



RURAL FINANCE PROGRAMMING PRINCIPLES

Rough Draft for Donor Discussion

The objective of this paper is to solicit views from donors with the objective of improving donor collaboration and consistency in donor rural finance programming principles that will expand the outreach of financial services in rural areas and strengthen the sustainability of the institutions providing those services. Today's **financial systems approach** enhances the efficiency and depth of savings, financing and insurance services available to rural communities. This approach supports rural employment and economic growth and, therefore, income generation and wealth accumulation in rural areas.

The structure of this paper and the USAID-sponsored *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* has been built around but is not limited to a conceptual framework wherein rural financial systems development is implemented through (1) establishing an enabling economic policy environment, (2) establishing an enabling legal framework (3) supporting mechanisms to reduce risk in rural financial intermediation, (4) building or restructuring sustainable financial institutions, (5) developing appropriate/innovative products for rural finance, and (6) supporting agribusiness linkages that deepen rural financial services.¹

(1) Establishing an enabling economic policy environment.

The role of Government economic policy is to support and stimulate market operation, not to administer market operations. Donors can provide incentives to eliminate Government biases in sectoral economic policies, such as agricultural price control and tax regimes, that reduce the profitability of rural production. The Government should not engage in price controls, interest rate controls, portfolio quotas, directed credit, operational subsidies or direct provision of financial services. The role of the Government in undertaking complementary investment in non-financial rural infrastructure to improve the return on rural finance investments. Donors may support Government development of rural education, health care, agricultural research and extension and public investment in physical infrastructure upon which financial services returns are indirectly dependent. This infrastructure is characterized by public goods—benefits available to the wider population and not adequately provided by the private sector.

Goal: Establish conducive economic policies that stimulate financial systems to expand rural financial services access in a sustainable manner.

<i>Donor Programming Do's</i>	<i>Donor Programming Don'ts</i>
<ul style="list-style-type: none">• Assist in the establishment of information infrastructure such as credit bureaus and property registries that reduce the risks for intermediaries.• Require clear prudential norms, transparent reporting and effective supervision consistent with international standards for donor supported deposit-taking institutions.• Support product innovation not by having the Government implement innovation itself, but by motivating the Government to establish a framework that allows innovators to experiment and benefit financially from desired innovations.	<ul style="list-style-type: none">• Do not support interest rate controls.• Do not provide credit or grants for subsidized interest rate lending, directed credit, or credit programs with political rather than commercial management.• Do not support direct provision of financial services by the Government.

(2) Establishing an enabling legal framework.

An adequate legal framework defines the manners in which a borrower and a lender may undertake secured transactions and how that contract will be enforced. The legal system needs to establish the mechanisms and rules by which (a) the lender takes collateral upon a specific property, (b) the claims on collateral are prioritized, (c) the claims are registered and (d) the collateral arrangement is enforced and liquidated. One of the critical issues is the clear definition of legal rights to land and the right of landowners to pledge land as collateral. Another constraint includes the ability of rural producers to pledge their crops as collateral.

Goal: Establish a legal framework that offers property for collateral in a transparent manner to reduce risk in lending and allow financial institutions to offer rural finance in larger amounts, at lower interest rates, and for longer terms.

<i>Donor Programming Do's</i>	<i>Donor Programming Don'ts</i>
<ul style="list-style-type: none">• Create incentives for establishing a single or umbrella legal framework that defines the priority of claims upon borrower collateral.• Support programs that strengthen institutions that title and register security interest.• Improve the security of land tenure legal frameworks by (i) strengthening title process and registries, (ii) defining transfer and pledging rights, and (iii) removing legal restrictions on mortgaging rural property (iv) removing restrictions on sales, rentals and other forms of transfer of rights.• Provide support for improved court and legal system, enforcement of contracts and bankruptcy law.• Encourage the use of collateral alternatives such as producer crops and joint liability groups.• Support the regulation and supervision of deposit taking institutions under the same or consistent and capable formal finance sector supervisor.• Encourage governments to simplify the regulatory structure thus reducing opportunities for rent-seeking behavior	<ul style="list-style-type: none">• Do not encourage unnecessary bureaucratic procedures that would provide opportunities for rent seeking.

