PAVING THE WAY FORWARD FOR RURAL FINANCE:

An International Conference on Best Practices

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I. Executive Summary

The objective of this effort is to review the lessons learned—the successes and failures in agricultural finance, financial liberalization and microfinance—to be applied to rural finance development and to initiate a structured dialogue towards donor and practitioner guidelines for rural financial market development.

Earlier decades saw heavy donor emphasis on small farmer credit and directed agricultural credit programs in agricultural finance. The *1972 Spring Review of Small Farmer Credit Programs* provided a heavy critique of the effectiveness of such targeted credit programs. Although many agricultural credit programs have continued since then, donor activities have significantly decreased in the area of agricultural finance, overall, and much of financial sector development activities by both donors and practitioners has shifted to microenterprise finance programs which are largely urban-based. While the field of microfinance has made great methodological strides in pricing and new product development, microfinance programs have found some of their greatest success in serving specific market segments in more diversified, typically urban, economies. The challenge now is to incorporate the lessons from microfinance into a sustainable financial market policy tailored for the specific challenges of rural economies.

Now is an opportune time for USAID and its peer donor partners to review what has been learned, what is transferable and what remains to be addressed in today's rural finance challenges. Now is the time to take stock again of what works well and what does not work well in rural finance. Failure to do so in an environment in which the needs for rural finance and agricultural credit go unmet opens the door to a new cycle of poorly designed policies and programs. The political-economic imperative felt by governments to do something (and to do something fast) about rural finance can and must be proactively and productively harnessed.

The rural finance review being undertaken is particularly timely and relevant for USAID for two reasons. First of all, as evidenced by USAID's past role in realizing the Spring Review and the Agency's more recent efforts in documenting microfinance best practice and guidelines through its Office of Microenterprise Development, USAID is well-positioned to continue its leadership role in capturing rural finance lessons learned to guide future policy and practice in both agricultural and financial sector development.

Secondly, recognizing that rural areas are critical for sustained economic growth and social stability in developing and transitional economies, USAID has appropriately made agricultural and rural development an Agency priority. Given the relatively high proportion of populations living in rural areas, today, servicing rural financial markets is important because of the combined (1) high incidence of poverty in rural areas and growing income inequality between urban and rural markets and (2) concerns for food security and population vulnerability in rural communities. Policy and programming recommendations generated by this *Rural Finance Review* will provide a principal input to the Agency's agricultural strategy and future programming guidance.

The United States Government has committed itself to achieving the OECD poverty reduction goal of halving world poverty by the year 2015. A reassessment of USAID's role in agriculture and the important part that rural finance could play a critical role in moving toward this goal has resulted.

The year-long review effort will prepare an international conference for the international community of donors, practitioners, academicians, and government representatives on the

way forward for rural finance development policy. This conference will include participation not only of donors but also of identified key practitioners who have demonstrated success and effective government policy makers who have articulated a need and a vision for rural finance services.

For USAID, rural and agricultural development in 2003 and beyond will represent a return, or "re-engagement," of the Agency in rural markets development. One of the objectives of the Conference will be to assist USAID's re-engagement in rural finance and to build a consortium of like-minded donors to work with USAID as it does so. The conference participation of donors and practitioners will assist USAID in becoming re-engaged in ways that complement what other donors, governments and private sector partners who remained active in the sector have been doing. The conference will build a coalition of knowledge and partners to guide this re-engagement.

In addition to advancing the collective donor and practitioner community understanding of "how to get the components right" for rural finance market development, this effort will specifically make recommendations for USAID's policy and programming needs as it re-engages in rural markets. These recommendations will be geared toward the specific strengths and objectives of the Agency, and will be developed as an input to the Agency's Agricultural Strategy.

II. Problem Statement

The state of rural financial markets in developing countries and economies in transition is characterized by low and decreasing availability of financing for both agricultural and non-agricultural activities. In developing countries and transitional economies, only a very few of rural populations have access to financial services. Rural areas are often characterized by a paucity of viable financial institutions and by lack of variety, breadth and range of financial services available. Rural communities often do not have access to savings services, credit products tailored to purpose, insurance, or transaction services. There is also very limited access to long-term financing needed for agriculture, land and other rural enterprises.

In view of the relatively high population proportion living in rural areas, servicing rural financial markets is important because of the combined (1) high incidence of poverty in rural areas and growing income inequality between urban and rural markets and (2) concerns for food security and population vulnerability in rural communities.

The shallowness of rural financial markets in part reflects weak integration of rural markets into broader economic markets: production mechanisms, distribution systems and capital flows.

