Sector analysis

Rural finance

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Introduction

Globally, 1,1 billion of people in the world are extremely poor, surviving on less than US$ 1 a day. Almost 70 percent of the world's poor live in rural areas, particularly in Asia and Africa, and a majority of them will still live in rural areas even as urban populations increase. This rural population has and will have agriculture as their main source of income. Given that the demand for food will increase as the population continually increases, agriculture development will be indispensable to development and poverty reduction.[1]

The interest of governments and donors to support financial services for rural poor weakened as a result of the large number of failures in this area. However, the commitment to MDG's including halving the number of people living below poverty line, urged the development community to renew the attention to alleviate poverty among the rural poor, as 70% of the world's poor live in the rural areas.

Definition of the sector[2]

Microfinance: financial services (savings, credit, payment transfers, insurance) for the poor and low-income people.
Agricultural finance: sub-set of rural finance dedicated to financing agriculture-related activities, such as input supply, production, distribution and wholesaling, and marketing.
Rural finance: financial services offered and used in rural areas by farm and non-farm population of all income levels trough a variety of formal, informal and semiformal institutional arrangements and diverse type of products and services, such as loans, deposits, insurance, and remittances. Rural finance includes agriculture finance and microfinance and is a sub-sector of the larger financial sector[3].
Financial services for the rural poor are represented by the shaded overlap of microfinance with rural and agricultural finance in figure 1. It includes financial services for all purposes and from diverse sources tailored to the needs of poor people in rural areas. Providers include both financial institutions, such as banks, credit unions and non-financial mechanisms.
State-owned banks include agricultural development banks, regional development banks, savings banks, and postal banks. Often they have extensive rural networks of branches or outlets. Privatized state banks may also have significant rural outreach, although in many cases the privatization process has reduced rural branch coverage.[4]

[1]http://web.worldbank.org, consulted 24. February 2006. One of the priority activities for Agriculture and Rural Development of the World Bank is **Empowering rural people**, including framers through creating land security and redistribution; decentralized and accountable public services; capacity building for farmer organizations; rural finance; and nutrition and household food security.

[2] Financial services for the rural poor, Helping to improve donor effectiveness in microfinance, Donor brief no. 15, October 2003, CGAP.
[3] Rural finance: recent advances and emerging lessons, debates and opportunities, G. Nagarajan and R.L. Meyer, The Ohio State University, USA, July 2005.
[4] Rural financial services through State Banks, Information note on microfinance and rural finance, January 2004, CGAP.

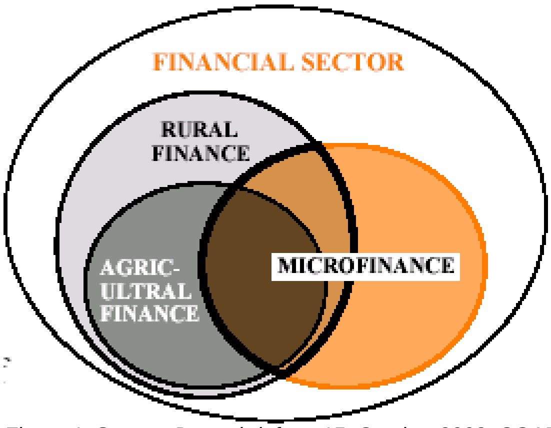

Figure 1. Source: Donor brief no. 15, October 2003, CGAP.

