



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

Discussant Reaction Paper

Comments on
“Models of Rural Financial Institutions”
by Manfred Zeller

**By Anthon Slangen
(FAO)**

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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.

General Comments

The lead paper of Manfred Zeller is not about which type of financial institution is better or worse for a particular target clientele in a particular environment. Indeed, the author concludes that there does not exist a blueprint for rural finance and he states, in fact, that institutional diversity is desired to enhance competition, outreach and welfare impact. This concurs fully with the views of the rural finance group of the Food and Agriculture Organization of the United Nations, which in its Position Paper on Rural Finance of June 1994 concluded that: “.....there should be a choice of institutions offering financial services competing with each other and the suitability of an institution to prevailing conditions and its acceptability to prospective clients should be the main criteria in promoting different types of financial intermediaries in rural areas”.

The importance of the paper lies in the focus it gives to the policy objectives of rural finance policy, which form part of the broader framework of rural development and poverty alleviation as set out in the United Nations Millennium Development Goals. In accordance with the new paradigm of financial market and systems development, the role of public investments is that of supporting the development and testing of new financial products and technologies and institutional innovations (versus the earlier focus in the directed agricultural credit approach on the supply of external credit resources). Donors and governments may decide to follow different financial sector intervention strategies in order to reduce poverty: indirect, by developing an enabling policy environment for economic growth and the operation of viable and sustainable financial institutions (the so-called frame conditions), and/or direct, by supporting financial institutions that are targeted specifically to poor clients. Governments, international development organizations, donors and NGOs in supporting specific types of financial institutions can differ also in the relative emphasis that they give to the objectives of financial sustainability, outreach and impact of financial services (Figure 1 - “Triangle of Micro Finance”). Both trade-offs and synergies may exist between these three objectives.

Specific Comments

1. Renewed interest in rural and agricultural finance

With regard to the three motivations (learning from the lessons of the failed approach of directed and subsidized agricultural credit and the recent changes in the economic environment of developing countries); the continued importance and role of the agricultural sector and rural development in improving food security and reducing poverty; and the success of the micro finance revolution in banking with the poor), it can be remarked that:

- The change in paradigm from directed and subsidized agricultural credit to financial market and system development has not been complete and many policy makers in developing countries and also some donors continue to support supply-led credit, thus undermining financial market development.
- An improved macroeconomic environment and financial sector reform are essential but not sufficient pre-conditions for accelerating agricultural and rural economic growth.
- The innovations and lessons from micro-credit have been important, but micro finance institutions which are expanding their operations to rural areas and agricultural finance face serious limitations and the outstanding challenge to improve and to expand agricultural and rural finance remain large.

FAO and GTZ as part of their rural finance and financial system development work started in 1996 a joint initiative entitled “Agricultural Finance Revisited”. Up to now six publications are available in the AFR Series which refer to policies and regulation and supervision, financial institutions (better practices and sources of funds) and client support (enhancing their financial management skills). A seventh publication on agricultural term finance will be completed before the end of this year.

2. Change in Paradigm and Policy Objectives in Rural Finance

The new rural financial market and systems development paradigm does not depart from the assumed needs of beneficiaries (as does the directed, supply-led credit paradigm), but bases itself on the effective demand of prospective clients (i.e. their willingness and ability to pay market prices) for different types of financial services (savings, credit, money transfer, insurance, etc.) both for production (farm, farm-related, and non-farm rural economic activities) and consumption/emergency purposes. While the new paradigm recognizes the possibility of market failures, it does not try to cure all the ills of the small farm and rural households and, instead, it concentrates on improving the financial intermediation. High transaction costs and risks have been identified as the main problems in rural finance and public investments play a crucial role in supporting the development of pro-rural poor financial and institutional innovations which aim at reducing them.

The policy framework for rural and, in particular, agricultural finance is more complicated than micro finance, as the policies which affect agricultural and rural finance belong to three different policy areas: macroeconomic, financial sector and rural/agricultural sector policies. In particular, agricultural and rural sector policies are highly political sensitive, while the three policies are not well integrated and often conflict with each other, rather than being mutually supportive. Policy making is an ongoing responsibility and not a single event that through effective policy dialogue should capture the views of all stakeholders, while monitoring and evaluation of key data will give the necessary feedback to policy makers on the effectiveness and impact of generated policies.

3. Urban-Rural and Farm-Non-Farm Dichotomies

The main reasons for these dichotomies lie in wrong policies (urban bias, cheap food), high transaction costs (density and dispersion of the rural population, poor rural infrastructure, low education and business development skills), high risks (segmented markets, volatile agricultural commodity prices, use of traditional technologies and low profitability of agriculture, covariant weather risks, few risk management mechanisms, inadequate legislation and poor contract enforcement), and poverty and low repayment capacity of targeted clients (small farmers and female-headed households, agricultural seasonality and few income sources, low access to basic needs).

