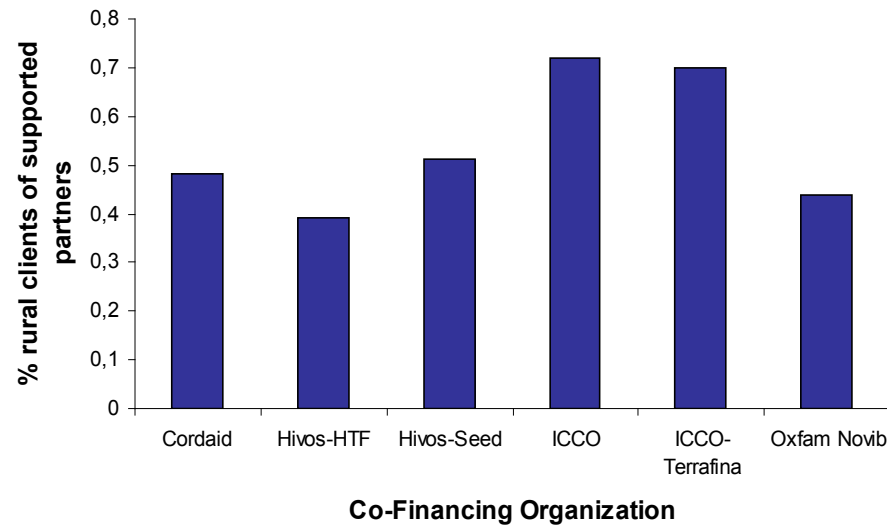
| Number of MFIs in the dataset per category | |
|---|---|
| Total | 154 |
| Cooperatives | 15 |
| NGOs | 59 |
| NBFIs | 71 |
| Banks | 9 |
| Supported by Cordaid | 41 |
| Supported by Hivos | 37 <i>(31 of HTF)</i> |
| Supported by ICCO | 39 <i>(10 of Terrafina Microfinance)</i> |
| Supported by Oxfam Novib | 37 |
| Grant Partners | 21 |
| Loan Partners | 58 |
| Guarantee Partners | 22 |
| Equity participations | 1 |
| Combination of instruments | 52 |
| Source of data: reports of partners and the MIX market | |

4.3. Rural Focus of CFOs

Out of the four MicroNed members, ICCO highlights its rural focus most strongly. Figure 2 confirms that the partners supported by ICCO and Terrafina Microfinance are relatively more active in rural areas.

On average, 70% of the clientele of these MFIs live in rural areas, compared to 40 to 50% for the MFIs supported by the other CFOs.

Figure 2: Rural clients per Co-Financing Organization



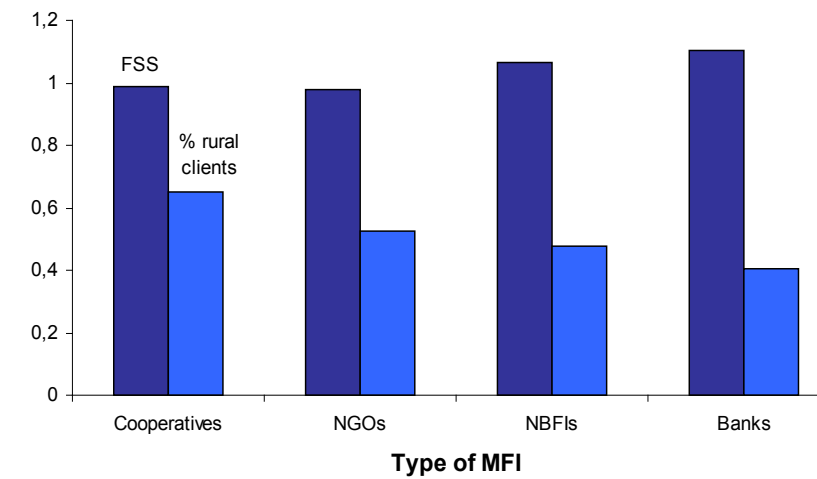
4.4. Rural focus per institutional type and levels of sustainability

Rural focus was also analysed per institutional type across the CFOs (figure 3). It was found that cooperatives have the strongest focus on rural clients, with over 65% of clients originating from rural areas. On average, NGOs also provide more financial products in rural areas. This percentage is much lower for Non Bank Financial Institutions (NBFI) and commercial banks. The latter receive support from funds such as the Hivos-Triodos Fund. It appears that for these funds sustainable partners are easier to find among the more formalised MFIs with less rural focus. The graph below indicates that less formal financial institutions with a higher rural outreach also maintain slightly lower levels of financial sustainability. This type of institution is a frequent recipient of grant funding by MicroNed members because they still require financial support and capacity-building assistance. Their path towards sustainability often takes longer than for urban MFIs and requires a more varied support package and therefore also more time of the respective CFO staff.

Recently, the European Commission proposed that MFIs should reach sustainability between 3-7 years. The European Microfinance Platform (eMFP) concluded from a study of 446 institutions that it is almost impossible for rurally based MFIs to become sustainable within such a timeframe (2007)²⁰. The eMFP proposes longer support periods of 7-12 years for MFIs to mature and become self-sustainable.

²⁰ European Microfinance Platform (2007). 'Note on the European Policy to Restrict Grants for Capital to Start-ups'.

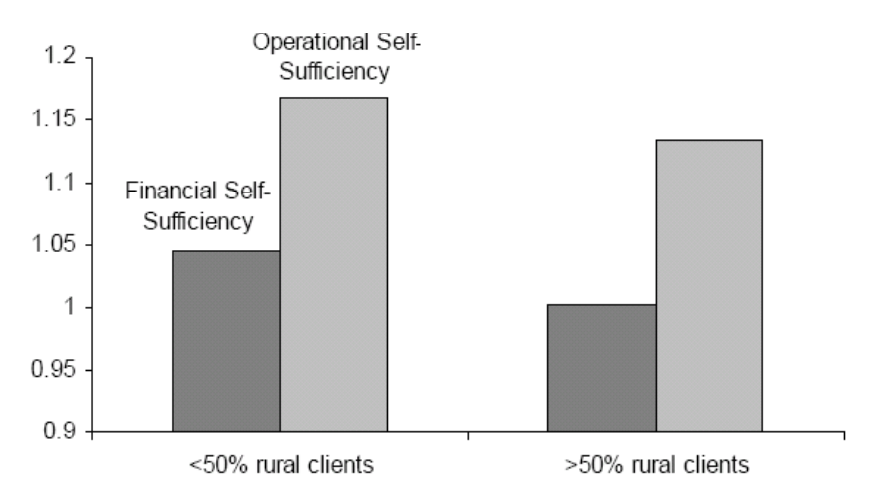
Figure 3: Sustainability and outreach per type of institution



4.5. Trade-off between sustainability and rural outreach?

On average, the partners of MicroNed members that have a more than 50% rural clientele also show lower levels of financial sustainability than the urban MFIs, as can be seen in the figure below.

Figure 4 : Financial and Operational Self-Sufficiency and rural clients



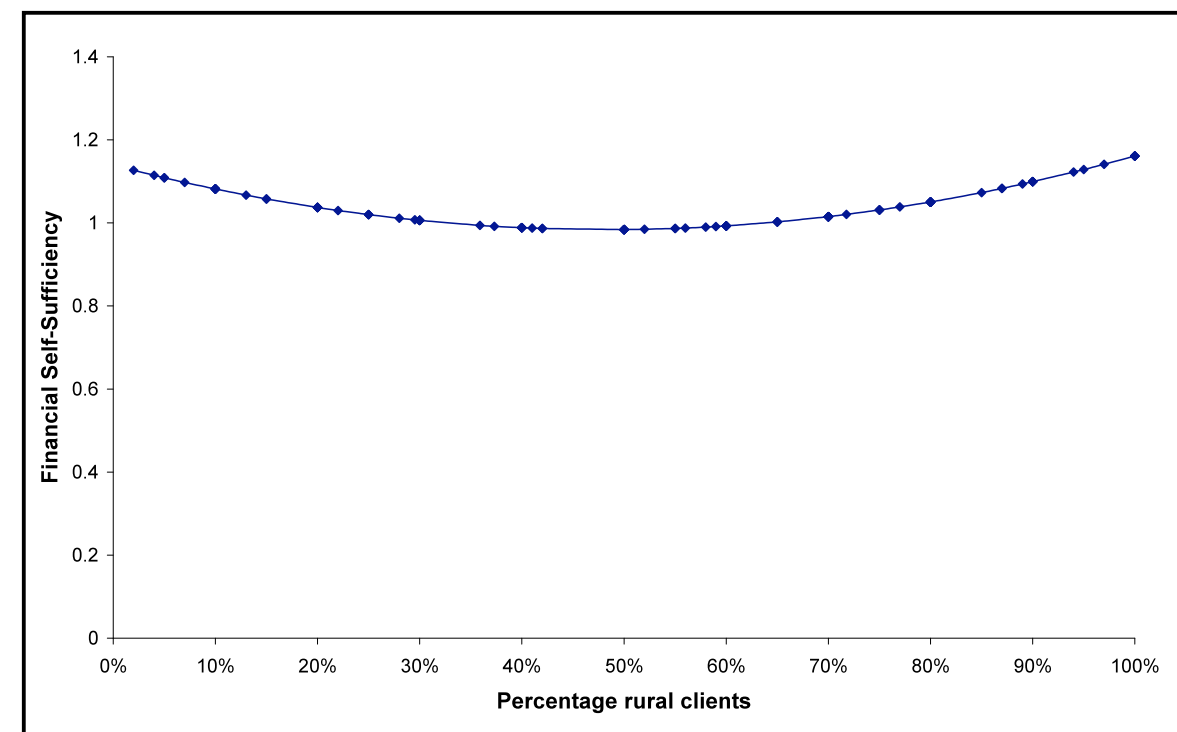
However, when analysing the sustainability characteristics of financial service providers in more detail, an interesting relationship between sustainability and rural outreach was found. In the master thesis research of the



Board Members of Kaderes SACCO at Board Meeting. See page 56.

research team a regression model was used to research relationships between the operational and institutional characteristics of MFIs, their rural outreach and profitability. Figure 5 plots the outcome of one of these models. As can be seen in the figure, MFIs that operate predominately in urban areas achieve almost the same sustainability levels as MFIs that have an almost completely rural clientele. It is remarkable that, contrary to the prevailing assumption that MFIs have to diversify their portfolio in order to balance sustainability with rural outreach, this study found that the MFIs of MicroNed members with a strong rural focus perform – albeit slightly - better in terms of long-term sustainability.