It is also, in part, a result of myriad obstacles characteristic of rural households and markets. While it would be misleading to treat rural households as being qualitatively different from urban households (*e.g.*, both urban and rural households manage a

portfolio of income, savings and consumption-smoothing activities), there are a number of features of rural economies that place rural families further down the risk continuum than urban households. These features are:

1. Agricultural enterprises are high-risk, susceptible to the shocks of weather and market conditions; agricultural crops or sectors are characterized by high geographic risk concentration.
2. The small operations that characterize rural enterprises are prone to high transaction costs.
3. Rural households lack traditional collateral assets.
4. There is often an inability to enforce contracts in rural areas.
5. Rural markets suffer from inadequate infrastructure which results in a low return on capital; for private investors, the relatively low return and marginal profit on rural activities amounts to a poor use of capital.

Together these features present a real challenge to the design of sustainable financial intermediaries, especially those based on the local information and peer selection and monitoring techniques that are core to many microfinance methodologies.

According to conventional poverty lending advocacy, job-creation and asset-accumulation are made possible by "turning the poor into entrepreneurs". Another strategy to consider is fostering the creation of robust rural financial markets in rural areas to build sustainable financial institutions, to stimulate the full range of job creation activities, and to stimulate information, product and capital flows between rural and urban areas. The solutions to these obstacles will be more than just credit and more than just agriculture. It will be important to identify those private sector solutions that are working and scaling up rapidly. Today's rural finance solutions require a combination of credible short-term solutions and a long-term integrated systems development approach:

- Agricultural sector policy which supports, not represses, agricultural sector income potential;
- Financial sector policy which supports financial institution sustainability;
- infrastructure which breaks production bottlenecks, reduces production risk and bolsters the return to capital;
- Human capital and management development;
- Financial institution restructuring towards maximizing sustainability and outreach; and
- Capital market development, for both external and internal sources of capital.

This effort will focus on the more immediate issues of rural finance sector development. Previous experience has provided lessons learned in what to do and in what not to do to develop robust financial markets. These lessons emerge from three notable experiences. The first of these is the earlier decades' expansion and then retreat of *agricultural*

finance. The second is the *liberalization of financial sector policy*. The third of these experiences is the latter decades' expansion of largely urban-based *microfinance*. This combined experience and knowledge can guide the formation of today's guidelines in *rural finance*.

III. Antecedents

A. Agricultural Finance Lessons Learned

Both bad and good antecedents exist in the agricultural finance experience. The "bad" or hard lessons that the development finance community has learned largely group around the non-sustainability of credit programs that are not market-price-driven:

Governments' involvement in the management and implementation of rural financial systems has proven expensive and inefficient. Such involvement is not governed by economic criteria alone. Governments often see state controlled rural finance institutions as tool for distributing political benefits to constituents in return for political support. . Governments have in the past and continue to use state controlled rural financial institutions to target specific rural groups for income transfer. The objective of these transfers can vary from helping the poor (Thailand) to buying votes (Zimbabwe).

Subsidized credit programs undermine the institutional sustainability of financial institutions, distort rural financial markets, and discourage savings mobilization. Institutions expand while subsidized external sources of credit are available but then collapse and fail as those funds dry up. Subsidy-dependent institutions fail to develop their own market-driven sources of funding. External supply-side funding, particularly when subsidized, crowds out alternative sources of internal funds.

The shallowness of rural financial markets is in part the result of government subsidies crowding out private sector participation. State involvement in rural financial institutions discourages or crowds out private sector capital investment in these institutions. The involvement of political objective-oriented government management in financial institutions is a disincentive for profit-oriented investment of private capital in a rural finance institution. The presence of subsidized institutions through which the government transfers low cost credit to certain market segments, undermines market prices and efficiency discouraging private sector institutions from investment in that sector. This significantly constrains donor leverage of private support for rural finance, a key requirement to expanding rural financial services.

Directed and targeted farm credit programs are characterized by concentration among a few large producers. The transaction costs and outreach capability of distribution systems tend to limit the depth and scale with which outreach can be expanded. Given the fungibility of money, funds were often diverted to other uses and purposes.

Credit programs that do not include repayment capacity as part of loan analysis impoverish their borrowers or destroy their lending institutions. Lending programs require prudential qualification criteria for retail lending institutions that access wholesale funds and individual repayment and risk analysis or crop-based project analysis for those clients who receive individual loans.

State agricultural development banks are characterized by inefficiencies, high operating costs, losses and de-capitalization. Widespread experience has required repeated recapitalization or seen failure of state agricultural development banks. Such suggests highly inefficient supply-driven applications of capital and weak non-market-driven management. Still, where state agricultural banks have failed, private sector institutions have not stepped in to fill the vacuum created.

