Rural Finance at the Inter-American Development Bank

Prepared by Mark Wenner
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Objectives of Rural Finance Strategy

The Inter-American Development Bank approved its rural finance strategy in June 2001 after a period of three years of research on best practices, internal debate, and extensive public consultation. The objective of the strategy is to promote the provision of efficient, broadly based, and sustainable rural financial services. In order to achieve this end, actions are being proposed in three areas; (1) creation of a favorable economic, legal, and financial regulatory environment; (2) strengthening and creation of sustainable and efficient financial intermediaries dedicated to serving rural populations; (3) and the promotion of innovative new financial services such as insurance, leasing, factoring, hedging, inventory credit, and greater use of debit, credit, and smart cards.

Audiences

The principal audiences of the strategy are operational staff of the Bank responsible for designing rural finance projects; policymakers in member borrowing countries interested in improving the functioning of rural financial markets, and upper management of the Bank who are called upon to review projects and to assure quality and logical consistency in Bank projects.

Areas of Action

The strategy focuses on how to improve access to four specific financial services: credit, deposits, insurance, and payments transfers. The primary, but not exclusive target group is low- and moderate-income rural entrepreneurs involved in both farm and nonfarm productive and commercial activities.

The aim of the Bank's rural finance strategy is to systematically remove the constraints on both the demand for and the supply of financial services in rural areas, thereby allowing profitable intermediation and risk –sharing. The recommended sequence of actions for the Bank is to engage in the following four steps:

1. removing biases in sectoral economic policies that have reduced the profitability and competitiveness of rural economic activities;
2. removing biases in the legal and regulatory framework that have increased the risk and cost of financial intermediation in rural areas;
3. strengthening and improving financial retail capacity for rural financial services by assisting promising institutions with staff training, purchase of equipment, design and installment of management information systems, support for market and product development studies and piloting exercises, and transfer of appropriate lending and deposit mobilization technologies; and.
4. introducing new products and services for rural finance, given that the policy environment is favorable and a number of solvent and capable financial intermediaries exist.

Taken together, these four steps should help to address the pervasive problems of unmitigated risk, imperfect information, and high transaction costs. Of course, the Bank should try to work with countries that have a relatively stable macroeconomic environment, overall banking sector strength, a high level of government commitment, and the presence of capable private sector counterparts. With these preconditions the chances of success in transforming rural financial markets are increased.

Implementation Plan

The strategy calls for each of the three regional operational finance and basic infrastructure divisions within the Bank to develop country level action plans to be discussed with borrowing country authorities in the normal country programming process, with the goal of including operations to implement the agreed upon action plan and the general Bank-wide strategic concepts.[1] The target for the period of 2001-2005 is to have 6 actions plans prepared, two per region. The countries selected should have generally favorable conditions and buy-in by the host country. The action plans should consist of (1) a diagnosis of country specific rural financial markets constraints: (2) a long–term plan to address these problems systematically; (3) a prioritized list of projects interventions; and (4) a provision for monitoring and evaluating, at the very least, adopted pilot projects. The action plans must be subject to a period of vetting with national stakeholders. No additional resources were budgeted for the implementation of the strategy.

Achievements to Date

Historically, the Bank has been and continues to be a major source of funding for rural finance projects in Latin American and the Caribbean. Between 1961-1998, it is estimated that financed US$ 9.7 billion of rural finance projects ($4.4 for targeted agricultural programs; $4.8 billion in support of financial sector and regulatory reforms; and US$474 million for retail capacity building). Direct lending for rural finance projects peaked in the 1980s. In the 1990s, with the demise of the directed, subsidized credit paradigm, the volume of direct support dropped considerably. The amount of monies supporting sector and regulatory reforms that indirectly affect rural financial markets, however, increased dramatically. Then new paradigm called for pursuing financial liberalization and giving a greater role to the private sector. Prior to the 1990s, the most common beneficiary of IDB support was state-owned agricultural banks and specialized lending agencies.

