THE WORLD BANK

At the end of 2002, the World Bank launched a renewed strategy for rural development: *Reaching the Rural Poor*. The strategy is founded on the critical requirements of creating an investment climate conducive to rural growth and empowering the poor to share in the benefits of growth. Developing effective rural financial services are a key component in achieving these goals, and to further the Bank's implementation of this strategy, a paper is under preparation to elaborate the rural finance aspects of the strategy. Below is the executive summary from the paper, which sets out the Bank's approach to developing rural financial services for the rural poor.

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Rural Financial Services: Implementing the Bank's Strategy to Reach the Rural Poor[1]

EXECUTIVE SUMMARY

The World Bank's new rural development strategy, *Reaching the Rural Poor*, seeks to expand access by the rural poor to a suitable "diversity of products and institutions that fill the financial needs of low-income rural clients in income generation and reduction of vulnerability." Well-functioning financial markets facilitate rural economic growth and poverty reduction by mobilizing and transferring funds, allocating them to productive investments (including improved agricultural technology and non-farm enterprises), and enabling households to smooth consumption and mitigate risks. The Bank's strategy, gives priority to "a proper enabling environment for the provision of financial services; the development of efficient, viable financial institutions and products; and investment in social and economic infrastructure" to improve financial management skills and business services in rural areas and establish an adequate economic base for extremely poor clients and communities.

The emphasis on developing rural financial systems emerged during the 1990s from: (i) recognition that supply-led, targeted credit through state-owned development finance institutions or farmers' cooperatives had failed to achieve or sustain objectives; and (ii) growing evidence from "the microfinance revolution" that the poor can successfully save, borrow and repay and that efficient rural and micro finance institutions (RMFIs) can serve them on a sustainable basis. Experience has shown that reliable access to credit when needed is more important to smallholders and the poor than the interest rate and that savings mobilization is an effective tool for expanding outreach and achieving financial self-sustainability.

The Bank supports the **financial systems approach** to developing rural finance based on the principle that commercially viable institutions are most likely to reach large numbers of clients on a sustained basis. The foundation for this approach – and the appropriate sphere for government action – is an **enabling environment**, including: *policies* that reduce historical biases against the rural sector and provide macroeconomic stability; a supportive *legal and regulatory framework* that facilitates secured transactions and contract enforcement and that permits a variety of both licensed and informal institutions

[1] Please note that this is work in progress, and should not be quoted or cited.

to provide a wide range of financial services; and complementary market-enhancing *institutions* such as associations, credit bureaus, industry standards, and monitoring mechanisms.

To build up the supply of financial services, the emphasis of project intervention is on **building the capacity of RMFIs** to respond to demands from rural households and enterprises. *Institutional capacity* to deliver financial services efficiently and achieve high portfolio quality can be strengthened by supporting cost-effective training and technical assistance to RMFIs and by providing performance-based grants to help improve management information systems and cover costs of reaching out to new clientele in rural areas. Development of *savings mobilization* is useful both to serve the poor who may not desire credit or be creditworthy and to enable commercial RMFIs to reduce dependence on donor funds. This may include support for savings and credit cooperatives and credit unions. To reach different segments of diverse rural financial markets, institution-building should also include introduction and development of *new financial products* (such as warehouse receipts, leasing, and micro-insurance) and support linkages to *commercial sources of funds* (e.g., through commercial guarantees for wholesale credit from banks to RMFIs and through equity funds for transformation into licensed financial intermediaries).

Stand-alone operations, preferably in the financial sector, should be the primary vehicle for development of sound RMFIs to extend the reach of financial services to the rural poor, with success measured by standard indicators of outreach (including depth of penetration to underserved groups, as well as numbers) and sustainability (including reduction of subsidy dependence, as well as high rates of loan and cost recovery). Credit lines are a suitable instrument only when assessment of RMFIs in a country demonstrates that liquidity is the primary constraint on their ability to reach targeted groups and that such funds can be provided at commercial wholesale rates without distorting financial markets, as required by the Bank's Operational Policy 8.30 on Financial Intermediary Lending.

Nevertheless, implementation of this approach in Bank operations faces special challenges in two types of circumstances: in situations of extreme poverty or crisis where economic opportunities and the conditions for financial systems are lacking; and when financial instruments are used to serve a variety of sectoral objectives. Effective demand for rural financial services is often constrained by poor business skills and services, lack of social capital, and inadequate infrastructure. The increasing importance of RMF components in operations oriented toward social protection and poverty objectives raises the risk that a focus on direct resource transfer may undermine achievement of longer-run goals for development of sustainable financial systems. Efforts to use credit to stimulate private investment may founder on the absence of effective financial intermediaries or may risk re-introducing government directed credit schemes that undermine development of rural financial systems.