Guaranty fund programs lead to moral hazard problems that can produce repayment disincentives and losses. Agricultural markets are characterized by high levels of risk. Risk insurance has been prohibitively expensive and guaranty programs have been associated with less than robust productivity. Yet, cases can be investigated to examine how individual institutions have developed innovative mechanisms for controlling, reducing or compensating for risk.

The removal of repressive or punitive agricultural sector, tax, and exchange regime policies today are more favorable for income generation in agriculture. This provides for more efficient capital application in agricultural markets. When combined with today's packages of production technology and market information technology, agricultural production and income generation generate higher levels of success.

The expansion of non-farm income activities in rural areas has rendered these markets more easily bankable. The expansion of myriad production and commerce or distribution activities—not all agriculture linked—have provided more productive return opportunities for expansion of financial institutions into rural areas. Rural finance includes but is not limited to agricultural financing. It also includes finance of a wider range of non-agricultural production, processing and distribution services which allow rural households to diversify their income.

Formal rural financial institution are only one part of a much broader more complex market that services the financial needs of rural residents. In some parts of the world, agricultural input manufacturers and wholesalers manage extensive vendors credit system that support the provision of small scale financing to input users. Loan guarantee experimentation facilitates the flow of financing of inputs to some producers. In countries where leasing laws are in place, other companies have expanded small and medium equipment leasing into rural areas. Systems that facilitate cash transfers from urban to rural areas have grown and are channeling hard currency transfers internationally. More need to be known about these innovative approaches and what needs to be done to spread the more successful approaches.

The agricultural finance experience provided the bad lessons and errors which destroyed or prevented institutional financial sustainability. It provided the good lessons in what is required to establish policy regimes that strengthen the returns and income generation potential of the sector. It left unanswered the questions of how to introduce new or restructured profitable financial institutions in the rural context, of what there is to learn from the non-conventional delivery of financial services through non-financial entities such as suppliers, and of how to address co-variance risks across agriculture, non-agriculture production, consumption smoothing, and housing. The roll-back of agricultural finance programs has left in many rural areas a vacuum of financial services, particularly for smaller households.

B. Financial Market Liberalization Lessons Learned

The improvements of agricultural sector policies were often followed by recent improvements in Central Bank and financial markets policy.

Financial repression including interest rate controls discourages savings mobilization and capital market growth. Price restrictions inhibit the ability of local markets to develop internal sources of capital supply. Although occasional "usury laws" which artificially control lending rates can still be found, most financial systems have eliminated state controls on both asset and liability interest rates. This has resulted in stronger financial performance of financial institutions, expansion of financial service outreach to populations who previously lacked access to services and some expansion of savings mobilization.

Where financial market liberalization has allowed greater entry, technology supports more market competition and greater efficiency. Private commercial finance has been characterized by concentration in urban centers and in associated industrial interlocking producers. With liberalization, financial markets have seen some deepening via an expansion of the banking sector into small scale markets previously unserved. Information technologies have increased the ability of many financial institutions to manage small savings accounts, and to a lesser extent small loans, on a profitable basis. Simultaneously, there has been entrance by a variety of nonbanking institutions dedicated to serving market niches such as payroll lending, security lending as well as the microentrepreneurs, women and poor.

Financial sector liberalization does not always produce greater entry. In some economies characterized by high levels of financial sector influence in policy making or where regulatory authorities have concerns about their ability to regulate myriad institutions, policy maintains high barriers to entry. High minimum startup capital requirements limit the entry of non banking institutions which have more experience and tradition of working with small scale and non secure collateral rural financing.

Central Bank policy has shifted from financial repression such as interest rate control and directed credit to macro-economic stability and prudential supervision of financial

institutions. State policy is applied less in implementation and more in establishing guidelines or incentives for sound market operation as well as in addressing market failures. The range of Central Bank conservatism or progressiveness influences how rapidly financial markets deepen with product innovation, institutional restructuring or expansion.

Market liberalization exists along a spectrum of government involvement in financial markets. Many governments continue to be involved in financial institution management to some degree. Lessons need to be drawn form those the impacts of real world situations where government did successfully withdraw, where they remained an actor but one with targeted influence and where they remain as a key player on key growth variables, such as, private sector investment, expanded rural book value and client base. etc. this might help provide information that would encourage adjustments and change.