In the new millennium, the number of projects in rural finance is increasing but the volume is small relative to other types of lending and even the level achieved in the early 1990s. The majority of projects are small operations (Social Entrepreneurship Program (SEPs) (average US$500,000 concessional loan per client; and Multilateral Investment Fund operations that range from US$300,000-1.5 million and can be grant, loan, subordinated loan, equity, or guarantee). The few large value transactions tend to be financial sector reform loans that have a component that affects rural financial markets or Global Microenterprise Loans that extend credit to urban and rural microentrepreneurs. In the period 1998-2002, the volume of direct rural finance operations sums to US$33.2 million, up from US$14 million approved in 1996-1998 but less than the US$47 million approved between 1991-95.

[1] Region I consists of the southern cone countries: Brazil, Uruguay, Paraguay, Argentina, Chile, and Bolivia. Region II consists of the countries in Mesoamerica (Mexico to Panama) and the island of Hispaniola (Haiti and Dominican Republic). Region III consists of the Anglophone Caribbean states (Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago) and the Andean states (Venezuela, Colombia, Ecuador, and Peru)

In terms of country level strategies or action plans, four have been prepared and two have been vetted and approved by national counterparts: Paraguay (Region I) and Ecuador (Region III). Financing has been obtained to complete a Central American action plan but the executing agency has not started to work. In terms of large scale projects initiated after the strategy that deal with rural finance, both deal with state-owned banks and both have generated internal debate: Reform of Public Banks in Paraguay (stalled due to a change in administration) and the closing of BANRURAL in Mexico and the creation of a smaller stated-owned entity (currently under preparation).

Interventions Being Championed

Four broad types of project inventions are being championed. First, an innovation loan that establishes a competitive grant fund to assist private sector intermediaries learn and adopt new lending technologies suited for rural small and micro nonfarm enterprises and agricultural lending as well as train their staff (Deepening Financial Services in Rural Zones (Ecuador), US$5 million, expected approval 2003). This operation still in a preparation phase is facing some legal and political obstacles, namely a debate as to whether public funds can be used to subsidize for-profit banks. Hopefully, these difficulties will be overcome. Second, additional injections of loanable capital and technical assistance to non-regulated, small-scale rural intermediaries, many of which are member owned and operate in very poor and remote zones. Third, support to rural finance innovators, that is, groups that are introducing non-typical but highly demanded financial services, i.e. deposits, credit and smart cards, and leasing. Fourth, support to state-owned banks to either be restructured or to be liquidated.

Implementation Successes and Failures

Greater progress has not been realized for a number of reasons. First, the regional operational departments do not have sufficient rural financial specialists. There are an estimated 16 specialists on staff working on banking and finance issues in the operational departments. Moreover, most of the financial specialists have backgrounds in either commercial banking, insurance, securities, pension fund management, and economics and none in rural banking. Second, the staff in the regional departments are swamped with work that has a higher priority placed on it by supervisors and managers, namely containing financial crises, shoring up fragile commercial banking systems, and improving the strength of banking supervisory authorities. Third, rural finance projects are widely perceived as difficult, risky, and extremely time consuming. The incentives for an operational staff person is to deliver one or two large operations in a year whereas the design of a rural finance project can be more conceptually challenging and more time consuming than other types of financial sector operations. Fifth, the regional operational departments are designed to work with the public sectors and most of the innovative and promising work to be done in field requires working with the private sector. But due to the high transactions cost associated with developing a Bank financed project, the question of sovereign guarantees for the loans going to private corporations, and the general lack of interest on the part of many private sector financial intermediaries to penetrate rural areas, there is not much demand for relatively large scale stand alone private sector oriented rural finance projects. Sixth, the vast majority of projects in rural finance is being approved by the Micro, Small and Medium Enterprise Division of the Sustainable Development Department (MSM/SDS) but these projects are small in transaction value and very dispersed across the region. They focus mostly on improving retail capacity in non-regulated financial intermediaries that have total assets less than US$10 million. While many of the clients are promising, the dispersed and limited funding does not constitute a critical mass of interventions in any given country that would allow a radical transformation in the functioning and efficiency of rural financial markets in a particular country. Nonetheless, as urban microfinance markets become saturated in Latin America, rural microfinance and rural finance are being seen as the frontier and operational staff in the Micro, Medium and Small Enterprise Division are being tasked with identifying and developing more rural projects than in the recent past. Sixty seven percent of the total SEP loan value approved has gone to rural groups in the 1998-2002 period. In comparison, to the regional operational departments, there is 6 staff working full time on developing microfinance projects in SDS/MSM. In summary, the Bank is designed and staffed to develop more microfinance projects than rural finance projects. For greater progress to occur, incentives will have to be changed, staff knowledgeable about rural finance added, and more budgetary resources allocated to finish the action plans to develop some pilot projects.