Figure 4 : Financial and Operational Self-Sufficiency and rural clients



CASE STUDIES APPROACH 1: SUPPORT TO RURAL CREDIT – LED MFIs

5.1. Introduction.

In this chapter, case studies will be presented relating to the CFOs' first rural finance approach, which centres on building sustainable MF institutions, whereby MFIs gradually are prepared for semi-commercial funding. Commonly, these MFIs are credit-led; they receive external funds for their loan fund and will introduce deposit services when they have matured and have acquired the appropriate legal status. Three rural MFIs belonging to this category will be presented²¹.

The case descriptions are followed by an outline of the type of support provided by the CFOs, feedback from one of the MFIs on donor support, and a paragraph with concluding remarks.

The case descriptions will focus on how MFIs address some of the specific constraints in rural microfinance, including risks, costs, products meeting rural demand and product delivery mechanisms.

The cases do not pretend to be representative of the types of MFIs supported by CFOs, nor of the type of support provided by the CFOs; these cases are merely presented as examples to illustrate how MFIs succeed in dealing with constraints inherent in rural micro-finance.

5.2. Presenting of three MFIs

Two of the three MFIs included in the case studies operate in Peru (Fondesurce and Confianza), the remaining one in Ethiopia (Buusaa Gonofaa). One of the MFIs in Peru (Fondesurco) has the legal status of an NGO; the other two are registered as financial institutions, but originated from NGOs. Confianza in Peru is the largest MFI, followed directly by Buusaa Ganofaa in Ethiopia. Fondesurco (the NGO) has a limited number of clients, but is exceptional in its performance; it received the CGAP prize for Financial Transparency in 2004, and an award from the Fund for Rural Development Innovations (FINDER²²).

Rural Finance Facility Buusa Gonofaa. Client showing his grainfield.

²¹ Main sources for case description are project documents and rating reports

²² Fondo de Innovación para el Desarrollo Rural

Some basic information on these MFIs is presented in the table below.

Table 4: Information of the three MFIs (data from December 2006)

| | Fondesurco | Confianza | Buusaa Gonofaa |
|-----------------------------|--------------------------------|--|---|
| CFO | Cordaid | Oxfam Novib | ICCO/Terrafina Microfinance |
| Country | Peru | Peru | Ethiopia |
| Legal Status | NGO | Small and Micro Business Development Entity (supervised) | Non Bank Financial Institution (supervised) |
| Start of Operations | 1994 | 1998 | 1999 |
| Number of clients | 1,818 | 36,407 | 26,247 |
| Gross Loan portfolio | 2,217,000 USD | 37,754,000 USD | 2,002,367 USD |
| Rating | | | |
| | Planet rating: B ²³ | Microrate: β + ²⁴ | Planet rating: C+ ²⁵ |

5.3. Profitability

The MFIs apply different strategies: the smaller Fondesurco (NGO) operates exclusively in rural areas and its portfolio is characterised by a high concentration of agricultural loans (80%). While Buusaa Gonofaa predominantly works in rural areas in Ethiopia and has a portfolio concentration in agricultural loans, it also operates in urban areas. Confianza transformed from a NGO exclusively targeting poor female rural clients into a MFI with a diversified portfolio in both urban and rural areas.

Even though the operating environment, client base and proportion of the rural portfolio differs for each MFI, profitability indicators are similar, as can be seen in the table below. Operational sustainability levels and portfolio yields are very similar for all three MFIs. This illustrates the findings of the portfolio analysis in chapter 3 that MFIs with a rural focus can be as least as sustainable as MFIs with a combined rural and urban portfolio. The table below lists some profitability indicators.

²³ B means: "Procedures are well developed, effective and incorporate a long term perspective. Some improvements could be made. Long term risks are identified in the strategic plan".

²⁴ β means: "Those MFIs working to define a clear and rational relationship among the social, financial and operational considerations of sound microfinance practice as compared to an international set of similar companies and emerging standards of the microfinance industry. Satisfactory efficiency and effectiveness. Acceptable risk. Satisfactory future prospects"

²⁵ C means: "Minimum required. Procedures are functional but with certain failings. There are minor risks in the medium term for operations"

Table 5: Profitability indicators

| | Fondesurco | Confianza | Buusaa Gonofaa |
|--------------------------------------|------------|-----------|----------------|
| Operational Sustainability | 120,4% | 112% | 124% |
| Return on equity (unadjusted) | 10,12% | 10.7% | 6.75 % |
| Portfolio yield | 29% | 31.4% | 29.7% |

5.4. Outreach indicators

Buusaa Gonofaa operates in the very poor rural areas of Ethiopia and has a clear poverty focus, while Confianza and Fondesurco tend to target the low-income rural population. Average loan balances differ significantly, although when adjusted to GNP per capita, the difference is much smaller. According to the Micro Banking Bulletin, the three MFIs reach the broad stratum of the market²⁶. It should be noted that this is a rather crude measure, but it provides some idea of the population strata reached by the MFIs.

The percentage of female clients differs substantially; the low percentage of Fondesurco may be caused by its concentration on agricultural loans, as land and agricultural produce marketing generally belong to the domain of men. The high percentage of female clients in Ethiopia is remarkable, given the rural focus of Buusaa Gonofaa.

Table 6: Outreach indicators

| | Fondesurco | Confianza | Buusaa Gonofaa |
|---|------------|-----------|----------------|
| Average loan balance | \$ 1,168 | \$ 1,037 | \$ 64 |
| Average Loan Balance per borrower / GNI per capita | 40% | 39% | 35% |
| Percentage female clients | 34% | 51% | 78% |

5.5. Products: loan conditions

The three MFIs are all offering credit. Two of them are planning to introduce savings products. Loan conditions are tailored to the cash flow of the rural population, which means their products are much more flexible than the standard microfinance products which are short term with regular repayments. Moreover, in the case of the two Peruvian MFIs, products cater not only micro, but also to small entrepreneurs.

For example, in the case of Fondesurco, working capital loan range between 100 and 10,000 USD, for periods between 3 and 36 months, the average loan period being 11 months. Payments are monthly, but a grace period may be granted for approximately 7 months.

²⁶ According to the Micro Banking Bulletin: low end: average loan balance is less than 20% of the per capita GNP; broad: average loan balance is between 20 and 149%; high end: 150% or more of the per capita GNP.

In the case of Confianza, the agricultural loans vary from \$ 150 and \$ 10 000 (average of \$ 1,132) with an average duration of 8 months. Disbursements as well as repayments are in line with income flows. Loans can be received in two or three disbursements, and repayments can be spread over the period of the loan, or be repaid at once.

Buusaa Gonofaa's loans range from 17 USD to 564 USD per client, for periods of 6 to 24 months. In urban areas, repayments can be weekly, biweekly or monthly. Bullet loans are used for rural clients, interest is paid during the course of the loan, the principal repaid in two to four bulk repayments during harvest times.

Both Confianza and Buusaa Gonofaa recently introduced a village banking methodology with the aim to increase outreach in remote rural areas and also, in the case of Confianza, to increase the number of female clients in rural areas. In the case of Confianza, the village bank approach does not include savings. Buusaa Gonofaa promotes a community-owned methodology, based on savings but linked to BG for credit.

In the table below, products and their share in the MFIs portfolio are presented.

| | Credit | Savings |
|----------------------|--|---|
| Fondersurco | Individual lending: Working capital, including for agriculture (91%) Investment Credit (5%) Multi-purpose Credit (4%) | Not allowed due to its NGO status |
| Confianza | Individual lending : Micro enterprises (60%) Consumer loans (17%) Agriculture (12%) Small enterprises (6%) Housing (5%) Village banking methodology (without savings) targeted at women groups (pilot phase, irrelevant proportion of the portfolio) | Not allowed due to its legal status; is planning to change status and to start offering saving products |
| Buusa Gonofaa | Group lending to groups of 12 – 20 individuals: Multi-purpose loans, concentration in agriculture (80%) Employees (20%) Group lending: Pilot with village banking type of system (including savings) for outreach in remote rural areas | Mandatory savings to guarantee loans; Voluntary savings product planned; Pilot of community owned village banking type of system based on savings |

5.6. Mitigating risks

In terms of risk management, the history of Confianza is worth highlighting. Its lending programme started out with an exclusively rural portfolio of small loans to groups of women who were almost exclusively engaged in potato farming²⁷. In 1999, more than 50 percent of the portfolio was at risk of default, due to plunging potato prices, weak monitoring and insufficient information about borrowers. Confianza revised its portfolio by diversifying into urban areas and non-farm rural activities, introducing stricter lending requirements, improving loan monitoring and adapting agricultural products to income streams of clients. Target clients shifted from poor rural women to low-income households in urban and rural areas. Currently, Confianza's policy is that agricultural loans should not exceed 15% of the total portfolio, to mitigate risks related to this sector. This target decreased gradually. In 2005 it was still 30%, even though demand is very strong and competition minimal. In absolute terms, Confianza's agricultural loan portfolio is large: 4,5 million USD, which is larger than the entire loan portfolio of Fondesurco.

In this aspect, Buusaa Gonofaa's strategy is diametrically opposed to that of Confianza. Buusa Gonofaa introduced an employee loan that became very popular and within a few months represented more than half of the portfolio. Buusa Gonofaa then set a limit of 20% on employee loans, despite the strong demand and increased emphasis on rural and agricultural loans.

Another risk-mitigating strategy applied by both Buusa Gonofaa and Confianza involves spreading the agricultural loan portfolio over branches located in areas with different climatic conditions and consequently different products.

In addition, Fondesurco and Confianza select households that have other sources of income than from agriculture alone.