Features (and challenges) of rural finance:[5]
In general there are many differences between rural and urban settings. The following features regard rural settings:

- Dispersed demand - due to low levels of economic activity and population density; on the other hand paralleled by larger family sizes and higher population growth rates;
- High information and transaction costs - linked to poor infrastructure (roads, institutional, telecommunications) and lack of client information (no personal identification or functioning asset registries);
- Weak institutional capacity - related to the limited availability of educated and well-trained people in smaller rural communities;
- Crowding-out effect - due to subsidized and/or directed credit from state-owned banks or donor projects;
- Low economy: the range of income-generating activities and the degree of economic diversification is lower, agriculture predominates, low profitability of economic activities;
- Seasonality – because of agricultural activities and long maturation periods for others, resulting in variable demand for savings and credit, uneven cash flow and, lags between loan disbursal and repayments;
- Farming risks - such as variable rainfall, pests and diseases, price fluctuations, and small farmers' poor access to inputs, advice and (national) markets;
- Lack of usable collateral - due to ill-defined property and land-use rights, costly or lengthy registration procedures, and poorly functioning judicial systems.

It should be noted that these features can vary greatly from one or the other rural area. In some countries absolute poverty may even be more severe in cities.
As a result of the above mention constraints, most MFIs have their working area mostly in urban areas. However, there is a development that MFIs are trying to reach out to the rural poor as well.

Developments in the sector

Two paradigms – needs-driven vs. financial systems approach[6]
1. The old school of needs- or supply-driven and 'agricultural credit as an input': in the 1950s and 60s this type of credit was provided by specialized credit institutions, followed by credit NGOs in the 1970s and 80s. Rural economy was equated with agriculture and credit was directed and adapted to crop, loan size, geographical area and target group. The interventions were intended to increase rural lending by reducing the costs and risks to

[5] Financial services for the rural poor, Helping to improve donor effectiveness in microfinance, Donor brief no. 15, October 2003, CGAP; Rural microfinance, H.D. Seibel, G. Almeyda, SIDA, 2004.
[6] Rural microfinance, H.D. Seibel, G. Almeyda, SIDA, 2004; Lessons learned in rural finance, The experience of the Inter-American Development Bank, M.D. Wenner, October 2002; Rural finance: recent advances and emerging lessons, debates and opportunities, G. Nagarajan and R.L. Meyer, The Ohio State University, USA, July 2005.

lenders that made loans to preferred rural clients and sectors. Credit was considered as an important means to speed agricultural development, expand exports, promote small farmers, reduce poverty, and ensure cheap food supplies to urban areas. Most governments invariably used rural finance for political objectives and underestimated the difficulties, costs, and risks of supplying sustainable rural financial services.
It is generally acknowledged that this type of directed / targeted credit failed, as this kind of subsidized credit programs distort rural financial markets, undermine the viability of many participating financial intermediaries, discourage the mobilization of savings (as a result of for example refinance schemes), and disproportionately benefit higher income borrowers. The focus on lending only for agricultural purposes ignored the potential benefits of supporting growth-intensive investments more appropriate for the rural poor or small, off-farm rural enterprises. On the other hand, subsidized agricultural credit often resulted in production inefficiencies by targeting the wrong products and creating artificial preference for capital-intensive investments that 'crowded out' abundant labor in rural areas.
2. The new school of demand-driven commercial finance with focus on institution building / financial systems approach and emphasis on building sustainable financial institutions which do not collapse once donor assistance comes to an end.
This paradigm shift occurred in the late 1980s and gained worldwide recognition in the 90s, at least in theory. Microfinance activities, starting in the 1970s, contributed to the evolution of the new rural finance paradigm by their efforts to show that the poor are bankable and the ability of (parts of) the microfinance sector to offer sustainable financial services. However, current microfinance technology is not perfectly suited for many rural clients. Moreover, they demand a variety of financial services other than credit, while most MFIs offer only microcredit. The new school analysed the rural economy as complex, comprising a multitude of agricultural and non-agricultural activities, and identified a need for continual access to reliable financial institutions with a wide range of financial services, especially savings' services. This led to a shift from agricultural credit to rural finance (meaning offering other financial services than credit only and provided for either agricultural or non-agricultural purposes).

Sustainable financial institutions requires:
- mobilization of own resources through savings,
- working through savings based member-owned SHGs operating at low costs
- serving rural clients engaged in both farm and non-farm activities
- high repayment rates
- covering costs from operational income
- earning enough profits to offset effects of inflation
- financing expansion from profits and savings mobilized.