(3) Supporting mechanisms to reduce risk in rural financial intermediation.

Risk can be pooled and managed for the mutual benefit of the individual producer and financial institution through insurance programs. Such programs will then increase the access of producers to agricultural credit. Index-based insurance programs provide financial institutions with greater incentives for investment in rural markets while maintaining the incentives for producers to produce effectively and avoid risks.

Goal: Reduce high degrees of price and production risk in agriculture finance.

<i>Donor Programming Do's</i>	<i>Donor Programming Don'ts</i>
<ul style="list-style-type: none"> • Create incentives for establishing or strengthening market information mechanisms such as price information services, distribution information and associations to reduce risk to producers and rural financial institutions. • Require accurate actuarial and statistical information modeling for donor supported insurance programs. • Support crop insurance programs which are profitable and are attractive to private sector ownership and management. • Provide incentives and support programs that determine insurance premiums and payments based upon indices such as rainfall, crop production histories, and natural events which are beyond the control of producers so that producers are still motivated to manage and maximize their production. • Require that donor supported deposit guarantee insurance have in place prior financial monitoring and supervision systems to reduce the risk of morale hazard. 	<ul style="list-style-type: none"> • Do not support the establishment of multiple peril insurance programs which decrease the incentive for producers to well manage their production. • Do not support insurance programs that lack adequate limits on what can be insured, have high monitoring costs, and/or face generally high losses. • Do not support crop insurance in markets characterized by decreasing productivity trends, unfavorable terms of trade, geographic concentration and small market size.

(4) Building or restructuring sustainable financial institutions.

Various financial institutions possess distinct comparative advantages which makes their co-existence and fierce competitiveness possible. Institutional diversity breeds competition and competition is healthy in that it breeds institutional innovation and sustainability. Institution-building is a function of information and incentives. Information begins with transparency and full disclosure of reporting by financial institutions. To be sustainable, rural financial institutions need to cover their full costs including financial costs, operating costs, provisions, and capital accumulation to meet capital adequacy requirements. Institutions must be able to pay full market costs (meaning non-subsidized costs) for their loanable funds. As part of this commitment, donors, as key investors in financial institutions, should consider taking an active role in the formulation of institutional policy and oversight. Active participation on the institution's board of directors either as a voting or nonvoting member should be seriously considered. The creation or restructuring of sustainable institutions requires a long-term commitment to put systems and trained personnel in place.

Goal: Establish a diversified range of rural financial, bank and non-bank, institutions which provide efficient financial services in rural areas and which are sustainable.

<i>Donor Programming Do's</i>	<i>Donor Programming Don'ts</i>
<ul style="list-style-type: none"> • Require rural financial institution partners to meet standardized international reporting and auditing requirements for the measurement and monitoring of sustainability and financial health. • Limit investment grants or operating subsidies 	<ul style="list-style-type: none"> • Do not support rural finance programs that lend at interest rates which fail to cover the lender's full costs. • Do not rely solely on Government-owned financial intermediaries to provide rural

for start up or restructuring to specific costs with clear objectives, timelines, and performance criteria for reaching sustainability.

- Require that partner financial institutions target, plan, and price to achieve full cost recovery and financial sustainability with operating revenues; create incentives for actually reaching full cost recovery and financial sustainability.
- Insist that governance of rural financial institutions be strengthened with (i) a clear definition of the roles and responsibilities of board members and managers, (ii) criteria for board candidates, (iii) internal controls, and (iv) conflict of interest controls.
- Provide credit lines only on a non-subsidized basis and only when local financial markets do not provide long term financing.
- Assure that, in donor supported rural finance programs, external credit is priced at commercial wholesale rates to financial institutions and at retail market rates to client-borrowers.
- Require that rural finance partners hire and dismiss management on commercial criteria and performance standards in response to market forces and not on political objectives.
- Donors should structure long-term partnerships with institutions they supporting by ensuring their participation on the institution's board of directors.

financial services.