The flexible products as described in the former section also limit the risk of non-repayment.

It is good to note that the PAR of 30 days is a good predictor for portfolio quality where the typical microfinance products, characterised by many small repayments, are concerned. This is not the case for bullet payment loans that all mature at roughly the same time of the year. When a considerable part of the portfolio consists of agriculture bullet payment loans, as in the case of Buusaa Gonofaa, a low PAR is not much of an indication in for example the planting season.

None of the MFIs cover their risks by insuring their agricultural portfolios.

²⁷ CGAP Agricultural Case study Number 1, August 2005

| Some of the risk mitigating policies | Fondesurco | Confianza | Buusaa Gonofaa |
|---|------------|------------|--------------------------------------|
| Spreading of the agricultural loan portfolio over branches located in areas with different climate conditions | | X | X |
| Selection of households that have different sources of income | X | X | |
| Avoiding concentration of agriculture in portfolio | 80% agric. | 15% agric. | 80% rural, of which most agriculture |
| Main target clients are not the poor, but low-income households in urban and rural areas | X | X | |
| Matching disbursements and repayments to needs and income streams of clients | X | X | X |

5.7. Reduction of costs

Rural microfinance institutions face higher costs than the urban institutions; these costs are, among other things, related to distances and to acquiring detailed knowledge of agricultural production and markets.

For Fondesurco, an important cost reduction strategy is its cooperation with other NGOs implementing market development programs. Fondesurco's strategy to enter new markets is based on the opportunities for complementary services from these NGOs. While eliminating the need for specific market studies, this kind of cooperation provides Fondesurco with detailed knowledge on the sectors and the business environment. Confianza also seeks to cooperate with institutions that have expertise in agricultural commodity prices and weather patterns for the agricultural loans. Sometimes these institutions are asked to provide training to their clients.

Another strategy involves limiting the action radius of MFI operations. Confianza limited its areas of operation in rural areas to 1,5 hours travel time from its local branches. Buusaa Gonofaa collects payments at its branches offices or collection points close by.

One third of Confianza's portfolio is concentrated in the Peruvian capital of Lima. Profit margins in urban economic activities are generally larger than in similar activities in rural areas; therefore urban populations can shoulder higher interest rates than people in the provinces. In Lima, Confianza's competition strategy is based on the provision of quality products in stead of on prices. However, competition is high in Lima and potential over-indebtedness of MFI clients constitutes a risk.

5.8. Conclusions

These case studies of MFIs illustrate the following:

- Diversifying urban and rural portfolios reduces risks associated with agricultural lending and provides opportunities to transfer profits of operations in urban areas where people can shoulder higher interest rates, to the higher-cost rural areas, where people involved in small-scale agricultural production in particular generate low returns on their activities. However, the extent to which cross-subsidization is a viable option will depend on the extent of competition in urban areas.
- However, with appropriate policies in place, it is possible for a rural microfinance institution to focus completely on rural areas and to concentrate on credit for agricultural activities and for livestock and still be profitable.
- Given the fact that operations tend to be more profitable in urban areas, MFIs operating both in rural and in urban areas, can easily be tempted to reduce their rural and especially agricultural focus, unless they have a very strong rural commitment and aim at sustainability rather than at profit maximisation.
- Diversifying the rural portfolio into different climate zones and catering to diverse actors (farmers and micro-enterprises) also constitutes an effective risk mitigating strategy.
- Successful rural and agricultural products differ from standard microfinance products; they are much more flexible and disbursement and reimbursements match the needs and income streams of the clients.
- Cooperation with NGOs developing market linkages and strengthening farmers' organisations substantially reduce costs for MFIs as these NGOs provide market information as well as linkages with potential clients and eliminate the need for specific market research.
- Village banking methodologies (based on savings or credit-led) may be used by MFIs to broaden outreach, to reach more women and to reach more remote rural areas.

5.9. Donor Support Mechanisms

5.9.1. Financial Instruments Used

The CFOs used loans, grants, equity investment in support of MFIs and also took on the role of broker. The type of support offered is summarised below.

Fondesurco: direct loans from Cordaid

Cordaid provided two loans to Fondesurco, in 2004 and 2007. In the case of the second loan, Cordaid first tried to provide a bank guarantee to a local bank. Several negotiations with banks took place, but the conditions these banks imposed were unfavourable. Therefore Cordaid opted for provision of a loan to Fondesurco, with the option to transform this loan into a bank guarantee if and when opportunities for local loans arise.

Confianza; grant, loan and equity investment by Oxfam Novib, ASN –Oxfam Novib Fund and Triple Jump.

Oxfam Novib has a long-standing relationship with Confianza. In 2001, a loan was granted in combination with a grant for technical assistance, staff training and system development. In 2004, Oxfam Novib decided to take an equity share in Confianza. At present, however, Oxfam Novib's policy no longer permits equity investments. Oxfam Novib's equity shares are being gradually reduced and its shares are being taken over by the NGO from which Confianza originates, SEPAR.

In 2006, Confianza was granted another large loan by the ASN-Oxfam Novib fund, a commercial fund that is managed by Triple Jump. The ASN-Oxfam Novib fund also took an equity stake in Confianza.

Buusa Ganoofaa (BG); grants, technical assistance and brokerage by Terrafina Microfinance.

Terrafina Microfinance provided BG with several grants. Issuing loans was not an option, as the Ethiopian legal framework does not permit the provision of loans by international institutions. Terrafina Microfinance also paid for business planning training. Interestingly, the pool of Ethiopian consultants trained by Terrafina Microfinance in their turn went on to train other Terrafina Microfinance partners in Ethiopia. Terrafina Microfinance also established a Product Innovation Fund in Ethiopia, which assisted BG to develop a poverty scorecard, the objective of which is to set up a social performance management system aimed at improving BGs' services. Terrafina Microfinance also acted as a broker, bringing together different parties to cooperate in the development of the scorecard.

Table 9: Support from CFOs

| | Fondesurco | Confianza | Buusaa Gonofaa |
|--------|--------------------|---------------------------|--|
| CFO | Cordaid | Oxfam-Novib / Triple Jump | ICCO/Terrafina Microfinance |
| Loans | USD 300,000 (2004) | USD 400,000 (2001) | |
| | USD 300,000 (2007) | € 1,570,000 (2007) by ANF | |
| Equity | | USD 400,000 (2004) | |
| | | € 496,000 (2007) by ANF | |
| Grant | | USD 31,765 | € 50,000 (2002) € 48,000 (2003) € 43,600 (2004) € 98,000 (2005) € 58,500 (2006) € 11,600 (2007) €110,000(2008) |
| TA | | | Business planning Poverty Scorecard |

5.9.2. Observations in relation to donor policies and instruments:

- CFOs do not only apply a wide range of instruments in their capacity of funding agencies, but also act as brokers.
- Donors can play a role in promoting important linkages between market development NGOs and MFIs, which benefit both parties. Strategic financing of rural market development NGOs (or other kinds of organisations) and MFIs in the same area can reduce costs of MFIs substantially.

5.9.3 MFI comments and suggestions for donor support

On request, Buusaa Gonofaa provided feedback on the role of donors, including Terrafina Microfinance. The other MFIs failed to respond to the request for feedback. BG's comments are summarised below:

BG benefited most from:

- Support to business planning
- Support to social scorecard measurement system.
- Subsidies for product innovation
- Subsidies for opening new branches to increase rural outreach

Weaknesses in donor support to BG:

- Donors tend to have a narrow focus and display a tendency to push their own projects.
- Frequently, project duration is too short to bring results; a more long-term focus is needed. This is particular important for rural MFIs, as these take longer than urban MFIs to become sustainable.

BG puts forward the following recommendations to donors to increase rural outreach of MFIs:

- Provide capacity-building and product / methodology innovation. For example, more community-owned systems could be developed and linked to the formal MFI structure for increased outreach in remote rural areas;
- Provide subsidies to cover operational costs which urban MFIs do not incur or incur to a lesser extent, e.g. transport costs;
- Provide equity contributions to serve as risk cushion in case of agriculture failure.

CASE STUDY APPROACH 2: SUPPORT TO MEMBER-OWNED MICROFINANCE INSTITUTIONS



Kaderes treasurer cross checking the SACCOs Books of Accounts.

6.1. Introduction

The second main CFO approach involves support Member-Owned Microfinance Institutions, either directly or through promoters. The size of Member-Owned Microfinance Institutions varies from small autonomous self help groups or village savings and loan associations, to large and sophisticated cooperative institutions and national networks. CFOs generally support the larger MOMFIs directly and the smaller ones through so-called promoters: NGOs involved in the formation and training of MOMFIs.

Members of Member-Owned Microfinance Institutions are both users and owners of the institution; members are involved in decision-making²⁸. They are distinguishable from mainstream credit-led MFIs in that member equity (shares, savings) constitutes the key source of funds. The MOMFI approach is attractive in the context of rural finance because they tend to have a strong presence in rural areas.

The case study offers a description of a promoter of Member Owned Microfinance Institutions: an NGO supporting savings and credit cooperative societies (SACCOs).

6.2. What are SACCOs and SACCO promoters?

SACCOs are member-owned organisations that can grow to any size. They are owned by their members, who are at the same time the main customers of the institution. SACCOs operate mostly in rural areas.

SACCOs and credit unions often originate from informal local initiatives of employees, farmers or other local entrepreneurs, pooling their savings and helping each other with credit. SACCOs tend to be close to their member-clients and therefore members have a strong feeling of ownership. SACCO savings accounts are very popular, with the number of accounts generally exceeding by far the number of loans. In particular for rural populations relying on irregular income flows savings facilities are very important, as it allows them to save money for the lean periods before harvest. However, the range of products (both savings and credit) SACCOs offer tend to be fairly limited.

Operational sustainability is normally not the main constraint for SACCOs, although sometimes the spread between the interest paid on savings and interest charged on credit is too small to cover their costs. Institutional sustainability is more often a constraint, as SACCOs tend to have complex governance and managerial issues, especially when they reach a substantial scale.