The new paradigm also recognizes that financial services may need to be augmented by[7]:

1. Complementary investments that help rural populations build assets and skills by developing economic and social infrastructure at the community level;
2. Social intermediation to facilitate formation of solidarity groups, SHGs, or cooperatives and to build social capital;
3. Training in both technical and management skills;
4. Supporting Business Development Services[8]: focus on (potential) entrepreneurs and address constraints to business creating and growth and include:

- Training, mentoring and advisory services
- Providing market information through market agents, databases, publications, visits and other mechanisms
- Linking entrepreneurs with potential buyers and markets

[7] Steel and Charitonenko, 2003, In: Rural finance: recent advances and emerging lessons, debates and opportunities, G. Nagarajan and R.L. Meyer, The Ohio State University, USA, July 2005.
[8] Microfinance, grants, and non-financial responses to poverty reduction: where does microcredit fit?, Focus Note, May 2001, CGAP.

- Building business networks and linkages to promote inter-firm cooperation
- Creating lower-cost or higher value-added technologies.

BDS providers are now expected to operate on an increasingly commercial basis. (See The Blue Book, ILO) This contrasts with social intermediation activities (health education, literacy training, group capacity building), which have some characteristics of 'public goods' and, accordingly, lower expectations of and possibilities for cost recovery.

A strategic approach that builds interactions and linkages between specialized institutions is needed for effective and coordinated poverty alleviation interventions. Where institutions are providing a mix of non-financial and financial services, these need to be clearly separated at every operational level (clients, systems, accounting, and management).[9]

The new paradigm encouraged major donors to shift from project components (e.g. supplying credit to needy farmers in an irrigation project) to stand-alone projects (e.g. building networks of sustainable financial institutions). However, this paradigm shift does not necessarily mean that rural finance should be skipped as a project component; in some cases rural finance might even strengthen the project. For example, in an integrated rural development project, it is possible to move from agricultural credit to building rural banks or savings & credit cooperatives. Agricultural credit is limited to a certain project period, while sustainable financial institution can offer a wider range of services, for an unlimited period of time, and has the possibility to extend financial services during the project period, and at the same time generate new resources for the longer term.

The recent introduction of financial systems approach in micro and rural finance has improved the overall effectiveness of rural finance interventions. But numerous challenges remain, especially in agricultural finance.[10] It is acknowledged that there are no solutions yet to many problems. To offer sustainable rural financial services in remote areas it is also necessary that a basic functioning national financial sector (including MF sector) for the low-income groups and poor are in place. So, access to sustainable financial services for the majority of the rural poor is still a goal for the longer term.[11]

<u>Value-chain approach</u>[12]

There is considerable interest to study rural finance from a value-chain approach (or supply chain analysis). Besides financial institutions, also value chain actors supply agricultural finance. This may imply that value chains should be taken into account to improve access to rural finance. USAID for example states that the value-chain financing complements the financial systems approach to rural and agricultural finance.

The financial systems approach takes the financial sector as the starting point, emphasizing the important role of financial institutions in facilitating access to a broad range of financial services. The financial systems approach focuses on building the long-term capacity of financial institutions and to increase the provision of rural and agricultural finance.

The value chain approach takes the production 'chain' as starting point, emphasizing the financing that is supplied <u>within</u> the agricultural value chain (value chain finance: e.g., input suppliers, processors, intermediaries and buyers). Often, buyers, traders and inputs suppliers are the only actors in rural areas willing to extend credit (e.g., trader credit, outgrower schemes and contract farming, and warehouse lending receipts). Moreover, they often can provide natural channels for provision of technical assistance to producers and can serve as stepping stones to more formal credit relationships.