Lessons Learned

Several lessons can be gleaned from the long track record of the Bank in rural lending: The lessons are categorized into three groups based on the type of intervention:

Target Credit Programs:

1. Subsidized credit programs distort rural financial markets, undermine the viability of many participating financial intermediaries, discourage the mobilization of savings, and disproportionately benefit higher income borrowers. In general, these types of programs failed due to faulty design assumptions and hostile economic environments in rural areas.
2. Unsubsidized wholesale credit projects promote the expansion and deepening of financial services to meet the needs of undeserved producers. However, it appears that under some conditions they can also expand and deepen rural financial markets. Those Small and Micro Enterprise Global Credit Loans (MicroGlobals) that succeeded in expanding rural producers' access to credit were carried out in countries with large agrarian sectors where intermediaries were already present in rural areas. It is important that final sub-borrowers should be charged market interest rates. The rates charged to intermediary institutions should be set at levels that do not undermine their deposit mobilization activity. The Bank's experience has shown that small-scale borrowers are more sensitive to the nonfinancial costs of transactions (processing fees, travel costs, and income lost due to delays in approval and disbursement) than to the financial costs (interest payments).
3. Experience with the Bank's MicroGlobal loans and Small Projects as well as with the Multilateral Investment Fund's projects, shows that a combined household and business model of credit analysis (in which all business and personal income and expenditure flows are considered in calculating repayment capacity), is more appropriate to this market segment, making restrictions on end use of credit impractical and undesirable.
4. The role of second tier or wholesale institution is important in deepening financial markets. However, care should be taken to avoid the negative effects of the arbitrary allocation and pricing of long-term resources.

Sector and Regulatory Reforms

1. Laws governing the creation, perfection, and enforcement of security interests and the attendant institutions should be improved. Small borrowers often lack secure title to land or are unwilling to pledge it in a loan transaction; therefore, other formal collateral substitutes are needed, especially moveable property.
2. Much also needs to be done in the area of supervision to identify the biases that may impede rural and microfinance intermediation, especially in the areas of licensing, minimum capital requirements, asset risk classification, documentation, and provisioning.
3. Complementary reforms are needed in titling, judicial process, and disclosure that would improve the environment for financial services. However, the Bank's experience in this arena is currently limited. It has shown that rural finance reforms have very low probability of succeeding if included in complicated, multifaceted operations.

4. The issues surrounding rural finance are complex and may require more evidence of consensus and political commitment prior to loan approval than there has been in the past.
5. Past experience with sector loans and technical assistance to promote reforms shows that particular attention must be paid to the political economy surrounding their implementation. Vested interests exist that benefit from the status quo and operations must be designed in ways that deal with the threat of opposition to change that is likely to arise.

Institutional Retail Capacity

1. The creation of sustainable financial intermediaries requires identifying organizations with strong leadership; a clear mission to assist the rural small- and microenterprise sector; a businesslike approach; a proven microfinance technology; and the creation of a partnership with these organizations to address institutional weaknesses. Therefore, the process of selecting institutions is crucial to success; the Bank's experience shows that broad consideration of alternative institutions and rigorous analysis of their actual and potential performance are essential.

2. Innovations are needed in financial service delivery technologies to lower transaction costs and allow financial intermediaries to expand financial services in rural areas. Parallel interventions are needed to reduce the high degree of production and price risk in agriculture. Such parallel efforts should include appropriate investments in physical infrastructure, improved extension services, improved marketing, and an increase in the provision of insurance services.

3. Building sustainable financial intermediaries capable of providing access to financial services to small rural producers is a slow process that requires a commitment over a long period (5-10 years). Rules or customary norms that prohibit granting of resources to the same group on multiple occasions need to be reevaluated.