²⁸ FINCA type of village banks are not included in this definition, as the decision-making lies with the FINCA MFIs, which maintain a client relationship with the participants in their banks. The definition for member-owned financial institutions is derived from the following study: Coady Institute 2008: Reaching the Hard to Reach: Comparative study of Member-Owned Financial Institutions in Remote Rural Areas

6.3. Presentation of SACCO promoter KADERES in Tanzania²⁹.

KADERES is an NGO that focuses on the promotion, formation and strengthening of community-based initiatives in the Kagera Region. The promotion of SACCOs by KADERES is part of the Rural Finance Scheme (RFS) in Tanzania, which was developed in 1999/2000 through a joint effort of a commercial private bank, the Cooperative College, two service providers in the area of (cooperative) financial services and SNV. The Rural Finance Scheme aimed to organise farmers in SACCOs as a first step, to gather them into Agricultural Marketing Cooperative Societies (AMCS) when certain targets within the SACCOs would have been reached (e.g. number of shareholders)³⁰. In addition, the RFS' aim was to link the SACCOs to a bank to increase their loan fund, when necessary.

Currently, Hivos and KADERES are developing plans that comprise not only financial services, but also include rural expansion and linkages between farmers and buyers to strengthen SACCO members' market access. In addition, KADERES wants to start providing loans to SACCOs and groups within SACCOs in order to enable them to better respond to their members' demand - however without discouraging their saving habits. KADERES also intends to run a guarantee fund to facilitate SACCO access to rural bank loans.

KADERES' services to SACCOs include:

- 1) Capacity-building of elected officers and staff
- 2) Monitoring: frequent checks of financial records and the SACCOs' general performance; incorporation of hand-written records into computerised MIS; provision of advice to accountants and elected committees
- 3) Provision of stationery

SACCOs pay for KADERES' services, but the fees do not cover the real costs and donor support is needed. In the longer run, SACCOs will become stronger and the need for support will be reduced; prospects are that SACCOs will then be able to cover the full cost of services.

Early 2007 a network of SACCOs was established, facilitated by KADERES. In the near future, this network will be availing itself of on KADERES services. KADERES' services to SACCOs are in high demand: 12 other SACCOs also applied for support.

The table below provides some information on both the promotional agency and the SACCOs it supports:³¹

²⁹ Sources for the description of the SACCOs are project documents, monitoring reports by an external consultant, KADERES' annual report 2007, and emails from KADERES' manager.

³⁰ The Rural Finance Scheme model is described in "Community-Based Microfinance Models in East Africa" November 2004. SNV, Hivos and FACET, pag 1 – 6.

³¹ Loan fund consists of savings, shares, profit. The figures are from December 2007

Table 10: Presentation of Kaderes

| | KADERES: Karagwe Development and Relief Services |
|--|--|
| Legal status | NGO supporting 6 SACCOs (Savings and Credit Cooperatives) |
| Start of operations | 1998; promotion of SACCOs started in 2001 |
| Activity | Promotion, formation and strengthening of community-based initiatives. |
| Number of members clients of the 6 SACCOs | 12 000 in 2007 (44% women) |
| Legal Status of the SACCOs | Registered under the Cooperative Act as Savings and Credit Cooperative Societies |
| Value of Shares, savings and current accounts | € 370,023 |
| Outstanding loan balance | € 412,134 ³¹ |

6.4. Profitability of the SACCOs

All but one SACCO are operationally sustainable; the SACCO that was not yet operationally sustainable only received support from KADERES for half a year. Profits are predominantly used to increase the loan fund.

Financial sustainability is not a relevant indicator, as the SACCOs have not yet advanced to becoming borrowing funds and most of them have not begun paying interest on their savings.

Table 11: Operational sustainability (December 2007³²)

| CHAKANYA | IGURWA | KAISHO | KYERWA | KIMULI | KITUNTU |
|----------|--------|--------|--------|--------|---------|
| 1.23 | 1.66 | 1.42 | 0.83 | 1.68 | |

6.5. Outreach

The SACCOs operate between 50 and 260 km from the urban areas. The number of members exceeds expectations. The majority of members is involved in agriculture (estimated at 75%), approximately 20% of the members are micro-entrepreneurs and 5% are employees. There are also groups and institutions which have become members of the SACCOs. Groups consist of 10 – 30 people; the total number of group members is slightly higher than the number of individual members. There is a total 67 institutions among the SACCOs' membership; these include primary and secondary schools, village and community authorities, health centres, cooperatives and churches.

³² From 2 SACCOs, the PAR is from the beginning of January. The PAR was very high by the end of December, due to the closure of the office to close the books. The PAR of January reflects better the reality.

In roughly half of the SACCOs, the majority of group members are women. The women's groups in particular are set up to provide mutual assistance on social challenges such as education, health and funerals. Some male groups are organised specifically for the implementation of micro-enterprises. Almost 97% of group members are peasants.

There is no information available on average loan balance.

6.6. Products

SACCO savings products have proved to be the most successful. The term deposits serve as basis for the loan fund; current accounts, by law, cannot be used for loans. Only one of the SACCOs is paying interest on savings.

The SACCOs offer individual loans and group loans. The SACCOs charge 12 – 18% interest per annum on their loans. In line with the needs of their members, loans are not only made available for productive activities, but also for school costs and emergency situations. However, as the table below shows, most of the loans are used for business purposes.

Table 12: Loan allocation of SACCOs in 2007 (averages of the 6 SACCOs)

| Agriculture | Business | School | Emergency | Others |
|-------------|----------|--------|-----------|--------|
| 11,0% | 67,9% | 14,2% | 3,9% | 3,1% |

Even though most of the members are involved in agriculture, the SACCOs' loan products are more suitable to off-farm activities; loan terms are often short (with a maximum of 6 months) to allow circulation of the loan fund among more members, and repayments have to be made regularly.

For the past two years, the SACCOs have been facing the challenge of cash shortages in lending to members, in particular during the annual crop harvesting season starting at the end of February and continuing to the end of September. The law stipulates that deposits on current accounts cannot be used for lending, resulting in a limited value of funds available for lending. The shortage of funds for lending leads to discouragement of members and withdrawal of savings. Some SACCOs made a decision to borrow additional funds from individuals to on-lend to members.

To address this situation, KADERES set out to develop a plan (which was subsequently submitted to Hivos) for management of a fund for provision of loans to the SACCOs and groups within SACCOs and the creation of a guarantee fund in order to facilitate SACCOs' access to credit from Commercial Banks. KADERES' loans are aimed at agriculture, petty trade, manufacturing, services and processing. The interest rate for SACCOs would be set at 10% p.a., and group lending at 15 - 18% p.a.

6.7 Reduction of costs

The SACCOs have very basic equipment and offices. While they employ salaried management staff, many tasks are carried out by elected officers, receiving a sitting allowance (board, credit committee, supervisory committee). Total expenses for the 6 SACCOs in the year 2007 amounted to less than € 22.000.

A considerable proportion of the SACCOs' members are organised into groups, which has a downward effect on the cost of communication with members. Moreover, the group structure is considered to reduce the risk of non-repayment.

6.8. Mitigating risks

One of the main challenges for the SACCOs is to reduce the portfolio at risk (PAR) As the table below shows, the portfolio at risk is rather high for most of the SACCOs.

Table 13: Portfolio at Risk

| CHAKANYA | IGURWA | KAISHO | KYERWA | KIMULI | KITUNTU |
|----------|--------|--------|--------|--------|---------|
| 30.3 % | 5.7 % | 8 % | 1.1 % | 9.2 % | 7.4 % |

Chakanya has a particularly high PAR, which is related to mismanagement and serious governance problems. Given the fact that this SACCO has persistently failed to follow KADERES' advice and efforts to improve the situation did not succeed, KADERES is considering cancelling its services to Chakanya.

Governance and management are key challenges. Over the past 5 years, KADERES terminated its cooperation with 2 SACCOs whose elected officers defrauded the members' funds by abusing their influential leadership positions in the community and in local government. KADERES' strategy for mitigating this risk includes capacity-building among SACCO staff and committees in order to maximise transparency of operations.

In some SACCOs, the high PAR is due to a small number of individuals receiving very substantial loans. As part of their risk mitigating strategies, the SACCOs intend to limit the maximum individual loan amount.

As mentioned previously, another risk mitigating strategy applied by the SACCOs is the peer pressure by the member groups.

6.9. Conclusions

This case confirms a number of issues which are a common feature in SACCOs³³:

- Management and government issues are the main bottlenecks for SACCO development
- External support and monitoring of SACCOs is needed to promote transparency, to clarify the responsibilities of staff and committees and to limit governance and management problems. Starting SACCOs in particular require intensive support in this area.
- SACCOs work at low cost, and therefore the costs to operate in remote rural areas do not constitute a major constraint
- Product development is limited; while savings products are in high demand, these remain very basic and no interest is earned. Loan terms are not adapted to agricultural activities and appear better suited to the dynamics of micro-enterprises.
- Typical of SACCOs is the provision of loans for social purposes.
- Compared to banks and MFIs, their interest rates are very low.

6.10. Donor Support Mechanism

In 2001, Hivos began assisting KADERES to set up a SACCO support program by financing a feasibility study on the promotion of rural MFIs. Based on this report, a proposal to found six SACCO's put forward.. Hivos provided KADERES with a grant to implement this programme. The SACCOs were successfully supported and in 2006, KADERES was awarded a second HIVOS grant for continuation of support to the existing SACCOs, further expansion of the SACCO network and for phasing out the donor relationship.

Characteristic for Hivos' seed capital grants is that they are provided in conditional tranches, depending on the attainment of certain performance indicators. In the case of KADERES, these were based on the performance of the individual SACCOs on the following scores: PAR, percentage of women, share capital average, mobilised savings, operational and financial sustainability. Hivos will not renew the current contract, which will end in 2008: *"Given the goal that a seed capital grant should not be for longer than 6 or 7 years, and given the expectation that even a significant extension would still not lead to KADERES qualifying for funds from HTF, the present contract will be the last for KADERES"* (Hivos' Organisation Assessment). Even so, KADERS is now (in 2008) proposing a new seed capital grant contract with Hivos, as Hivos' view on seed capital grants has altered to a certain extent. In addition, KADERES is also planning to take on responsibilities as fund manager, which opens up new opportunities for loans from HTF in the future.