While market liberalization has occurred, correcting many of the policy problems producing institutional unsustainability, simple free market liberalization leaves unaddressed market imperfections which skew the distribution of the fruits of liberalized market production. Little investment has flowed into rural areas where returns are low because of low productivity, lack of risk information, and lack of infrastructure. Therefore, discussions of government policy need to address the role that governments fulfill in addressing market imperfections.

C. MicroFinance Lessons Learned

With the reduction of agricultural credit programs and the improvements in financial sector policies, donor attention shifted to microenterprise finance and then wider microfinance. The expansion of largely urban-based microenterprise credit programs overcame many of the price-based concerns of generating institutional sustainability. The microenterprise programs developed a number of lending methodologies which shifted transaction costs and risk analysis to clientele via loan graduation schemes and solidarity lending. Microenterprise lending graduated to micro*finance* in recognition of the multi-purpose use of small loans and savings services. While microfinance has been limited in its ability to generate local savings and capital and to reach scale and significant numbers of clients, a number of successful microfinance institution leaders have achieved scale and performance sustainability. Much of the development finance pricing lessons, innovative instruments, and institutional sustainability lessons have been documented from the microfinance programs of the decade of the 1990s. Many of these lessons can be culled, adapted, and transferred for rural finance.

Microentrepreneurs will pay higher, non-subsidized interest rates in order to gain access to capital. Microentrepreneurs have a high shadow price for capital. This is particularly true in commerce characterized by high turnover and short working capital periods.

The field of microfinance has resulted in credit delivery / lending innovations. There have been a number of innovative methodologies in risk analysis, credit screening, supplier

advances and solidarity lending. Some reduce the risk and transaction costs; others shift the risk and transaction costs to the client. Increased transaction or operating costs are borne through the lending interest rate.

There has been some success with non-subsidized directed credit programs aimed at developing specific sectors. Where particular markets were identified as priority groups or industries to develop, provision of tailored market priced financial services has demonstrated impact in allowing entrepreneurs or specific segments to grow.

Yet, credit programs that focus on specific, narrowly defined target groups are often not sustainable. Sustainability of financial institutions requires scale to both generate sufficient income volume to cover expenses and to achieve economies of operation. Sustainability also requires diversification of risk across economic activities and clientele.

Recently, there has been increased recognition of the importance of other financial services beyond microenterprise credit. Household units require credit for various purposes such as consumption smoothing, education, production, medical emergencies, commerce, and housing from different members at one point in time or from the same member over different points in time. The frequency of demand for savings services from net savers is often more numerous than the demand for loans from net borrowers.

The pervasive financing via private commercial input suppliers, dwarfing financing provided by financial institutions, indicates that there is a demand for this service and that input suppliers are doing something right. Some financial institutions such as credit unions have begun to provide supplier credit financing via retail suppliers to microentrepreneurs and rural producers.

Rural households, like small holding companies, manage a number of agricultural and non-agricultural income, consumption and savings activities through the year. Appropriate management optimizes income stability and the growth of wealth, both fixed and liquid assets. Microfinance experience offers an opportunity to build on this and minimize the risk of loan default by providing stability support to the income flow of the household.

Rural finance, not limited to agricultural finance alone, requires a variety of financial services for rural entrepreneurs. Each type of institution—bank, credit union, leasing company or microfinance institution—provides different products to separate and reach overlapping markets. An out grower contracting system could provide production credit to farmers while in the same household, a microfinance institution provides consumption smoothing credit to maintain household income levels and enterprise credit to run the non-farm enterprises that the family is engaged in. For microfinance institutions to grow in rural areas, they will have to overcome many of the same high transaction costs and risk management constraints that other rural financial institutions face. MFI's will also need to overcome problems that are unique to their set of institutions (*e.g.,* high interest

rates and transaction costs, the length of loan terms, risk reduction methods more appropriate to urban settings, etc.).

The microfinance experience has contributed to lessons learned in getting the pricing right to cover costs and to build longer term institutional sustainability. It has provided a stimulus for the development of more innovative lending methodologies. It has provided the lessons in failures to achieve sufficient scale of economies and of diversification to achieve institutional sustainability. It left unanswered the questions of how to generate internal capital for microfinance operations.

D. Summary Antecedents

The lessons in improved agricultural sector and fiscal policy as well in Central Bank and financial sector policy can provide a stimulus to rural finance development. The lessons from agricultural credit in "bad" pricing and from microfinance in "good" pricing suggest the need for more aggressive market based pricing in rural finance in order to build longer term sustainable institutions. The experience of microfinance in elevated lending interest rates is not completely transferable to the agricultural production portion of rural finance where longer term crop cycles and thinner production to sale margins place limits on how high interest rates can be raised but the core principles of market pricing and institutional sustainability apply. The same products developed in microfinance may not provide transferable products to rural finance; group lending may not fit many types of agricultural producers. Yet, the same type of energy observed in the microfinance sector can be applied to product innovation and the identification of who in the rural sector is applying successful technologies that can advance the rural finance sector in spreading innovation.