In addition to the aforementioned modality lessons, evaluations and staff interviews indicate that a recurrent area of weakness in IDB rural finance operations is lack of adequate technical monitoring and supervision. The incentives in place favor routine administrative monitoring for contract compliance rather than pro-active troubleshooting and assistance in shaping or providing timely remedial interventions. The situation has improved over time but further improvements are still needed. In order to enhance the probability of success in attaining project goals as well as the overall effectiveness of development aid, greater effort and resources will have to be dedicated in the future to pro-active supervision.

Recommendations for Other Donors Interested in Rural Finance

Based on the experience of the IDB in promoting rural finance, donors entering this field after a hiatus or for the first time should pursue the following actions. First, acquire a critical mass of knowledgeable professionals to identify, design, and monitor rural finance projects. Moreover, the staff needs to be well coordinated and able to work across internal jurisdictional boundaries because successful rural finance projects depend heavily on successful rural development interventions.

Second, accept that most of the interventions in rural finance will be small value transactions (less than US$6 million) and the projects will be costly to prepare and supervise. The emphasis should be on quality of project and promoting catalytic interventions. Thus, staff must be given the necessary time and leeway to develop pilots and to adequately monitor and supervise them. Ideally the principal designer of a project should be involved in the monitoring and supervision of the project. The bilateral donors, who rely more on grants and guarantee instruments, may find this approach more palatable. Multilateral institutions that depend more on loans to generate interest income in order to cover administrative and overhead expenses will have a more difficult time finding the right balance and will have to pursue cross subsidization polices in project programming. Administrative costs, for example, tend to be lower on large infrastructure projects and savings can be used to cover the above average administrative costs of preparing rural finance and other time consuming social sector projects. Moreover, bear in mind that liquidity is often not the critical constraint. Rather the binding constraints tend to be lack of appropriate delivery mechanisms, weak institutional governance, weak management skills, lack of risk mitigation tools, and hostile external environments that reduce the set of profitable investments and make intermediation more risky that it should be. Therefore, greater emphasis has to be placed on technical assistance and coordinated programs that relieve several of the aforementioned constraints.

Third, the incentives in the donor organization have to be right. Political pressures to quickly disburse monies to a particular target sector, group, or country or to use interest rate subsidies must be strenuously resisted. Building deep and efficient rural financial markets is a slow and painstaking business that depends heavily on the sound macroeconomic fundamentals, the degree of counterpart commitment, and the technical and institutional capacities in the host country. Donor staff that work on small valued but complicated transactions need to be rewarded commensurate with the staff that work on large valued but less complicated transactions. Moreover, bureaucratic procedures continually need to be streamlined in order to reduce transaction costs for private sector partners.

Fourth, publicly owned banks are often justified as a response to market failure but the performance of these entities in most of developing countries has been resoundingly negative with a few exceptions. State-owned development banks tend to be politicized, inefficient, money losers, perpetuators of poor repayment cultures, and often serve as barriers to the entry of legitimate private sector intermediaries in a liberalized regime. Where they operate they should function according to commercial norms and should be phased out of first tier lending as quickly as possible and moved into wholesale or second tier lending. Private management contracts and mixed private-public capital structures should be explored as ways toward privatization or at least improved efficiency. Emphasis has to be on market-based, private sector driven approaches. The temptation to work with ailing state banks just because they have an extensive branch network has to be avoided.

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Donor Program Review: Rural Finance at the Inter-American Development Bank

Prepared by Mark Wenner

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The principal audiences of the strategy are operational staff of the Bank responsible for designing rural finance projects; policymakers in member borrowing countries interested in improving the functioning of rural financial markets, and upper management of the Bank who are called upon to review projects and to assure quality and logical consistency in Bank projects.

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The strategy focuses on how to improve access to four specific financial services: credit, deposits, insurance, and payments transfers. The primary, but not exclusive target group is low- and moderate-income rural entrepreneurs involved in both farm and nonfarm productive and commercial activities.

The aim of the Bank's rural finance strategy is to systematically remove the constraints on both the demand for and the supply of financial services in rural areas, thereby allowing profitable intermediation and risk –sharing. The recommended sequence of actions for the Bank is to engage in the following four steps:

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8. introducing new products and services for rural finance, given that the policy environment is favorable and a number of solvent and capable financial intermediaries exist.

