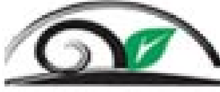

Paving the Way Forward for Rural Finance
An International Conference on Best Practices

Remarks

Opening Remarks

Presented on June 4, 2003

By **Katharine McKee**

(Director, USAID Microenterprise Development Division)

These remarks were made possible by support provided in part by the US Agency for International Development (USAID) Agreement No. LAG-A-00-96-90016-00 through Broadening Access and Strengthening Input Market Systems Collaborative Research Support Program (BASIS-CRSP) and the World Council of Credit Unions, Inc. (WOCCU).

All views, interpretations, recommendations, and conclusions expressed in this paper are those of the author (s) and not necessarily those of the supporting or collaborating institutions.

Risk has emerged as a central theme in our discussions so far. Specifically, the challenge of coping with idiosyncratic risk has come up a number of times. This morning **you** will be subjected to idiosyncratic risk! This is what happens when the conference organizers ask a single individual to try to summarize a rich and complex set of presentations. I'm not sure there's an insurance product available on the market for conferences to guard against this kind of risk.

Instead of really trying to be comprehensive, I have selected a few points from yesterday that I found provocative, inspiring, or worthy of further discussion today. While the selection might seem idiosyncratic, I hope you find them useful. I'm going to reverse the order of the agenda so far, by starting not at the policy level but down with clients and the products they demand. Our discussions so far have really focused much more on the supply side. Then I will talk a little bit about institutions, and close with a few comments on government and donor policies and roles.

So let's turn to the CLIENTS:
Something that struck me again yesterday as I listened to Juan Buchenau's presentation and the spirited debates about agricultural finance, savings and remittances, trader and processor finance – we really need to be clear about how we view the client market.

And one key question at this level, particularly for lending, is "are we financing the household or a specific economic activity?" Let's look at the household in some more detail – just as we need to clearly differentiate what type of agricultural and rural economy we're talking about, we need to differentiate clients and their capacities and objectives as well.

There are several points I'd like to make about this distinction:

- First, households have complex economic strategies. Marty Hanratty even suggested that we think of households as small holding companies. This has powerful implications for their demand for and use of financial services.

- Second, the role of **risk** within the household is key – and how access to appropriate financial services can help households manage risk as well as take advantage of opportunities.

- We've seen several triangles over the last two days – yesterday most interestingly: 1) Manfred Zeller's triangle concerning the trade-offs and synergies in balancing financial sustainability, welfare impacts, and outreach/depth, and 2) Juan Buchenau's triangle distinguishing between a lower layer of diverse rural households ("households in transition") with mixed economic activities, and two upper layers of specialized farms and non-agricultural enterprises. Manfred used his triangle to good effect to discuss institutional implications and Juan to segment the market for innovations.

- I'd like to jump off from Juan's triangle, modify it a bit, and particularly look within the "households in transition" stratum to make some further distinctions. I hope it will illustrate how useful it is to look at different types of households, their risks, their goals, and how their characteristics affect their demand for rural finance.

My triangle has three horizontal slices. The relative size of each will depend on the degree of socioeconomic inequality. On the bottom of the triangle, we have households that are economically active but barely above the survival level. (Note that destitute households might be outside the triangle altogether – it may be unclear how financial services alone, even savings, can really help them.) These households on the bottom are subject to many risks and have few assets with which to cushion against shocks. Their main goals? To increase and stabilize income, generate a small surplus, and begin to build modest assets. Their key motivation is security.

In the middle slice we have households that are stable but poor. Their main goal is to build more diversified economic activities and assets – when they have the opportunity, including access to financing, they are more likely to start a second microenterprise, agricultural or not, than to significantly expand a single enterprise. Their key goal is diversification.

And in the top slice, we have just-poor and near-poor households that have diversified their assets and reached a level of consumption and economic security such that they can contemplate specializing in one activity or enterprise. These are the early adapters with new agricultural technology. They are the ones wiling to take the risk of developing a new product or trying to tap a more distant and lucrative market for their microenterprise. So their key feature, from a household holding company perspective, is specialization. Note that Juan's upper levels include both firms and households.

Now you may wonder where this is going. The point I want to make is that the status of the household affects their demand for and capacity to use different types of rural finance.

- Those at the bottom may be looking for emergency loans, working capital to start enterprises with low entry barriers, flexible savings to begin to build up a small cushion. Those in the middle are also looking for diverse services. Both of these slices are fundamentally looking for diverse household finance – and if we're a lender, the way we lend to them safely is by underwriting the household and its diverse income sources.

- But the slice on the top of the pyramid is beginning to specialize in one or a few more significant activities, be they agricultural or not. The potential returns from the specializers are greater, but so may be the risks. <u>Now</u> we need to start underwriting the activity and not just the household. It's probably this slice that is more likely to be served by traders and processors – these households can afford to take the risk of investing in more input-intensive agriculture. And the

traders/processors are going to be looking for more stable and well-endowed borrowers, given the risks of their business.

Now one important point that was made on Day 1 and came up again yesterday is the phenomenon of poor households "self-insuring," especially by saving in kind. This has been one of the major light bulbs for me of the past two days – that this risk management strategy can actually lead to under-investment and unrealized productivity gains.