What remains unanswered from most previous experience is how to carry out financial institution restructuring and reform. Despite the success in moving most institutions to market pricing, there are limited success stories of restructuring the accounting, policy, products, costs and governance of insolvent financial institutions to achieve transparency, profitability, scale, and sustainability as is needed for success in rural finance.

The rural sector has its own characteristics which have to be addressed: geographic spread, heterogeneity of population, seasonality of economies, lower profits, higher risks, insecure loan collateral, and deficient or absent financial institutions. Therefore, previous experience can provide lessons but advancement of the rural finance sector will require dedication to its own characteristics and development of its own lessons learned. This will require cross-cutting themes and integration of the policy environment, infrastructure complementarity, institutional sustainability and outreach, and innovations in technology.

IV. Key Themes

The success of experiences in rural finance has often depended upon the successful simultaneity of four key strategic themes. The *policy* environment—legislation and regulation—provides the incentives for production and investment in the sector. Where producers are unable to ameliorate risk, acquire inputs or distribute product, financing is not enough to produce profitability. Consequently, *infrastructure complementarity* or co-location is an important part of rural finance feasibility and investment returns. Perhaps the greatest challenge today is to fill the vacuum of financial institutions which can be created or restructured to achieve *sustainability and outreach* in rural sectors. Experience has suggested that *innovations in technology*, practice, products, and services are required to address the risks, cycles and information characteristics of rural finance.

Each theme is examined individually as success of the whole can be impaired or blocked by the failure of one of the four. Each will be a discussion center for the research preparation and paper presentation on an international conference on rural finance. The first two (policy and infrastructure) will be dealt with in less detail than the latter two (institutional sustainability and technology) which are focused upon financial services. The conference is expected to produce general guidelines for policy framework that supports rural finance development and for infrastructure complementarity that maximizes the return on rural finance development. Yet, the conference is expected to produce more in depth operational conclusions and guidelines on achievement of financial institution sustainability and outreach as well as innovation in technologies for rural finance services.

A. The Policy Environment

The policy environment shapes the milieu of norms, incentives and behavior in which financial institutions and clients operate. The theme will begin with articulation of the full range of benefits and costs of government involvement in rural finance; including economic, financial, political, and social impact. Market efficiency suggest a minimalist role of government whose responsibility is not the control and manipulation of economic forces but the establishment of a favorable policy environment in which economic forces may create wealth. This includes the correct operation of:

- Property rights, title, contract enforcement, borrower/ lender rights.
- Market-driven interest rates.
- Monetary policy and inflation control.
- Analysis and removal of biases in sector economic policies that discourage rural production.
- Elimination of interest rate controls, high reserve requirements, and credit controls.
- Players in the larger financial market including the stock market, commercial banks, and the capital market.

The discussion will seek a better idea of what it will take to encourage government withdrawal from management or subsidization of financial institutions and government

focus upon establishing a supportive policy framework for private financial markets to work. Government involvement in financial markets would be limited to the policies listed above and would not become directly involved in service distribution. Government would have a role to overcome rural financial market imperfections in property rights, contract enforcement and communications to reduce the real risk tied to rural lending. Perceived private sector risk in rural lending, may need other government interventions such as tax incentives, special reserve requirements or government guarantees to bid down these perceived risk and induce market leaders to enter the rural market.

Still market imperfections or failures abound in the wrinkles of imperfect information, less than complete competition, unequal wealth endowments, and covariance of risk factors. As a result, policy environments may range from simplistic minimalist positions to more assertive promotion positions dedicated to redressing market imperfections or promoting strategic initiatives with incentive programs.

Financial sector policy in most economies has moved away from controlling interest rates and directing credit. It has become more focused on protecting the soundness of financial markets: monitoring risk, undertaking prudential supervision, and sharing of sector-wide credit risk (credit bureaus). Entry to financial markets has become the practitioner – regulator debate of what is prudent versus how to deliver small-scale nontraditional services to the underserved.

One theme presenter will frame the policy framework that is suggested for sound rural finance development. The presenter will also frame the debate for unresolved policy issues which impact the success of rural finance efforts. The conference will present a panel organized around the theme presentation. Panel presenters will be those invited to present case studies of where policy frameworks were put into place to support productive rural investment and vigorous finance sector development: what worked, what did not work and what were the lessons to be learned.