³³ See: R. Chao- Béroff et al. 2000: "A comparative study of Member Based Microfinance Institutions in East and West Africa". MicroSave Kenya.

Table 14: Support from CFO

| | KADERES |
|--------------|---|
| CFO | Hivos |
| Grant | € 170,387 for 2001 – 2006 € 90,000 for 2006 - 2008 |
| TA | Monitoring visits from consultant to KADERES twice a year |

Observations:

- Given the fact that Member-Owned Microfinance Institutions fill a gap in the provision of financial services in rural areas, it is important for CFOs to support these institutions. Support for smaller MOMIs through promoters is an efficient way of increasing access to financial services for the CFOs' target groups.
- Most promoters will not become sustainable themselves, as most MOMFIs will not be able to pay fees covering the costs of support. However, the costs involved in promotion and training of MOMFIs are probably (much) lower than the costs for development of sophisticated credit-led MFIs³⁴.
- Hivos' seed capital grant policy was aimed at allowing the organisation to progress to (semi) commercial funding and support was therefore short-term. When this policy is applied to financing microfinance promoters that have little or no opportunities for becoming operationally sustainable, it limits the options for longer-term strategies that capitalise on experience and expertise gained by the (SACCO) promoter.
- CFOs have not yet elaborated policies for supporting promoters. Performance indicators for promoters also remain to be developed. Performance indicators adapted to promoters of village savings and loans associations are being developed by the SEEP network³⁵. The CFOs might consider adopting these indicators.
- A multi-stakeholder approach strengthens the demand for services of MFIs (in this case SACCOs) by providing opportunities for members/clients to expand their businesses through linkages with extension services and potential buyers.

³⁴ See: Coady International Institute 2008: "Reaching the hard to Reach, Literature Review".

³⁵ SEEP Network; Savings-Led Financial Services Working group; Ratios subgroup. 2008 "Ratio Analysis of Community Managed Microfinance Programs"

CASE STUDIES APPROACH 3: SUPPORT TO VALUE CHAIN FINANCE



Rain Forest Company coffee quality handling.

7.1. Introduction

The case studies presented in this chapter constitute examples of the CFOs' third approach: the financing of actors in the value chain, based on a rural economic development perspective. The enterprises in the chain provide (financial) services to other actors in the chain, mostly to secure supply of produce. Financial services are also provided by actors outside the chain, such as banks or MFIs. The lenders use the strength of the value chain to reduce risks. CFOs are increasingly interested in 'value chain development'; this means that CFOs actively promote (sustainable) inclusion of CFOs target groups (producers) in value chains to improve their participation and benefits

One needs to bear in mind that the most common sources of credit for farmers - apart from money lenders and traditional ROSCAs and ASCAs³⁶- are agri-business actors such as traders, input suppliers and processors (rather than MFIs). These actors provide services such as credit and technical assistance as part of wider market transactions with actors in the value chain. Such services are known as embedded services.

The challenge in rural finance is to build on these existing relationships and to complement the 'financial market' orientation, focusing on sustainable financial institutions, with the 'product market' orientation, focusing on the role of finance in market development and increasing the efficiency of the value chain³⁷. Value chain actors provide different types of products to farmers, including as trader credit, contract farming and warehouse receipt credit³⁸.

Trader credit refers to credit provided by buyers to sellers of produce and can be in kind (input) or in cash e.g. to enable farmers to hire temporary labour at harvest time. Sometimes technical services are provided to guarantee quality and to reduce credit risk. Repayment is due at the time of sale of the produce.

Contract farming was developed as a solution for concerns regarding the quantity and quality of certain crops; input is always provided (on credit), and generally includes technical assistance. The loan is deducted upon sale of producers' produce³⁹. Contractors exert more control over producers than in the case of trader credit: Farmers produce the contracted produce under conditions set by the contractor. Farmers assume the risk of production, and contractors those of marketing⁴⁰. Often, contract farming occurs in the case of high value speciality crops with 'niche markets', or when buyers need reliable supplies. To promote repayment, techniques similar to those

³⁶ ROSCA stands for Rotating Savings and Credit Associations; ASCA: Accumulating Savings and Credit Associations

³⁷ Source: Robert Fries, Banu Akin 2004: "Value Chains and their Significance for Addressing the Rural Finance Challenge." Micro Report # 20. Accelerated Micro-enterprise Advancement Project.

³⁸ Other products are leasing, guarantees, investments in subsidiaries. Source: idem as in footnote 34

³⁹ Source: CGAP Occasional Paper no 11. 2005: "Managing risks and designing products for agricultural microfinance: features of an emerging model."

⁴⁰ Source: Posthumus, reader HPC and MMF: "Five models of contract farming".

in microfinance are used, such as group liability and close monitoring. When a formal agreement is concluded between the contracting company and the farmer, this may qualify as collateral for MFIs or rural banks⁴¹.

Warehouse receipt credit is less prevalent. Here, producers are issued with a receipt when storing their produce in a warehouse. Against this receipt, a loan can be obtained from a financial institution. The produce stored serves as collateral.

Traditionally, producer organisations are the most 'natural' partners for CFOs, because of their poverty focus. However, it is increasingly accepted that donors can increase their leverage by entering into strategic partnerships with companies. In the cases presented below, the CFOs supported different types of companies: a trading company set up by a NGO implementing a market development programme for farmers (Savannah Farmers); a trading company set up by business people (Cheetah Limited); and a trading company created by individuals linked to producers' cooperatives (Rainforest Company). These companies deliver embedded services to farmers: extension services and credit (in kind). CFOs supported these companies with grants, loans or equity; the companies used the grants to provide extension services; the loans to buy produce, to on-lend to farmers as input credit and to invest in the development of a contract-farming system; the equity to set up operations. In one instance, the CFO also acted as brokers, linking the company concerned to an MFI for the provision of the required input credit.

Again, these cases should not be considered as representative for the type of partners of CFOs, nor for the type of support CFOs provide to companies. These cases are merely intended to illustrate ways of integrating rural finance in CFO market development programmes.



⁴¹ Because of the increasing interest in contract farming issues, FAO opened a recourse centre: <http://www.fao.org/ag/ags/contract-farming>.

In the table below, the key characteristics of the companies supported by the CFOs are presented:

Table 15: Characteristics of companies

| | Savannah Farmers Marketing Company | Cheetah Limited | Rainforest Company |
|--|---|---|--|
| Country | Ghana | Malawi | Peru |
| Supported by: | ICCO | Cordaid | Hivos / HTF |
| Type of support | Equity through ACDEP Guarantee on loans Direct loan managed by Oikocredit Advise | Grant Loan Brokerage | Grant Guarantee on HTF loan |
| Origin of company | Market development NGO | Dutch businessmen | Individuals from cooperative coffee sector |
| Main produce | Sorghum Groundnut Soybean | Paprika | Coffee |
| Market | Local market Guinness Ghana Breweries Ltd | Export market European Food Industry | Export market in Europe and US |
| Type of Credit provided by Company to farmers | Trader credit | Contract Farming | Trader credit |
| Extension Services provided | By related NGO | By company and NGOs | By company |
| Involvement of Financial Institution | Involvement of Rural Bank is foreseen | MFIs | No |

A description of the three case studies is followed by an outline of the advantages and disadvantages of credit provision through private companies as opposed to MFIs.

7.2. Trader Credit Case: Savannah Farmers Marketing Company in Ghana.

7.2.1. Introduction

The Savannah Farmers Marketing Company (SFMC) was established in 2005 as a private limited liability company by the Association of Church Development Projects (ACDEP), with the support of ICCO. Farmers join Farmer-based Organisations (FBOs); SFMC buys the produce of these organisations and sells it on to companies. One of SFMC's main clients is Guinness Ghana Breweries Ltd. Currently, all shares are in the hands of the NGO ACDEP; in about 3 years, ACDEP will be transferring its shares to the farmer organisations and the FBOs will become (part) owners of SFMC.

7.2.2. Trader credit

SFMC buys seeds in bulk and delivers these to farmers as credit in kind. In addition, when needed, SFMC provides credit for land preparation services. Credit is redeemed at harvest time. In its first year, the company made a loss due to a combination of circumstances (such as unforeseen price fluctuations). Through side selling⁴², farmers could escape the repayment of their loans. In this first year (2005), 2.935 farmers participated, divided into 226 groups and monitored by 7 'stations' - a type of ACDEP satellite offices specialising in provision of extension services to farmers. In 2006, participation rose to include 3.150 farmers. In the first year, 30% of the farmers failed to (fully) repay their loans. In 2006, the percentage of defaulters had dropped to 20%.

SFMC suffered from marketing risks in combination with the risk of credit default. SFMC proved unable to repay the loan it had received from Oikocredit for on-lending to farmers on time.

In order to find alternative ways for providing credit to farmers, SFMC hired an expert to develop different models. SFMC stipulated that the parameters for these models include the separation of financial services from marketing activities and that borrowing should not be limited to farmers linked to SFMC. Eventually, SFMC decided to pursue a two-step strategy:

Step 1: Creation of a unit within SFMC, responsible for drawing up an inventory of credit needs and provision of a list of credit applications to the rural banks, to help them decide who are eligible for a micro-loan. The rural banks are responsible for loan recovery. Banks pay commission and client processing fees.

Step 2: A split-up of SFMC into two different business units: a marketing unit and a financial services unit. The financial services unit is set up to operate as an independent body, evaluating the performance of clients and selecting the most reliable ones for recommendation to the financial institutions (rural banks) for credit. The financial services unit will monitor clients until their loans are repaid. The bank will demand a higher fee as more services are provided than under step 1; clients will also be required to pay a higher processing fee to the Financial Services Unit. Risk of non-recovery does not pass on to financial services unit. The financial unit's services will not be limited to the farmers organised by ACDEP.

⁴² Side selling is breaking a purchase agreement with a credit provider to sell to another buyer.

The table below lists the advantages and disadvantages of both steps.