In such situations, the conditions for eventual development of rural financial systems may best be addressed through **complementary investments** in social and economic infrastructure to improve well-being, reduce vulnerability, and raise skills, assets and debt capacity of target groups. Certain non-financial interventions can help build demand for and *ability to utilize rural finance*, such as strengthening local groups and organizations, training in business and financial skills, and business development services that support both agricultural marketing and non-farm enterprises. In remote areas beyond the reach of RMFIs, training and support for the initial costs of local savings and credit associations can help communities to mobilize and manage their own financial resources on a sustainable, if modest basis, building a foundation for subsequent relations with RMFIs. Where extreme poverty or crisis situations make financial flows uncertain and sporadic, *alternative interventions for poverty reduction* are likely to be a more effective starting point than credit-based instruments or attempts to introduce RMFIs. The importance of empowering communities to develop infrastructural and social services adapted to their needs is increasingly recognized through government measures to decentralize responsibility and through supportive programs such as community-based rural development (CBRD) and social investment funds. Basic investment in water, sanitation, transport, energy, education, and health

can help lower transaction costs and risks of both daily life and operating a business, making it easier to take advantage of available opportunities and raising the productivity of labor. Nevertheless, increasing reliance on local private contractors and service providers makes it important to improve their access to financing and business development services in parallel with development of infrastructural and social services.

CBRD and social fund programs are also under increasing pressure to fund productive assets and "income-generating activities" for the poor, as are operations for post-conflict and disaster recovery and for communities affected by HIV/AIDS. RMFIs are best suited to the "entrepreneurial poor" and should not be expected to be able to address such problems directly. Special credit programs should be avoided in such situations, both because persistent low repayment of government-sponsored loans creates a "culture of entitlement" that undermines development of sustainable RMFIs, and because credit creates a debt burden that people in such situations are unlikely to be able to bear. Grant programs targeted to eligibility characteristics may be appropriate in such situations, provided that they are designed to avoid conflict with private and financial sector development objectives. Some Bank operations are experimenting with equity-enhancing grants in parallel with (but separated from) commercial credit through RMFIs.

These non-financial and grant-based interventions may be preferable alternatives to credit in situations where rural financial market development is not yet feasible or would take too long to serve other objectives. Part of the strategy for implementing the financial systems approach in Bank operations is to analyze the extent to which it is constrained in meeting specific objectives and to design complementary or alternative measures that are consistent with long-term financial market development. For example:

- *Financing agriculture*: The proportion of agricultural investments and inputs that can be financed directly through RMFIs is often limited by low returns, lack of risk management mechanisms, lack of acceptable collateral (or enforcement), and absence of effective rural financial intermediaries. *Complementary financial measures* include developing suitable products (savings, insurance), special incentives for rural branch networks, and capacity-building for commercial savings and credit cooperatives. *Alternative interventions* include investment in infrastructure (especially transport) and marketing services, and grants to match equity contributions of the very poor to accumulate assets.
- Financing for private investment in *rural infrastructure and enterprise* is generally constrained by limited entrepreneurial skills, inadequate equity funds, lack of specialized intermediaries and instruments, and weak supporting services. *Complementary financial measures* include "smart subsidies" and build-operate-transfer approaches to bring in external investors. *Alternative interventions* include facilitation of market-based business development services, e.g., through demand-driven matching grants.
- *Poverty reduction in situations of extreme poverty, conflict, disaster, or HIV/AIDS*: Use of credit in safety net situations imposes a heavy debt burden on the recipients and undermines sustainability of RMFIs due to uncertain income flows and lack of social capital. *Complementary financial measures* include capacity-building and grants for initial expenses for local savings and credit associations. *Alternative interventions* include grassroots management training to raise skills and basic infrastructure to improve economic opportunities.

The choice and sequencing of the strategic elements described above depends on prior analysis of the conditions prevailing in each country –particularly in rural and remote areas – and in the specific objectives being pursued. When the primary objective is increased access of the rural poor to financial services, development of the capacity of RMFIs to deliver services should follow – or at least parallel – establishment of a conducive policy, legal and regulatory environment. In situations where extreme

poverty, poor economic opportunities, or crisis preclude sustainable financial intermediation and make credit an unsuitable instrument, then complementary investments and alternative grant-based approaches should be undertaken first in order to establish effective demand and more suitable conditions for financial interventions.