B. Infrastructure Complementarity

Rural financial markets are the collecting, pooling, safeguarding, and reinvestment of capital: intermediation. Real goods production and distribution requires adequate physical infrastructure and services. The development of financial markets is a necessary but not sufficient condition for rural wealth creation and income generation. Rural communities also need the production infrastructure and services to employ that capital for higher returns.

Rural development projects have often aimed at reducing risk and breaking up physical infrastructure bottlenecks through investment in irrigation systems, input provision systems, storage facilities, transportation systems and processing facilities. Programs invest in reduction of institutional obstacles and transaction costs though building human capital with extension programs, research stations, crop testing stations and incentive programs for provision of new services. The expansion of market product and price

information systems has proven very effective in many countries to assist producers in projecting their input and harvest investments, in smoothing their income flows and in increasing their wealth.

The answer to effective rural market development is not to be found in finance alone. It requires the simultaneous and matching growth of complementary production infrastructure. Nor is rural finance only engaged in providing financial services for agricultural production and marketing; it is increasing engaged in providing services to significant levels of rural non-agricultural production and marketing. Therefore, integrated rural financial market development programs need to address also the:

- "How" to sequence rural finance programs with infrastructure development programs,
- "How" to dovetail rural finance with infrastructure to maximize the investment return on finance at the institutional level and the income and asset growth at the individual level,
- "How" to co-locate and integrate these projects for maximum impact.
- "When" it is opportune to invest in rural production activities.
- "When" new financial services will face a profitable investment opportunity.

Again the answers may not be limited even to two simultaneous but unlinked sectors: the real goods market and financial markets. The largest volume of credit in both urban and rural markets is provided by often unmeasured supplier input credit. Real goods suppliers provide inputs on a discounted basis to be repaid by the receiver after sale of the receiver's product. Just as credit unions have recently modeled new microfinance products after patterns of supplier credit provision, rural financial institutions may have much to learn in the provision of services from input suppliers. In some cases, rural financial development may most efficiently be served by the development and growth not only of financial institutions but also of the credit capacity of real goods suppliers or by tying together alliances between financial institutions and suppliers.

It is beyond the resources and purview of the *USAID Rural Finance Review* conference to undertake an indepth review of all rural development: how to successfully implement irrigation, warehousing or distribution projects. Rather, a theme paper will be prepared and presented on the questions of how to sequence, dovetail, co-locate rural finance and infrastructure development programs for maximum impact in rural finance. The key remains how the presence or development of infrastructure increases the return on investment in rural areas and, therefore, the demand for investment opportunities to capitalize. These increases in investment opportunities attract capital and create the need for new financial services.

Again, a panel will be built around the theme presentation and will include invited presenters who can present successful cases where this complementarity has been achieved.

C. Institutional Sustainability and Outreach

The burgeoning experience of development finance has presented and documented many lessons in maximizing both institutional financial sustainability and outreach. These have included the obvious: importance of sound business management, pricing, and commitment to discipline. It has also included basic financial sector principles:

- Importance of economies of scale in offering services via open-door massification, expansion, or networking.
- Importance of mixed and wide breadth of clientele to be sustainable: reaching scale, diversification of risk, and complementarity/intermediation between net savers and net borrowers (vs. fears of "mission drift").
- Diversity of financial services to tailor products to purpose of client, to diversify risk to the financial institution, and to spread costs over a greater volume of activity.

Community financial institutions have met serious challenges that come with growth: increasing size come economies of scale, economies of scope, efficiencies, higher volume of profits, and greater sophistication of services. Yet, with increased size also come higher levels of risk. Personal risk information is lost and the financial institution requires professional management, skilled staff, and efficient management information systems. Transaction costs rise. Therefore, upgrading of business management capacity is critical to development of rural financial institutions.

Still, the primary challenge today in any area of development finance, and especially in rural finance, is how to achieve financial institution reform, and sustainability and outreach: mission, vision, accounting, efficiency, policy, management, products, services and governance. The field experience of agricultural credit and microenterprise finance makes available various institutional options and cases of trial and error:

- Creation of new institutions.
- Upgrading and reform of state development banks.
- Transformation and privatization of state development banks.
- Downward expansion (to "poorer" markets) of commercial bank operations.
- Expansion of MFIs and NGOs from urban to rural areas.
- Commercialization and expansion of financial cooperatives and credit unions.
- Utilization of municipal, post office or other extant facilities in rural areas.
- Network interlinkage of autonomous rural financial institutions.
- Linkage of banks with local rural non-banking financial institutions.
- Introduction of mobile banking.
- Accreditation or rating of financial institutions.