Table 16

| Advantages and disadvantages of SFMC's two-step model | Disadvantages associated with step 1 |
|--|--|
| Advantages associated with step 1 <ul style="list-style-type: none"> • Less costly to implement • Optimal use is made of local banks' expertise | <ul style="list-style-type: none"> • The bank selects the farmers and is less willing to reach out to the most remote areas • Farmers will have to deal with the banks directly, heightening the likely occurrence of delays • Earnings on SFMC's intermediary role will be limited |
| Advantages associated with step 2 | Disadvantages associated with step 2 |
| <ul style="list-style-type: none"> • SFMC financial services unit is involved in the selection of the clients • SFMC marketing unit can focus its entire attention on the marketing of the harvests of the farmers • A wider and more diverse group will be served • The financial services unit has the potential to become financially sustainable | <ul style="list-style-type: none"> • It is more expensive • Capacity-building in the field of microfinance is needed |

As rural populations lack confidence in rural banks, it was decided that, after the start-up phase, SFMC's financial services unit would assume responsibility for the selection and monitoring of clients, thus avoiding that farmers would have to deal directly with the rural banks. The model's first step was necessary to allow for capacity-building in the area of microfinance and in selection and monitoring of clients. One of the changes SFMC thinks to make to reduce the risks involved in agricultural lending is to de-link repayments on credit from the use of credit, to prevent farmers defaulting on their loans due to failure of the activity. In addition, only farmers who have diversified their sources of income will be eligible.

7.2.3. Donor support

ICCO provided ACDEP with a grant of € 100,000, which it used to buy shares in SFMC. ICCO thus became part of SFMC's Board of Directors. ICCO participated as a moderator – helping to strike the right balance between development and economic goals – and also contributed its expertise, based on its experience with similar projects. For SFMC, this capital injection was crucial to set up operations and helped to induce a business mentality.

In 2007, ICCO took a step back, but retained its advisory role as part of the support contract. ICCO opted to progress beyond the role of a mere funding agency to assume advisory and mediatory responsibilities.

ICCO also supported SFMC with a 100 % guarantee on a loan from Oikocredito to augment SFMC's working capital. This loan, amounting to € 45,000, was used for the purpose of on-lending to farmers during the first season of operations (2005/2006). This guarantee was higher than usual, because of the high risk involved. Normally, guarantees do not exceed 75% of the loan. Subsequently, Oikocredito continued to provide seasonal loans of up to € 300,000, all with a 100% guarantee from ICCO.

7.3. Contract Farming Case: Cheetah Limited, Malawi

7.3.1. Introduction

Cheetah Limited was set up in 1995 by two Dutch business men with a strong sense of social responsibility. Cheetah provides dried paprika products, predominantly to the European food ingredient industry. Cheetah operates in Malawi and Mozambique. The company contracts small holders to produce paprika, provides inputs and extension services, and guarantees a minimum price.

Cheetah prefers contracting groups of farmers, but also works with individual small holders. In 2005/2006, some 12 000 farming families worked under Cheetah's contract-farming system, with Cheetah providing seeds and extension services to its farmers and farmers' groups. The provision of extension services was supported by international NGOs like Cordaid (and CARE, Clusa, World Vision, Technoserve, etc.)

Cheetah operated at a loss between 2004 – 2006, due to the following reasons:

- Reduced paprika supplies due to rain shortage, late planting and mismanagement
- Price-setting by the Paprika Association in Malawi (an umbrella organisation acting as a 'watchdog for the industry')
- Shipping delays in Spain, leading to the destruction of 4 containers of paprika

7.3.2 Input credit: MFI versus private company provision

Two modalities were piloted: input credit through an MFI and through Cheetah. Initially, input loans were provided by the Malawian MFI PRIDE. However, this modality proved unsuccessful: loan recovery was a mere 51%. During the second year of operations, Cheetah took the provision of loans into its own hands. Loan recovery remained very low at 62%. In the third year, another MFI willing to provide the input loans was found⁴³. Cordaid provided the loan capital for on-lending, first to PRIDE, and later to Cheetah. In addition, Cordaid provided Cheetah with a working capital loan to allow it to purchase the paprika produce from its farmers.

PRIDE Malawi was an MFI offering a single type of product – a Solidarity Group Guarantee Loan - to a predominantly urban clientele. PRIDE lacked expertise in the provision of credit for agricultural activities and failed to develop an appropriate lending methodology. In addition, a genuine commitment to expand into rural areas appeared to be lacking. Analysis delivered the following reasons for the low repayment rate on the loans issued by PRIDE:

- Agricultural risks: disappointing harvests due to a drought at the beginning of the season;
- Household cash flow: the farmers used up their credit investing in food crops or school fees. Female farmers in particular tended to prioritise the need to secure immediate household subsistence over investing in cash crops.
- Unwillingness to pay: Farmers sold their produce to Cheetah under a different name to prevent loan repayment being deducted from the proceeds, or sold their produce to another buyer (side selling)

A better lending methodology could have prevented these problems. For example, one of the lessons learned in agricultural microfinance is the need to de-link loan use and repayment sources, while looking into all income streams of households as a whole, in order to define repayment capacity⁴⁴. And make sure that harvest failure does not become a reason for defaulting.

Because of PRIDE's low loan repayment rate, Cheetah decided to take the provision of loans into its own hands in the following season. However, Cheetah fared only slightly better. This time low repayment could not be linked to agricultural risks, as weather conditions had been favourable and harvests were good. The main reason for defaulting appeared to be an unwillingness to pay. It appeared that some producer groups and farmers entered into collaboration with Cheetah in order to access a loan (grant), rather than to grow paprika. Cheetah only engaged with farmers who had repaid their loans in the previous season; however, from their experiences in the previous season, they had learned that repayment could not be enforced.

In 2007, as part of a research project funded by the World Bank, Cheetah initiated a pilot together with the Malawi Rural Finance Company (MRFC), which provided input loans to 3,900 farmers. The World Bank project researches the effects of biometric registration (fingerprints) on repayment rates. MRFC has extensive experience in rural finance and boasts a broad network of staff in rural areas to closely monitor farming production. MRFC is optimising its use of social collateral by making groups, rather than individual, farmers collectively responsible for repayments.

⁴³ no information available yet about its performance.

⁴⁴ CGAP Occasional Paper no 11; "Managing risks and designing products for agricultural microfinance: features of an emerging model." August 2005

7.3.3. Donor support

Cordaid has been offering support to Cheetah Malawi since 2004. An interesting aspect are Cordaid's experiments with support for a variety of actors and its use of different financing instruments. A grant was issued to help Cheetah provide technical assistance to its farmers (€172.275), while a loan of € 50,125 was provided in support of several small-scale investments in its contract-farming programme.

In addition to issuing a loan for on-lending to farmers, Cordaid also provided the necessary guarantees on a working capital loan from local banks to help pay for farmers' crops (USD 270,000 in 2004; USD 245,000 in 2005; and USD 125,000 in 2006.) Because of the container problem in 2005, USD 125,000 out of the USD 245,000 guarantee was called in by the National Bank of Malawi. Cordaid converted this amount into a direct loan to Cheetah.

Cordaid supported PRIDE Malawi with a loan of € 500,000 in 2003, and an additional loan of € 65,000 for the Cheetah programme in 2004. Cordaid had linked up Cheetah and PRIDE, in the hope of ensuring an improved performance by having credit be provided by a MFI. Cordaid's aim was to assist PRIDE to increase its outreach in rural areas.

Although both PRIDE and Cheetah professed an interest in continuing their cooperation, Cordaid decided to call a halt to the collaboration with PRIDE in this project, because PRIDE's lack of commitment. PRIDE had conditioned the continuation of the input loans by demanding a lowering of the interest rate on the loan provided by Cordaid and a refusal to take responsibility for the risks associated with its services. PRIDE only repaid half of the loan Cordaid had provided. Cordaid proceeded to issue this sum as a direct loan to Cheetah Malawi in support of its input credit scheme.

7.4. Trading Company: Rainforest Company

7.4.1. Introduction

This case discusses a more mature trading company in a developed value chain. Rainforest Trading S.A.C. is a business consortium involved in the coffee sector, promoting strategic alliances between producers and the market. The mission of Rainforest Trading is:

"To improve the competitiveness of small coffee farmers' organisations, providing them with professional support in management, finance and technical assistance to access the international market in a sustainable way which benefits small producers."⁴⁵

Rainforest Trading currently works with 7 cooperatives and 1 federation of 21 cooperatives, representing some 10 000 coffee farmers in total. Rainforest Trading was established in 1999; its creation was inspired by the successful export programme of the coffee-cooperative COCLA, which is still one of Rainforest Trading's principal associates.

7.4.2. Services provided by Rainforest Trading:

Rainforest Trading provides the following services⁴⁶:

- Organisation and co-ordination of awareness-raising and technical assistance programmes promoting environmentally-friendly production;
- Organisation of supplies of coffee from producer organisations on the basis of coffee quality;
- Generation of direct purchasing contracts between the organisations and buyers operating in various market niches;
- Supervision and verification of the quality of processing and shipment;
- Training of the organisations' personnel.
- Application for and negotiation of working capital for organisations to harvest their members' crop.
- Transfer of market information to producers' organisations

The table below presents a number of indicators regarding the impact of Rainforest Trading's services.

Table 17: indicators performance Rainforest Trading 2003-2006.

| Indicator | 2003 | 2006 | Change |
|------------------------------------|------|------|--------|
| Sales volume (quintals) | 38,9 | 44,2 | 13% |
| Revenues (million US\$) | 3.27 | 5.64 | 72% |
| Average revenue per quintal (US\$) | 84 | 128 | 52% |
| Number of cooperatives | 7 | 17 | 143% |

⁴⁵ Source: www.rainforestrading.com

⁴⁶ Source: www.rainforestrading.com



Rain Forest Company coffee picking.

The increase in average revenue per quintal is substantial, indicating an improved quality of the coffee, and a larger proportion of organic coffee. The number of cooperatives increased even more rapidly than overall sales volumes, which suggests that new cooperatives that are joining Rainforest Trading are smaller in size. Small-size cooperatives are the most vulnerable to price-volatility in the world market and thus benefit the most from the services offered by Rainforest Trading.