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[9] Microfinance, grants, and non-financial responses to poverty reduction: where does microcredit fit?, Focus Note, May 2001, CGAP.
[10] Financial services for the rural poor, Helping to improve donor effectiveness in microfinance, Donor brief no. 15, October 2003, CGAP.
[11] Rural microfinance, H.D. Seibel, G. Almeyda, SIDA, 2004.
[12] Rural finance: recent advances and emerging lessons, debates and opportunities, G. Nagarajan and R.L. Meyer, The Ohio State University, USA, July 2005; A fresh look at rural & agricultural finance / Value Chain Finance, Chelmers et al., RAFI Notes, Issue 1, January 2005, and 2, June 2005.

The value-chain approach limits the attention to the specific needs of the agricultural chain as a whole, and to quickly facilitating whatever linkages are needed to ensure the growth of that chain. The actors in the value chain do not specialize in financial services and generally only offer relatively short-term credit. This credit is often tied to a specific crop. When market dynamics change, the lending relationships often disappear. Also dependency relations are developed that can in some cases become harmful. Moreover, a project that does not engage financial institutions will ignore the supply of crucial services such as long-term investment credit, savings, and insurance. Without increased access to capital a value chain actor will have a difficult time expanding lending operations.

A complementary approach of which figure 2 is a graphic representation, is based on a number of principles:
- build on existing relationships and finance flows
- start with a clear understanding of the multitude of actors, including financial institutions that are either current or potential providers of financial services
- recognise the importance of long-term financial intermediation
- understand policy implications of interventions.

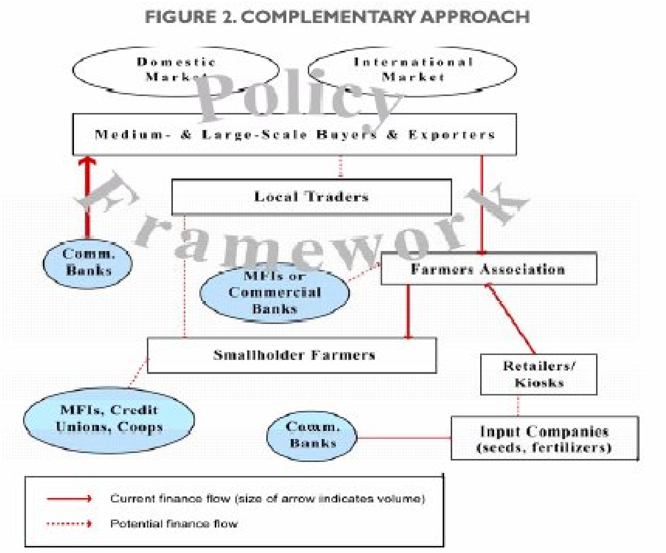

Figure 2. Source: RAFI notes, issue 1, USAID, 2005.

The value chain approach is still developing. One should be aware of the danger of isolation by promoting the development of only a specific cluster within the chain. The development of integrated marketing and financial systems should not be ignored.
The role of value-chain financing is still debated and tested under several contexts.

SWOT of rural finance

Strengths[13]:	Weaknesses[14]
- high level of social capital and collateral substitutes - informal mechanisms used to enforce contracts	- assumption that credit is a binding constraint; rural finance is often treated as an equivalent for agricultural credit, which is used as 'input' for agricultural production objectives: supply-driven basis

[13] Von Pischke, 2003, In: Rural finance: recent advances and emerging lessons, debates and opportunities, G. Nagarajan and R.L. Meyer, The Ohio State University, USA, July 2005.
[14] Financial services for the rural poor, Helping to improve donor effectiveness in microfinance, Donor brief no. 15, October 2003, CGAP.