Herein lie the most problematic and controversial issues of development finance: what institutions to work with, how to work with them, what works for one type of institution may not work with another, what works in one context may not work in another … how to draw conclusions, recommendations or guidelines? At least one theme presenter will

focus upon these questions and will organize panels of practitioners and donors that have worked in these areas. The objective of these panels will be to derive principles, lessons learned, and guidelines for how to achieve financial institution sustainability and outreach in rural areas.

D. Innovations in Technology

The analysis of rural financial services has reviewed several levels: the policy environment, the complementary real goods production infrastructure, and the financial institution. The next level of analysis lies in the services or products provided and in the associated innovations in technology and practice. Innovations in technology, management information systems and client screening reduce transaction costs to both financial service providers and clients.

The microfinance industry has presented many new products and services. Many of these products can be applied to non-agricultural production lending to aid rural households in expanding their sources of income. Some of these such as microfinance group lending have proven non-transferable to agricultural lending due to high transaction costs, group time requirements, rapid cycles and small amounts. Microfinance services built upon high interest rate charges work well for short turn around, high turnover vending retail services. But, rural and, in particular, agricultural investment returns, limit how high interest rates can be raised to cover the high costs of group methodologies and high levels of client monitoring.

There are a number of existing rural distribution systems developed by private sector companies to distribute agricultural inputs (manufacturers, wholesalers and retailer systems), to supply goods or services (super market chains, building supply franchises), or to collect and market outputs (warehousing guarantee schemes, contract farming operations). Many of these are used by financial service organizations to extend rural financial service into the countryside. These rely on existing business agreements or arrangements to reduce the upfront investments and operating costs while reducing risk. For example, finance companies work alongside contract farming companies to provide consumption financing and other forms of financial services to contract growers while assuring repayment through the contract.

More can be learned in rural financial services for agriculture production today by learning from rural lenders—what they are doing that works. Much can be learned by duplication of methodology or alignment with input credit suppliers. Today there is greater recognition of the demand for savings services and the prevalence of savings in financing subsistence agriculture and rural non-agriculture production activities. Little has yet been done to strengthen the expansion of savings services.

Product development for rural financial services can do more to tailor loan services and conditions to match loan purpose and to provide medium and long term credit products,

with associated term funding, suited for land, perennial crops, soil and water system investments, machinery, storage facilities, etc. Other products that offer potential for greater rural financial development include:

- Remittances.
- Doorstep services.
- Expansion of individual insurance services: funeral, health, life.
- Development of agricultural risk insurance and hedging products.
- Warehouse receipt financing.
- Development Credit Authority.
- Leasing and factoring.
- Card services: debit, credit, smart cards to lower transaction costs,.

At least one theme presenter will provide an overview of innovations in technology and practice from agricultural credit and microfinance credit experience. The presenter will build upon these to provide insights in product and service innovation in rural finance. This will include a critical review of what is transferable and what is not, what incurs greater risk and what reduces risk, and what is cost-efficient and what is too costly. The conference will build a panel around the theme presentation with invited presentations from practitioners who have implemented innovative services in rural finance.

V. Paving the Way Forward

A. Overview of Implementation Steps

Much has been learned since the Spring Review that can be applied constructively to address today's rural finance challenges. USAID has documented much in rural finance and microfinance guidelines, best practices, and case studies. To assist USAID in its review of rural finance, WOCCU will capture and disseminate lessons from past and current rural finance experiences and practices to formulate both practitioner and donor guidelines for rural financial market development in the areas of (1) the policy environment, (2) infrastructure complementarity, (3) institutional sustainability and outreach, and (4) technology innovations. Key elements will include a review of rural finance literature and rural finance programs, preparation of theme papers, presentation of the experience and lessons learned of recognized best practitioners, invitation to present by practitioners and donors. This effort will involve CABFIN and the donor representatives that have been following CABFIN development as a virtual consultant group. These will be presented at an International Donor & Practitioner Conference on Rural Finance in Washington DC in July-August of 2003.

For USAID, WOCCU will manage the steps to input information, identify success cases, prepare research and organize the conference. WOCCU has hired a full-time Rural Finance Project Coordinator to carry out the following project implementation steps over the period of one year. Working in cooperation with BASIS personnel (Michael Carter), senior WOCCU staff (Brian Branch, Lucy Ito, and Curtis Slover), will also assume the

responsibility of summing up the final lessons learned and guidelines in rural finance. WOCCU will review what has been learned and what can be applied as well as what remains to be addressed in today's rural finance challenges. WOCCU will present donor-practitioner guidelines on the way forward for rural finance development.