The success of the Rainforest Trading Company is based on its combination of technical assistance to ensure quality and continuity, and its export contracts with reputable buyers in Europe and the U.S. Technical assistance to farmers constitutes a part of Rainforest Trading's work that is not sustainable, and thus needs subsidies.

Rainforest Trading issues working capital loans to the associated coffee cooperatives on the basis of an estimation of the volume of sales. The cooperatives use this capital for the harvesting and storage of their coffee crops. Rainforest Trading covers these loans partly out of advance payments received from international buyers for the purchase of coffee and partly from additional loan funds from, for example, HTF. An increase of the loan fund by HTF is providing new opportunities to increase the exportable volumes of coffee. Rainforest Trading formed a credit committee to decide on loan applications from the cooperatives.

7.4.3 Donor support instruments

Hivos first engaged in a relationship with Rainforest Trading in 2003. The decision to support the company was made because Rainforest Trading facilitates linking producers to buyers and because of the combination of credit and technical assistance provided to the member cooperatives.

Hivos provided a grant of € 99,000 in 2003, followed by a second grant of € 173,236 in 2006. These grants were used by Rainforest Trading for the provision of Business Development Services to the cooperatives in the following areas: management of coffee plantations including quality management and group certification; commercial management; business management including book-keeping and the management of credit.

The Hivos Triodos Fund (HTF) issued Rainforest Trading with a loan which it used to on-lend to farmers for the harvesting and storage of their crops. In addition, HTF also provided a direct loan to COCLA, the federation of cooperatives which is a member of Rainforest Trading.

7.5. Conclusions

The cases presented merit the following observations:

- Building a close relationship with clients through selection, screening, and monitoring is essential for both MFIs and for the private companies providing financial services;
- MFIs have the advantage that they have more opportunities to de-link loan use and repayment sources and to take all income streams of households into consideration in order to define repayment capacity⁴⁷;
- Companies are often in need of securing produce and therefore have a tendency to be less strict vis-à-vis defaulters;
- The use of group liability and innovative borrower identification techniques can reduce prevent loan defaulting for both private companies and MFIs; When financial services are provided by private companies, the system should be geared to limiting side-selling; companies should, for example, ensure timely payments for the produce bought.



Rain Forest Company coffee processing.

47 CGAP Occasional Paper no 11; "Managing risks and designing products for agricultural microfinance: features of an emerging model." August 2005.

The table below lists a number of advantages and disadvantages related to credit provided by (M)FIs versus trading companies⁴⁸. These are derived not only from the case studies presented here, but also from other cases discussed at MicroNed's rural finance learning event of MicroNed (December 2007) and from the literature⁴⁹.

Table 18: Advantages and disadvantages associated with credit provided by (M)FIs or trading companies.

| Credit provided by: | Advantages | Disadvantages |
|---------------------|---|--|
| Company: | <p>For all parties:</p> <ul style="list-style-type: none"> • Efficient because loans (in kind) are linked to sales. Repayment of loans is concluded in the same transaction as the sale of the produce • If extension is provided: close contract between company and farmers. <p>For farmers:</p> <ul style="list-style-type: none"> • Access to extension and a secured market | <p>For Companies:</p> <ul style="list-style-type: none"> • Risk of market, product and repayment all with one party. • No financial services expertise. • Working capital locked up in loans to farmers • Risk of side-selling (especially with trader credit) and thus risk of non-repayment. • Reputation risk <p>For farmers:</p> <ul style="list-style-type: none"> • Other needs for financial services are not addressed • Cost of loan not transparent; no interest rate but costs hidden in discount on price • Conditions of loans may be, but are not necessarily, exploitative. (depending on, for example, levels of competition) • Smaller, remote farmers might be excluded |
| (M)FIs: | <p>For MFIs</p> <ul style="list-style-type: none"> • Potential clients in untapped market • Enhanced expertise in lending techniques • Opportunities to de-link repayment from loan use, and to take into account all income streams of households to assess repayment capacity <p>For Companies</p> <ul style="list-style-type: none"> • No risk of non-repayment <p>For farmers</p> <ul style="list-style-type: none"> • Access to more diversified financial services • Transparency in cost of loans • Opportunities to choose market | <p>For MFIs</p> <ul style="list-style-type: none"> • Need to invest in product development and capacity-building in agricultural lending • Need to ensure that farmers have access to extension services and input <p>For Companies</p> <ul style="list-style-type: none"> • MFI is outsider to the operational system • Need to investment in contacts with MFIs to provide them with information on clients and markets. <p>For Farmers</p> <ul style="list-style-type: none"> • Credit from MFIs may be more expensive than credit provided by private companies. |

48 Many of these points were identified during the MicroNed / AgriProfocus learning event on Microfinance, December 13, 2007, at ICCO's offices in Utrecht

49 Douglas Pearc (CGAP) 2003: "Buyer and Supplier Credit to Farmers: Do Donors have a Role to Play?".

7.6. Role of donors

7.6.1. Summary of instruments used by the donor agencies.

Opportunities to deploy a variety of instruments give CFOs the chance to experiment, while making them powerful supporters in the field of value chain finance. Two of the cases presented are at an experimental stage, which is reflected in the associated loan repayment problems.

Table 19: Support from CFOs

| | Savannah Farmers Marketing Company | Cheetah Limited | Rainforest Company |
|--------------------------|--|---|--|
| CFO | ICCO / Oikocredit | Cordaid | Hivos / HTF |
| Loans | € 45,000 (2005) Oiko | € 50,125 Cheetah | € 162,148 (2003) € 291,252 (2004) € 352,380 (2005) € 454,813 (2006) |
| | € 194,000 (2007) € 250,000 (2008) | USD 125,000 (2005) Cheetah | |
| | | € 65,000 (2004) PRIDE | |
| Guarantee | 100% on loans from Oiko | USD 270,000 (2004) local bank USD 245,000 (2005) idem USD 125,000 (2006) idem | |
| Equity | Through grant to ACDEP | | |
| Grant | € 100,000 to ACDEP Technical Assistance | €172,275 Cheetah | |
| Brokerage /Advise | Advice and co-ownership of initiative | Brokerage between the trading company and MFIs | € 173,236 in 2006 € 99,000 in 2003 |

7.6.2. Comments and suggestions of partners:

Upon request, two partners commented on the type of support received from the CFOs.

Cordaid's support to Cheetah Malawi was appreciated by the latter. In particular, Cordaid's open-mindedness with respect to Cheetah's activities and the different support instruments provided have been of crucial importance to Cheetah's search for an efficient contract-farming system.

Overall, SFMC was also positive, as ICCO's support helped enhance its activities in rural areas. The visits from donor staff in particular were much appreciated.

SFMC provided the following **suggestion**:

- The level of support provided by ICCO is insufficient to reach farmers in the more remote rural areas. Distances are a problem and SFMC feels that it would benefit from donor support in the form of transportation means, to allow for improved monitoring of farming activities. That would extend ICCO's support to the most vulnerable groups.

7.6.3 Conclusions with regard to donor support:

- The use of public funds to guarantee loans to private companies (local banks and Oikocredit) has a large effect compared to the relatively low input of public funds
- Grant-funding for extension services to farmers provided by private companies is an option where and when no other public or private organisations are providing (quality) services at reasonable cost;
- Loans to trading companies for on-lending to producers accumulate risks for the company (risks of reduced supplies due to crop failure; price risks; and risks of non-repayment of loans);
- Seed capital grants and equity investment are powerful instruments for getting companies started;
- Loans provided by a trading or processing company can be a valuable option to provide access to small farmers (complementary or as an alternative to the option to involve urban MFIs).
- Urban MFIs with an interest in expanding into rural areas will need means for product development and capacity-building.
- In rural finance, CFOs are having to deal with multiple stakeholders and consider what kind of support to which actors in the value chain will generate the most impact for farmers against lowest costs.
- Brokerage is important, but also requires a lot of knowledge of capacities of local actors, which will not be always possible when operating from a distance.



Senegalese business woman.

8.1 Learning from experience

The objective of this study was to outline lessons to be learned from the experiences of CFOs. The study shows that the CFOs have substantial experience with different models of rural microfinance and value chain finance involving multiple actors. However, much of the knowledge available within organisations tends to be tied up in experts' minds. In rural development departments engaging in financing activities, exact information on the financial performance of the institutions providing financial services is often lacking. This is hardly surprising, as staff in these departments tend to view financial services from a wider rural development or market development perspective. Generally some interaction on rural finance does take place between the microfinance and the market development experts within the CFOs, but mostly on an ad hoc basis and generally not set up with an aim to develop a joint rural finance practice.

While much of the literature concerns donor roles in microfinance, elaboration of the role of donors in rural finance is still at the early stages of development. However, given their substantial rural portfolios, their expertise in both microfinance and rural development and the wide range of instruments at their disposal, CFOs are in an excellent position to play an important role in developing good practices with regard to rural finance.,

Meanwhile, it is important that CFOs start drawing lessons from both their own and each other's experiences in a more systematic manner. All CFOs have developed specialised approaches, and could be a valuable resource to others in their particular fields of expertise. This would contribute to the development of greater expertise among CFOs in the field of rural finance.

If an interaction can be achieved between the CFOs two main areas of expertise and microfinance officers were to begin systematically viewing rural microfinance from a wider rural development perspective, and rural experts would start looking at value chain development through a financial services lens, more innovative and technically sound solutions in rural finance could be developed. Further testing of various supporting policies is necessary. In order to be able to learn from each other's experiences, further case study work is required.

This study does not include case studies on sector support. However, as described in chapter 3, the CFOs are also supporting initiatives at the meso and macro levels, including for branch organisations, wholesale networks, innovation funds and lobby organisations. CFOs also support product development in rural areas at a sectoral level. MicroNed offers a practical platform for the exchange of experiences and results relating to this level of support.

8.2. From rural microfinance to rural finance

Several participants in MicroNed's rural finance learning event of 13 December 2007, highlighted the need for thinking out of the microfinance box and the imperative to develop a comprehensive rural finance policy. Based on general conclusions of this study, the following sections will look at the elements such a policy should contain.