4. Types of Rural Financial Institutions

- Credit projects and development projects with financial services components have had a troubled history in FAO. Main weaknesses have been a lack of assessing of an existing effective demand for financial services, poor project formulation, inadequate administration of financial services and an absence of essential non-financial support services. Due to the use of subsidized interest rates and poor loan recovery most of the so-called project revolving funds have been depleted soon and little has been achieved in continuation of the financial services to the target population after project termination. A main principle has been that credit funds should be administered by interested and qualifying financial institutions (including NGOs) which should be allowed to follow their

standard lending and operational procedures. However, when a bank does not put in also own loan funds, then its commitment will remain minimum. This may change in the case of guarantee funds, but the objectives of additional bank funds (the ratio is often not higher than 1:1) and sustainability are often not attained due to poor design and implementation of the guarantee fund or in case the credit-financed investments are not profitable. Moreover, adequate savings components have rarely been included as a “savings first” approach and this error is often repeated in the new generation of project activities under the FAO Special Programme for Food Security.

- Credit unions, in particular, but also village banks have proven to be important players, although due to the focus on less poor clients and government interventions (the first) and small size (the second), their impact, sustainability and outreach often have been limited. These types of grassroots organizations clearly need horizontal and vertical integration and/or linkages with mainstream financial institutions to resolve their liquidity problems and to reduce high covariant risks by diversifying their loan portfolio. Lack of adequate regulation and supervision and adequate governance and capitalization present other main constraints.
- New types of regulated micro banks are interesting, because they service a neglected middle market of clients who have become too big for micro credit from micro finance institutions who use solidarity or joint liability group lending technologies but are still too small for commercial banks. The IPC model of micro banks in different parts of the world is interesting, because it is moving also into rural and agricultural finance.
- Agricultural development banks: their options are to reform or to close them. A number of these specialized banks, in particular in Asia, have been successfully reformed and their advantages lie in large branch networks and well trained staff who are familiar with agricultural and rural finance.
- Trader finance, interlinked credit arrangements and contract farming, which in different forms existed before liberalization e.g. between agricultural state banks and parastatal marketing boards, have taken new and large dimensions in the new market economies in developing countries and is of great interest to FAO and publications and studies exist in inventory credit (warehouse receipts), contract farming and trader credit. The main question is what role donors can play.

4. Transferability of Micro Finance Best Practices

Although I recognize the large contributions of the micro-credit revolution, I am less optimistic than Manfred Zeller that the transferability of the micro finance best practices is simply a question of adaptation of current loan contract features to rural and farm households. Main achievements of micro finance institutions have been the reduction of transaction costs through standardization of loan products and lending procedures and increasing the productivity of loan officers (staff incentives schemes) and management of credit risks through the selection of clients with business experience and financing initially only the expansion of existing business, delegation of a certain lending authority to field staff, loan appraisal based on cash flow analysis and adjusting of loan repayment schedules to the loan repayment capacity of the borrower, provision of repeat loans and graduation of borrowers, and the use of loan collateral substitutes. Major constraints and outstanding challenges related with agricultural and rural finance are, however, an unmet effective demand for different types of financial services and not only credit, existing frame conditions (unfavourable macroeconomic and business environment, specific sector policy distortions and an inadequate legal and regulatory/supervisory framework), low population density, poor infrastructure (including irrigation), absence of non-financial support services, low economic diversification and availability of non-farm income sources, high covariance of weather risks

and natural calamities, and an incomplete analysis of the comparative advantages between for instance, individual and group lending.

Recommendations and Agenda for Donor Activities

1. Support the provision of different types of financial services (not just only credit) both for production (farm, farm-related, and non-farm activities) and consumption/emergency purposes.
2. Promote the active participation and empowerment of rural people by involving them in the planning and implementation of activities that are meant to improve their living conditions and increase their self-help capabilities.
3. Strengthen the financial sustainability, outreach and impact of a variety of individual financial institutions as well as promote both horizontal vertical integration between them.
4. Enhance dialogue and establish partnerships between international development organizations, donors, governments, NGOs, the private sector, financial institutions, and support organizations to clients for exchange of information, case studies and research, formulation of policies and strategies, and implementation of pilot action plans.
5. Examine the ways of integrate the supply of essential non-financial support services with that of financial services through different provider structures.
6. As a follow-up to main focus of FAO support in the past to agricultural development banks and agricultural credit/rural finance departments of Central Banks and based on the FAO/GTZ Agricultural Finance Revisited series of publications support to member governments and others in the areas of rural finance policies, savings and safeguarding of savings, risk management and insurance mechanisms, new financial products and technologies, different institutional structures, operational procedures, and training.
7. Support better banking in the context of the MicroBanking System training and installation support to bank automation and development of integrated MIS.
8. Support networks of rural financial institutions with development of data basis (Agribank Stat), exchange of information on better practices, research, and capacity building and training activities.
9. Disseminate publications and audio visual materials on rural finance in different languages, convert them in training materials and develop new publications and training materials on identified key themes.
10. Form a partnership with international development organizations, donor agencies and networks on strengthening the capacity building in rural finance (CABFIN) through the development and maintenance of a knowledge management information system on better practices in rural finance and relevant training materials and courses for different target audiences (policy makers, financial institutions and clients).