Project implementation steps include:

(a) Literature Review of key works in development finance since 1972 yielding a synthesis of major initiatives, findings of recent strategies, and lessons learned up to the present.

(b) Program Review in consultation with African Development Bank, Asian Development Bank (ADB), CABFIN, Consultative Group for the Alleviation of Poverty (CGAP), Enterprise Development Innovation Fund (EDIF) of DFID, Inter-American Development Bank (IDB), International Fund for Agricultural Development (IFAD), International Finance Corporation (IFC), United States Agency for International Development (USAID), the World Bank, and others. Each donor will be asked to submit a review paper on *Rural Finance Lessons Learned and Best Principles & Practices*. The scope of the program review will not be limited to donor submissions.

(c) Identification of Best Practitioners in the field of rural finance to be invited to present at International Rural Finance Conference. This review of rural finance principles and practice offers an opportunity to explore what lessons have been learned "under the radar screen." This effort is intent on identifying the "quiet gems" whose instructive lessons have not been widely known or available up until now. This review effort is committed to culling relevant experience in rural finance development that may have gone unnoticed to date.

(d) Principle Theme Papers to be written by hired consultant writers. Each theme paper will be the keystone for each panel session. These include:

- Key Elements to Getting the Policy Environment Right.
- Interface between Rural Finance and Goods Production and Marketing.
- Successful Elements in Rural Financial Institutions Achievement of Sustainability and Outreach.
- Technology Innovations in Rural Finance.

(e) Planning Meeting in Madison, Wisconsin, with consultant writers and BASIS project implementing partners including USAID to make preliminary presentations, confirm conceptual framework, review preliminary research and coordinate plans for implementing the International Rural Finance Conference.

(f) Focused Solicitation for Papers from successful practitioners and donors to author case studies of institutional options and performance and to participate in conference panels on themes of:

- Policy Environment
- Infrastructure Complementarity
- Financial Institution Sustainability and Outreach
- Product Innovation
- Practitioner Case Studies

(g) International Rural Finance Conference to be held for donors, practitioners, researchers, and government representatives in Washington, DC. (July - August 2003). Several panels will address getting the policy environment right, rural finance-infrastructure complementarity, achieving financial institution sustainability and outreach and technology innovations in product and service design and delivery. Consultant theme writers will lead panels with a general presentation; other panel participants will include solicited donors and representatives from practitioner institutions.

(h) Input to USAID Agricultural Strategy—a document specific to the needs of USAID policy and programming needs will be presented to USAID. These recommendations will be geared toward the specific strengths and objectives of the Agency, and will be developed as an input to the Agency's Agricultural Strategy.

(h) Rural Finance Program Guidelines for Donors and Practitioners / International Rural Finance Conference Proceedings – WOCCU will be seeking other donor funding to publish and distribute post-conference a summation of the lessons and experience generated by the rural finance activity along the lines of a Conference proceedings, and Rural Finance Program Guidelines for Donors and Practitioners. (This implementation step is beyond the approved resources available on the current grant and is subject to co-financing from USAID/OMD or from another donor.)

The role of donors is one of the pieces of the rural finance development puzzle. There is a diverse array of development mechanisms (loans, grants, private sector) that donors are beginning to tap. This effort will capture any "donor best practices" and will consider questions such as: How far should donors go in directing implementation? What are the comparative advantages and strengths of various donors? Can donor coordination take advantage of comparative strengths? Is it time for donors to show leadership by moving from the battle cry of "poverty alleviation" to "trade-led export growth" that more effectively reducing poverty levels?

(j) A Rural Finance Website that WOCCU will consult with USAID and BASIS/CRSP to develop and maintain *during and beyond* the project period.

The website will post: the rural finance literature review, synthesis of recent rural finance strategies, donor portfolio review papers on rural finance lessons learned and best principles and practices, commissioned principle theme papers and case studies, International Rural Finance Conference "Paving the Way Forward for Rural Finance" proceedings, and the final post-conference learning product—Rural Finance Program Guidelines for Donors and Practitioners. This will be incorporated into the new CABFIN Rural Finance Gateway. Availability of these rural finance resources on the website prior to the conference will facilitate access by regional participants. Advance use of the website will increase the likelihood of deeper and better-informed discussion at the conference itself. After the conference, the website—linked to appropriate donor, practitioner and academic websites—will continue to provide access to all background papers and will offer extensive dissemination channels for the conference outputs and recommendations. (This implementation step is subject to co-financing from USAID/OMD.)