If we think about the goals of households in the bottom two slices, we can understand this strategy – it fits with their goals of guarding against systemic and idiosyncratic risk, and building more diverse assets. The availability of rural finance, however, especially flexible savings and emergency loans – can permit these households to shift from in-kind to financial savings**,** which have some advantages from the perspective of risk and fungibility if good investment opportunities come along. Michael Carter talked about the goal of helping the household achieve a more "entrepreneurial" portfolio.

We may need to think more about the value of services that permit poorer households to reduce their "self-insurance" through in-kind savings. The challenge is not to "teach poor people/farmers/fill in the blank to save" but to teach them the value of saving in cash and financial instruments.

So let's take a look at a few implications of these client observations for rural finance PRODUCTS:

Yesterday we got to the heart of the matter – financing agriculture. Now I think in many ways one of the most important statements was made by Dave Richardson when he said "all agriculture is not created equal." I think that Dave then forgot to take his own advice and ended up on a pretty pessimistic note in terms of the prospects for successful agricultural lending.

There's agriculture and there's agriculture. We need to differentiate between different types of agricultural zones and activities, because the implications for rural finance – and particularly the risk profiles -- are quite different.

Buchenau's reported finding that for a number of the innovations he looked at, delinquency and default wasn't higher for agricultural loans than for the non-agricultural portfolio (or was even lower, in the case of several of the lending programs profiled in the CGAP/IFAD piece) – I would wager it's due to the type of agriculture that is being financed.

There were actually many useful distinctions made throughout the day – staple vs. cash crops, short-cycle vs. long, input-intensive vs. non, rainfed vs. irrigated, exported vs. local market – each of these features affects both the risks and returns from agriculture and hence the feasibility of financing the specific agricultural activity.

I think our discussions today would benefit from being still more specific about the preconditions for different types of agricultural products. And from recognizing that some agricultural activities actually have quite high returns. And that some don't but the household chooses to cross-subsidize them any way, for reasons economic and otherwise.

We heard an excellent presentation by Doug Pearce building on Juan's brief discussion of trader/processor financing. Before lunch, after listening to Juan and Marguerite, my enthusiasm for pursuing this model was tempered by a better sense of the potential down sides. But by the end of the day, I was cautiously optimistic again that this model -- and particularly finding new ways to link these non-financial institutions with financial institutions – would have a significant contribution to make in some markets. When I think of much of rural Africa, or at least the commercializing part, and the transition countries, the relatively low marginal costs of supporting this kind of finance are appealing.

Another point about products. Business development services (BDS) and non-financial services are simply more important in rural than in urban areas – yes, this kind of statement approaches blasphemy in the mainstream microfinance field, which has at times exhibited a less than open mind to the potential contributions and commercial viability of BDS. As Doug reminded us, for example, embedded services play a particularly important role, and are a key to the success of trader and processor financing.

And as Dick Meyer has been saying for years, finance generally follows economic opportunity, not the other way around. Non-financial interventions that permit households to enter new markets and tap new economic opportunities may be essential preconditions to many types of rural finance.

We had a lot of discussion about innovation and some very important points were made:

- Juan and the final panelists yesterday shared some important observations about the features that more powerful innovations share – what makes them really value-adding from the perspective of the client and/or the financial institution. What makes them timely? Likely to be taken up in the market?

- That we need to be looking for innovations in process as well as products – including adaptations of existing finance technologies as well as coming up with completely new ones

- I think we need to put more emphasis on institutional innovation as well, including different types of **linkages** between financial institutions and other institutions, both formal and informal. This point came up in discussing trader financing (the role of private players such as commercial processors), remittances (the role of home associations), and savings (I was surprised that Juan didn't mention the India phenomenon of Self-Help Groups which now serve a reported 8 million villagers) – the fundamental innovation in each case might be the strategic partnership between a FI and something else rather than the financing process or product.

Now let's take a quick look at the rich discussion of institutions:
I just want to underscore one point that ran throughout the entire panel led off by Manfred Zeller and underscored by Juan's. LOTS of different institutional types can succeed in rural finance, and there is a great deal of value from having diverse players in the market. We don't know where the next generation of innovations will come from – nor which institutions are going to be in a position to run with them on a significant scale. They all have their strengths and weaknesses. The trick is to identify those that are exceptionally well-managed (Robin Young) and that have both the inspiration to come up with ideas for meaningful innovations and the systematic approach and hard work to follow up on them.

Governments and donors:
All the plenary papers yesterday offered excellent advice to donors and governments about what to do and what not to do. I hope the prescriptions will be synthesized, hashed out, and incorporated in the donor guidelines, the first draft of which we'll be discussing in a few hours.

Just two final points: I do think we need to give more thought and discussion to the "feasibility gap" described by Claudio on Monday. How are we going to both frame and SELL the new roles that we'd like the state to play. And are we really on the same page about what those roles should be?

Finally – on donor coordination, a topic that will occupy much of our time today and came up fairly often yesterday. I'm reminded of David Stanton's quote from Mashatam Gandhi about British civilization. To paraphrase: "What do you think of donor coordination? I think it would be a good idea." Isn't it really observed more in the breach than in actuality? Perhaps our discussion this afternoon will help us get more concrete about how we need to change not just our policies but our actual practices on the ground.

Well, I hope you've survived your exposure to idiosyncratic risk none the worse for wear! Thanks for your attention. Thanks especially to all the fabulous contributors to yesterday's rich and far-ranging discussions. And thanks to the organizers for both the inspiration and the perspiration that has gone into this exceptionally well-organized and stimulating event.