- Do not rely on Government-owned non-financial institutions or non-financial ministries (likely to pursue political ends) to implement rural finance projects.

(5) Developing appropriate/innovative products for rural finance.

Innovations may help reduce the costs of rural finance operations for financial institutions, lower transaction costs for client and institution, or reduce the risks to the institution and the client. The worth of innovation is in the increased profitability of the financial institution and in the increased income or wealth through access to financial services at the client level. Innovations may be the creation of new products, changes in the characteristics or application of old products, or simply the transfer of products and technologies from one country or one sector to another.

Goal: Introduce product innovations which expand rural finance services by reducing the costs of services, reducing the risks of providing services, or expanding the range of financial service characteristics tailored to the disbursement, term, and repayment characteristics of the economic activity of the clients.

<i>Donor Programming Do's</i>	<i>Donor Programming Don'ts</i>
<ul style="list-style-type: none"> • Provide incentives for strengthening rural financial institution lending capacity to include household multi-activity repayment analysis for farm and non-farm activity lending. • Develop long term funding vehicles and methodologies at market interest rates to finance 	<ul style="list-style-type: none"> • Do not limit partner financial institution services to just agricultural credit. • Do not support uniform supervision policies which place barriers to providing rural lending services via nontraditional collateral arrangements.

longer term agricultural investment.

- Restrict innovations which require large financial investment to larger and financially sound institutions.
- Ensure commitment of the financial institution introducing the proposed innovation; require co-funding of institution where innovation is introduced.
- Emphasize savings services among regulated financial institutions and credit for purposes beyond agricultural production.
- Establish standards for warehousing and strengthen boards which monitor the quality of warehousing receipts.

(6) Supporting agribusiness linkages that deepen rural financial services.

Non-financial institutions provide interlinked credit arrangements such as contract farming, supplier trade credit and output distributor advances. Rural traders who advance agricultural inputs or purchase harvest are important providers of credit in rural areas. Large supply or processing companies often use the traders as middle men to interface with producers. Where traders are absent, the processors often work directly with the producers. Traders apply their patronage history knowledge of clients to screen credit recipients who usually tend to be small and medium producers. Trader credit operations therefore tend to be limited to a small number and geographic area but are replicated on a major scale.

Goal: Expand financial services through interlinked markets and coordinating with commercial non-financial entities.

<i>Donor Programming Do's</i>	<i>Donor Programming Don'ts</i>
<ul style="list-style-type: none">• Support trader or processor business relationships linked to credit without distortion or crowding out of private sector activities.• Support the development of liquidity management systems for traders and traders' supplying companies.• Ensure that the resource allocation distortions caused by donor intervention are transparent and outweighed by the public benefits of the intervention.	<ul style="list-style-type: none">• Do not support or promote programs in which supplier, processor or trader relationships with producers are "predatory", i.e., locking producers into production/debt peonage through credit terms.

¹ The text of this paper draws from but is not limited to the papers commissioned for this conference, including *Deepening Rural Financial Markets: Macroeconomic Policy and Political Dimensions* by Claudio Gonzalez-Vega, *Legal and Regulatory Requirements for Effective Rural Financial Markets* by Heywood Fleisig and Nuria de la Pena, *Risk Management Challenges in Rural Financial Markets: Blending Risk Management Innovations with Rural Finance* by Jerry Skees, *Models of Rural Financial Institutions* by Manfred Zeller, *Innovative Products and Adaptations for Rural Finance* by Juan Buchenau and *The Evolution of Institutional Issues in Rural Finance Outreach, Risk Management and Sustainability* by J.D. Von Pischke.