Taken together, these four steps should help to address the pervasive problems of unmitigated risk, imperfect information, and high transaction costs. Of course, the Bank should try to work with countries that have a relatively stable macroeconomic environment, overall banking sector strength, a high level of government commitment, and the presence of capable private sector counterparts. With these preconditions the chances of success in transforming rural financial markets are increased.

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systematically; (3) a prioritized list of projects interventions; and (4) a provision for monitoring and evaluating, at the very least, adopted pilot projects. The action plans must be subject to a period of vetting with national stakeholders. No additional resources were budgeted for the implementation of the strategy.

Achievements to Date

Historically, the Bank has been and continues to be a major source of funding for rural finance projects in Latin American and the Caribbean. Between 1961-1998, it is estimated that financed US$ 9.7 billion of rural finance projects in 463 different operations ($4.4 for targeted agricultural programs; $4.8 billion in support of financial sector and regulatory reforms; and US$474 million for retail capacity building). Direct lending for rural finance projects peaked in the 1980s. In the 1990s, with the demise of the directed, subsidized credit paradigm, the volume of direct support dropped considerably. The amount of monies supporting sector and regulatory reforms that indirectly affect rural financial markets, however, increased dramatically. Then new paradigm called for pursuing financial liberalization and giving a greater role to the private sector. Prior to the 1990s, the most common beneficiary of IDB support was state-owned agricultural banks and specialized lending agencies.

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Greater progress has not been realized for a number of reasons. First, the regional operational departments do not have sufficient rural financial specialists. There are an estimated 16 specialists on staff working on banking and finance issues in the operational departments. Moreover, most of the financial specialists have backgrounds in either commercial banking, insurance, securities, pension fund management, and economics and none in rural banking. Second, the staff in the regional departments are swamped with work that has a higher priority placed on it by supervisors and managers, namely containing financial crises, shoring up fragile commercial banking systems, and improving the strength of banking supervisory authorities. Third, rural finance projects are widely perceived as difficult, risky, and extremely time consuming. The incentives for an operational staff person is to deliver one or two large operations in a year whereas the design of a rural finance project can be more conceptually challenging and more time consuming than other types of financial sector operations. Fifth, the regional operational departments are designed to work with the public sectors and most of the innovative and promising work to be done in field requires working with the private sector. But due to the high transactions cost associated with developing a Bank financed project, the question of sovereign guarantees for the loans going to private corporations, and the general lack of interest on the part of many private sector financial intermediaries to penetrate rural areas, there is not much demand for relatively large scale stand alone private sector oriented rural finance projects. Sixth, the vast majority of projects in rural finance is being approved by the Micro, Small and Medium Enterprise Division of the Sustainable Development Department (MSM/SDS) but these projects are small in transaction value and very dispersed across the region. They focus mostly on improving retail capacity in non-regulated financial intermediaries that have total assets less than US$10 million. While many of the clients are promising, the dispersed and limited funding does not constitute a critical mass of interventions in any given country that would allow a radical transformation in the functioning and efficiency of rural financial markets in a particular country. Nonetheless, as urban microfinance markets become saturated in Latin America, rural microfinance and rural finance are being seen as the frontier and operational staff in the Micro, Medium and Small Enterprise Division are being tasked with identifying and developing more rural projects than in the recent past. Sixty seven percent of the total SEP loan value approved has gone to rural groups in the 1998-2002 period. In comparison, to the regional operational departments, there is 6 staff working full time on developing microfinance projects in SDS/MSM. In summary, the Bank is designed and staffed to develop more microfinance projects than rural finance projects. For greater progress to occur, incentives will have to be changed, staff knowledgeable about rural finance added, and more budgetary resources allocated to finish the action plans to develop some pilot projects.