	- subsidized interest rates creates market distortions and unsustainable financial services - lack of analysis of true market demand - lack of cross-sectoral collaboration: specialists of financial sector and rural/agricultural sector often do not work together: rural development projects are often designed without financial sector expertise - lack of alternative models to replace the discredited approach in agricultural credit; agricultural finance is therefore often ignored in many agencies
Opportunities[15]: - increasing demand for agricultural development because of population growth - high demand for financial services in rural areas	Threats[16]: - vulnerability: systemic, market, credit risks, etc. - operational: low investment returns, low investment, low asset levels, geographical dispersion - capacity: infrastructural capacity, technical capacity and training, social exclusion and institutional capacity, etc. - political and regulatory: political and social interference and regulatory framework, export market protection, etc.

Strategic options[17]
Most recommended options for Woord en Daad are marked with *.

Micro/meso-level:

* Build staff capacity to improve interaction between financial sector and rural development staff to ensure financial expertise is included on any rural project that has a finance component.
* Programs should be designed upon an understanding of agricultural value chains and the supply and demand of rural financial services.
* Assess and build upon the ability of existing actors and institutions to deliver appropriate rural and agricultural finance services.
* Make use of and strengthen available local social capital and local savings capacity (e.g. SHGs)

[15] Von Pischke, 2003, In: Rural finance: recent advances and emerging lessons, debates and opportunities, G. Nagarajan and R.L. Meyer, The Ohio State University, USA, July 2005.
[16] Miller, 2004, In: Rural finance: recent advances and emerging lessons, debates and opportunities, G. Nagarajan and R.L. Meyer, The Ohio State University, USA, July 2005.
[17] Financial services for the rural poor, Helping to improve donor effectiveness in microfinance, Donor brief no. 15, October 2003, CGAP;
A fresh look at rural & agricultural finance / Value Chain Finance, Chelmers et al., RAFI Notes, Issue 1, January 2005, and 2, June 2005;
Microfinance, grants, and non-financial responses to poverty reduction: where does microcredit fit?, Focus Note, May 2001, CGAP;
Lessons learned in rural finance, The experience of the Inter-American Development Bank, M.D. Wenner, October 2002;
What matters in rural and microfinance, H.D. Seibel, University of Cologne, Development Research Centre, 2004.

- Fund innovations in delivery mechanisms and products.
* Separate financial services from the agricultural development element: financial services should have no direct link with the agricultural input, but should offer a broader range of services and should (have the perspective to) become sustainable financial institutions.
* Parallel interventions are needed to reduce the high degree of production and price risk in agriculture. Such efforts should include appropriate investments in physical infrastructure, improved extension services, improved marketing, and provision of financial products like insurance services. (Micro-insurance offers a way to manage specific risks by sharing the cost of unlikely events among poor households. Credit cooperatives have offered forms of life and health insurance for years. This product may be most useful in those situations where it is also most difficult to implement, such as areas at high risks of natural disasters, or more recently, in populations suffering form HIV/Aids.)
* Determine the appropriate role for subsidies: instead of subsidizing interest rates to end-clients, donors should use grants to build institutional capacity and promote innovation. No subsidized or targeted credit in agricultural projects.
* To improve selfsufficiency of credit supplier by improvement of the savings' base of credit (only appropriate when inflation is not too high).
- Use savings for subsistence / low yielding activities, use credit for high yielding activities.
- Promote link to Business Development Services (BDS) suppliers.
* Where institutions are providing a mix of non-financial and financial services, these need to be clearly separated at every operational level (clients, systems, accounting, and management).
- When credit is too risky for clients and providers grants could be considered, like termination payments (for persons laid off from formal / government sector) or micro-grants (provide safety net for e.g. IDP's). These interventions can be used to graduate poor from vulnerability towards economic self-sufficiency. Therefore coordination with any existing financial institution is necessary. For hardcore poor or HIV/Aids affected people, a longer term safety net may be necessary, to enable them to invest time and resources in learning skills and building an asset base.

Macro-level:

- Lobby: help improve the enabling environment like improve judicial / legal aspects, eliminating government interest rate subsidies for agricultural lending, remove policy biases against agricultural sector, promote investments in infrastructure, etc.