This study does in no way purport to offer an exhaustive list of policy issues, and merely notes the issues deducible from the findings of this research. The issues are listed according to the three main CFO approaches for supporting financial services in rural areas.

8.2.1. Policy issues related to support to (credit-led) MFIs (first approach)

Promoting commitment of stakeholders to rural finance

A precondition for successful rural finance is a real commitment to rural areas on the part of all parties involved. With microfinance in urban areas being less risky and more profitable, donors, investors, MFI staff, board and shareholders must be committed to reaching out to rural areas. MFIs, donors and investors prioritising short-term achievement of financial sustainability or profit maximisation, will likely be less committed to rural area development.

Holistic approach

CFOs must focus not only at MFI performance, but also take into account the livelihoods of the clients and the markets in which clients or potential clients are involved. CFOs must actively engage in the promotion of opportunities to link up MFIs with actors in value chain or with market development organisations that will help increase the impact of donor support. The case studies showed how MFIs may reduce costs and increase market expertise by linking with, for example, NGOs engaged in market development programmes. In these times of increasing commercialisation of microfinance, the added value of donor agencies is their potential to place issues in a broader development context.

Promotion of good practices in rural microfinance

The case studies and the portfolio analysis demonstrated that even MFIs with an exclusively rural portfolio, even with a concentration on agricultural loans, can be sustainable when using appropriate lending and product delivery methodologies. The case studies reflect the good practices emerging for rural and specific agricultural microfinance⁵⁰. CFOs can play an important role in promoting good practices among their partner MFIs and among microfinance sector associations.

⁵⁰ A study from successful agricultural MFIs identified 10 main features of successful agricultural microfinance: CGAP: Occasional Paper 11. Managing risks and designing products for agricultural microfinance: features of an emerging model.

Different grant policies for rural MFIs

A recurrent theme in rural microfinance is whether or not rural microfinance institutions require grant policies that are different from policies for urban microfinance institutions.

Since they operate in a more complex environment, it emerges that rural MFIs need more grants, for a longer period of time, for product development and improving efficiency of operations.

In addition, for rural MFIs investing in linkages with NGOs and private companies with an aim to help market integration of (potential) clients and to gain the necessary market information is also of key importance.

Another, controversial, approach is to finance MFIs to subsidise (remote) rural clients directly, by means of a voucher system, which grants clients a reduction on their interest rates for a maximum amount per year⁵¹. The rationale is that because profit margins in remote rural areas tend to be lower, the extra costs for providing financial services in these areas cannot be transferred to the rural population. For the same reason, one of the MFIs in our case studies (BG from Ethiopia) suggested that donors should subsidise the extra costs for rural MFIs that urban MFIs do not encounter.

It is important that CFOs make informed policy decisions regarding the use of subsidies for predominantly rural MFIs, including those that have reached operational sustainability.

8.2.2. Policy issues related to support to Member-Owned Microfinance Institutions (second approach)

CFO microfinance policies are based on the good practices guidelines for CGAP funders. These guidelines have been developed in large part based on experiences with credit-led MFIs. While CFOs are engaging with different types of MFIs, funding policies are not yet (fully) adapted to suit these operations. Given the importance of member-owned MFIs in rural outreach and for the provision of basic financial services, including savings services, to the rural population, it is important to adapt funding policies to this type of MFI.

In addition, the indicators for monitoring the performance of such member-owned institutions need to be adapted, as the weight of various financial performance indicators differs for credit-led and member-owned MFIs. Institutional sustainability in terms of governance and management also requires specific attention, in particular in MOMFIs too large to allow for peer control.

⁵¹ Source: J. Bastiaensen and Pedro Marchetti: "A critical review of CGAP-IABD policies inspired by the Fondo de Desarrollo Local, Nicaragua". In Enterprise Development and Microfinance, June/September 2007.



Village Bank in Bujumbura.

The case studies indicate that an efficient way to help the smaller member-owned microfinance institutions (small SACCOs, self-help groups and village savings and loan associations) along, is to offer support to NGOs that promote and train these institutions. Promoters generally are unlikely to become fully self-sustainable, as most MOMFIs will not be able to pay fees covering the costs. However, the costs for the promotion and training of MOMFIs are estimated to be (much) less than the cost for the development of a sophisticated credit-led MFI⁵².

Performance indicators adapted to promoters of village savings and loans associations have been developed by the SEEP network. CFOs might consider adopting these indicators.

8.2.3. Policy issues relating to value chain finance

The challenge for rural finance is to complement a 'financial market' orientation aiming at sustainable financial institutions, with a 'product market' orientation focusing on the role of finance in market development and increasing efficiency in the value chain.

We saw that financial institutions are capable of providing a wider range of financial services than actors in the value chain. However, these financial institutions are most often absent in rural areas. In addition, as the case studies showed, when urban MFIs are pushed to provide agricultural finance, their performance is not automatically better. CFOs may well opt to assist private companies to learn from MFIs' good practices. However, it should be taken into account that loans to trading companies for on-lending to producers accumulate risks for the company (risks of reduced supplies due to crop failure, price risks and risks of non-repayment of loans).

The case studies showed that CFOs engage in various ways with private sector in the 'product market' to promote 'embedded services', providing both loans and grants to different actors in the value chain. It is important to build on these experiences and to elaborate policy guidelines to promote embedded services as an integral part of rural finance policies. These policies should include a definition of CFOs' possible roles with regard to trading credit, contract farming and warehouse receipt credit. A point of attention is grant funding for private companies (provided by CFOs for extension services) by which the companies' market position improves and profits increase. CFOs should define the conditions in which grants to companies are justified.

A positive step towards the development of a comprehensive policy framework is the Task Force on Value Chain Finance for Producers, established earlier this year by MicroNed members, in concert with a number of other organisations involved in rural finance. The Task Force aims to enhance the exchange of learning experiences and work on the development of a policy framework for linking producer organisations to financial service providers.

⁵² See: Coady International Institute 2008: "Reaching the hard to Reach, Literature Review".

TWELVE KEY CHALLENGES FOR RURAL FINANCIAL SERVICE PROVISION



Rain Forest Company coffee storage for shipping.

From:

Examining Design and Innovations in Rural Finance For Addressing Current and Future Challenges

By Calvin Miller FAO Rural Finance Workshop: SEEP Pre-Event

October 26, 2004

Twelve Key Challenges in Rural Finance

Pages: 1 and 2.

Key challenges for rural financial service provision

Vulnerability Constraints

1. Systemic Risk – rural incomes, especially among the agriculturalists, are highly susceptible to similar risks at the same time. Weather is the most uncontrollable and often devastating risk but disease and plagues are similarly important. Failures in agriculture affect not only the farmer households and the production and marketing linkages but also the rural non-farm economies that revolve around and depend upon those income flows. Even so, the most problematic is farm credit because of higher risk.
2. Market Risk – especially in developing countries, there both cyclical and seasonal price fluctuations of agricultural commodities, not only due to local production variation but also affected by “outside forces” such as political price and exchange controls, subsidies and globalization.
3. Credit Risk – collateral, especially mortgage, is a missing element in most rural finance, hence increasing the risk of the lender. Similarly collateral substitutes may be costly in both financial terms as well as social stigma risk terms as can be the case with peer lending. Other support services and information networks such as credit bureaus are often not available to help lower the risk. For term lending, a financial gap risk between sources and uses of funds poses another risk constraint.

Operational Constraints

4. Investment Returns – rural capital revolves slowly, with often one or, less frequently, two crops per year. For investment capital the returns are even slower and in spite of that are often faced with very low profit margins. Hence the margins for error are much less than for example in commerce or most microfinance, which tend to have high returns per unit of funds invested and higher profit levels.

5. Low Investment and Assets – the relative poverty in rural areas causes common crises to become major crises due to the lack of asset “cushion.” Any loss of expected income through sickness or production losses cause significant impact. In compensation, traditional networks and production risk minimization become more important than profit maximization. The small asset base also reduces savings and borrowing capacity, thus constraining economies of scale in the use or provision of services.
6. Geographical Dispersion – rural areas are characterized by low density of population and high dispersion, which is coupled with a relatively low market potential, with a relatively low market potential make access and communication difficult and hence high costs of operation for both production and marketing and for access and delivery of services.

Capacity Constraints

7. Infrastructural Capacity – poor communication, pitiful roads, unequipped schools and missing social and health services decrease efficiency of operations, discourage new services and increase the outflow of the most talented and resourceful persons and a reluctance of educated families to live in rural communities.
8. Technical Capacity and Training – a relatively unskilled rural population reduces opportunity for ready access and adaptation to new technologies and employment. The lack of capacity affects not only the productivity and competitiveness in the changing marketplace but also the ability to find trained staff for service provision.
9. Social Exclusion – cultural, linguistic, gender, racial, religious and educational constraints affect market and financial integration. Such barriers reduce production and marketing efficiencies. These are required in order to compete effectively in the marketplace and thereby generate income and levels of assets needed to reduce poverty and vulnerability. HIV/AIDS makes this even worse in many countries.
10. Institutional Capacity – while there is an abundance of organizations in rural areas, the relative capacity is lacking. This includes management and technical capacity, size/economies of scale, competitive viability, economic integration and often risk-bearing capacity. Even when urban based institutions have the capacity to reach into rural areas, there is little incentive to do so. An exception to the capacity constraint is at the micro level where the social fabric is able strong and is sufficient for the level of operations undertaken and may also form linkages with intermediaries of higher institutional capacity.

Political and Regulatory Constraints

11. Political and Social Interference – loans can be forgiven, savings can be withheld, interest rates can be capped, mortgages can be rendered useless and payments can be suspended due to decree. Even danger is not uncommon; hence uncertainty can become an insurmountable hurdle.
12. Regulatory – regulations and/or a lack of enforcement of them hinder rural as well as urban environments. Land tenure regulations, banking laws, exchange rate manipulation and tax considerations are examples of such constraints that destabilize and/or hinder viability of business and financial operations in rural areas.

Shopkeeper in Mali.





Client Village Bank Burundi.

Colofon

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