



**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**

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After reading Manfred Zeller's paper on Models of Rural Finance Institutions, I was struck by the inconsistency of three of the four conclusions he mentions on pages 30-31. First, he states that we must "learn from past failures", yet second, in spite of our failures, he says that "there is no blueprint for rural finance", and finally, he curiously concludes that the "best practices of urban-based microfinance are relevant for rural and agricultural finance". In my opinion, that is a very dangerous statement in view of the fact that rural agricultural finance is a very different animal from urban-based microfinance.

After having spent 9 years of my professional career managing a \$200+ million dollar agricultural loan portfolio, I learned a few lessons that if gone unheeded, will most assuredly wreak havoc with your basic MFI that wants to dabble in the rural microfinance marketplace. Without wanting to overly criticize the statement that there is no blueprint for success of rural finance, I can unequivocally say that there is blueprint for failure, and some of the ingredients of failure ironically have been part of the mantra for success of MFI's involved in microfinance activities. To illustrate my point, I will share five lessons learned from the trenches of agricultural finance:

- 1 **Debt Load Matters.** In my experience, I would rarely lend money to any agricultural borrower who had a debt to asset ratio greater than 50%. This means that MFIs who believe that providing loans is the best solution for bringing poor farmers out of poverty will be in for a BIG surprise!! If farmers do not learn how to save, and if MFIs don't offer farmers savings products to encourage savings, they will be doomed to failure.
- 2 **Interest Rates Matter.** I quickly learned that when interest rates are high, most agriculturally-oriented projects are not profitable enough to repay the debt service. Anyone who believes that agricultural lending will support the same interest rates that are currently used in microenterprise lending will likewise be doomed to failure.
- 3 **Repayment Periods Matter.** In agricultural lending, I learned that you MUST structure your loan repayments to the cycle of production. This means that in all cases (unless you have a dairy cow), weekly or monthly loan payments will be out of the question. How will this fit within the current philosophy of many MFIs to not let the borrowers go very long without making a loan payment by requiring frequent amortization schedules? It is another formula for failure.
- 4 **Collateral Matters.** Some of my most unhappy moments in agricultural lending were when I didn't have any solid collateral to protect my lending institution from the unpredictable swings of a farmer's cash flow. It is imperative to have good collateral so that when a farmer gets into trouble, you have something to work with. The "social collateral" of group guarantees will be worthless, because when there is a crop failure, everyone will be paying off each other's debts. I doubt there will be anyone willing to continue to pay for someone else's debts ad infinitum.
- 5 **Diversification of Loan Portfolio Matters.** Finally, one of the keys to success of my lending operation was that I tried to diversify my loan portfolio into different geographical areas of the country and different agricultural products. The current "cookie-cutter" mentality of many MFIs to lend for just one type of loan activity is a sure-fire formula for failure in rural finance.

As I stand back and ponder these five lessons I learned in my years of agricultural lending, I must confess that I am highly skeptical about the capacity of the vast majority of MFIs to jump into agricultural lending. Most of them in their current state, seem ill-equipped to deal with the risks at hand. Without a lot of imagination, I can easily see history repeating itself!

As to a "model" institutional blueprint for success, certainly any institution that cannot address the aforementioned blueprint for failure should think twice before taking the plunge.