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conditions they can also expand and deepen rural financial markets. Those Small and Micro Enterprise Global Credit Loans (MicroGlobals) that succeeded in expanding rural producers' access to credit were carried out in countries with large agrarian sectors where intermediaries were already present in rural areas. It is important that final sub-borrowers should be charged market interest rates. The rates charged to intermediary institutions should be set at levels that do not undermine their deposit mobilization activity. The Bank's experience has shown that small-scale borrowers are more sensitive to the nonfinancial costs of transactions (processing fees, travel costs, and income lost due to delays in approval and disbursement) than to the financial costs (interest payments).

7. Experience with the Bank's MicroGlobal loans and Small Projects as well as with the Multilateral Investment Fund's projects, shows that a combined household and business model of credit analysis (in which all business and personal income and expenditure flows are considered in calculating repayment capacity), is more appropriate to this market segment, making restrictions on end use of credit impractical and undesirable.
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7. Much also needs to be done in the area of supervision to identify the biases that may impede rural and microfinance intermediation, especially in the areas of licensing, minimum capital requirements, asset risk classification, documentation, and provisioning.
8. Complementary reforms are needed in titling, judicial process, and disclosure that would improve the environment for financial services. However, the Bank's experience in this arena is currently limited. It has shown that rural finance reforms have very low probability of succeeding if included in complicated, multifaceted operations.
9. The issues surrounding rural finance are complex and may require more evidence of consensus and political commitment prior to loan approval than there has been in the past.
10. Past experience with sector loans and technical assistance to promote reforms shows that particular attention must be paid to the political economy surrounding their implementation. Vested interests exist that benefit from the status quo and operations must be designed in ways that deal with the threat of opposition to change that is likely to arise.

Institutional Retail Capacity

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agriculture. Such parallel efforts should include appropriate investments in physical infrastructure, improved extension services, improved marketing, and an increase in the provision of insurance services.

3. Building sustainable financial intermediaries capable of providing access to financial services to small rural producers is a slow process that requires a commitment over a long period (5-10 years). Rules or customary norms that prohibit granting of resources to the same group on multiple occasions need to be reevaluated.

In addition to the aforementioned modality lessons, evaluations and staff interviews indicate that a recurrent area of weakness in IDB rural finance operations is lack of adequate technical monitoring and supervision. The incentives in place favor routine administrative monitoring for contract compliance rather than pro-active troubleshooting and assistance in shaping or providing timely remedial interventions. The situation has improved over time but further improvements are still needed. In order to enhance the probability of success in attaining project goals as well as the overall effectiveness of development aid, greater effort and resources will have to be dedicated in the future to pro-active supervision.

Recommendations for Other Donors Interested in Rural Finance

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Second, accept that most of the interventions in rural finance will be small value transactions (less than US$6 million) and the projects will be costly to prepare and supervise. The emphasis should be on quality of project and promoting catalytic interventions. Thus, staff must be given the necessary time and leeway to develop pilots and to adequately monitor and supervise them. Ideally the principal designer of a project should be involved in the monitoring and supervision of the project. The bilateral donors, who rely more on grants and guarantee instruments, may find this approach more palatable. Multilateral institutions that depend more on loans to generate interest income in order to cover administrative and overhead expenses will have a more difficult time finding the right balance and will have to pursue cross subsidization polices in project programming. Administrative costs, for example, tend to be lower on large infrastructure projects and savings can be used to cover the above average administrative costs of preparing rural finance and other time consuming social sector projects. Moreover, bear in mind that liquidity is often not the critical constraint. Rather the binding constraints tend to be lack of appropriate delivery mechanisms, weak institutional governance, weak management skills, lack of risk mitigation tools, and hostile external environments that reduce the set of profitable investments and make intermediation more risky that it should be. Therefore, greater emphasis has to be placed on technical assistance and coordinated programs that relieve several of the aforementioned constraints.

Third, the incentives in the donor organization have to be right. Political pressures to quickly disburse monies to a particular target sector, group, or country or to use interest rate subsidies must be strenuously resisted. Building deep and efficient rural financial markets is a slow and painstaking business that depends heavily on the sound macroeconomic fundamentals, the degree of counterpart commitment, and the technical and institutional capacities in the host country. Donor staff that work on small valued but complicated transactions need to be rewarded commensurate with the staff that work on large valued but less complicated transactions. Moreover, bureaucratic procedures continually need to be streamlined in order to reduce transaction costs for private sector partners.

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