



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

Discussant Reaction Paper

Comments on

**“The Evolution of Institutional Issues in Rural Finance:
Outreach, Risk Management and Sustainability”**

by J.D. von Pischke

**By Richard Rosenberg
(CGAP)**

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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.

1. Models for Rural Finance. I share JD's view that the overall state of rural finance is disappointing. However, there are promising new models, mainly those produced by the 'microfinance revolution' of the past two decades. (The new microfinance is not a predominantly urban phenomenon: most of its clients are in fact rural.) Thus, I'd argue that we know how to do good rural finance, and that the main obstacles to its expansion are political and managerial, not technical.

There are, however, two frontiers of rural finance where progress has been limited:

- There is relatively little sustainable crop lending. Borrowers from the sustainable rural microfinance institutions do use some of their loan proceeds for cropping. But typically the portion of funds used for this purpose is relatively small, and most of the borrowers have non-crop income sources from which they can repay a loan if a crop fails. The problem is the inherent risk in crop production. We should expect substantial improvement in sustainable crop credit only when we find ways to reduce or hedge the farmer's business risk. This is a challenge that goes beyond tinkering with credit methodologies.
- Most of the successful rural finance is in areas that are densely populated and accessible. Getting services out to areas that are remote and sparsely settled will always be a problem for finance, just as for most other services. Not surprisingly, the few models that do it sustainably seem to grow slowly and to rely on the clients themselves to provide much of the retail management. Depending on evidence about impact, a respectable argument can perhaps be made for long-term subsidy of remote rural finance in some cases. On the other hand, it may also be useful to remember that the original meaning of the word "civilization" is "moving to the city."

2. Trust Funds. JD suggests that, if rural finance is going to be subsidized, the vehicle ought to be long-term "trust funds" so that the services being supported don't disappear in smoke at the end of each 5-year project cycle. This seems eminently reasonable. It also dovetails nicely with the current push by the Microcredit Summit to establish national wholesale funds everywhere as the predominant vehicle for supporting poor people's finance. As is often the case with eminently reasonable ideas, variants of this one have already been tried. So far, the results have been happy in a few cases and disappointing in most. The keys to success appear to be (1) the existence of a critical mass of competent retail lenders, (2) competent management of the wholesale fund, (3) de facto exclusion of the government from the fund's decision-making; and (4) the absence of disbursement pressure that forces fund managers to support weak retailers. Note that donor technical assistance has sometimes proved useful in helping strong retailers get stronger, but seldom succeeded in changing weak retailers into strong ones.

3. Can we donors clean up our act? It is hard to argue with the picture JD paints of donor involvement in rural finance:

--Our project quality has been generally bad in the past.

- Recent years have seen not only the emergence of more successful models but also improved donor awareness of sound practice principles.
- Nevertheless, the average quality of our financial services interventions—and not just the rural ones—is still distressingly low.

Why has better understanding of the right way to do things not led to a more dramatic improvement in project quality? In my experience, it comes down to skills and incentives.

Skills. It turns out that the quality of finance projects correlates fairly strongly with the knowledge level of the direct-hire donor staff involved. The notion that the necessary technical perspective can just be contracted out to consultants does not square with experience. Most of the good financial-services consultants I know are working on projects where the direct-hire donor manager is reasonably knowledgeable about the issues. Generalist donor staff with no background at all in finance have a hard time telling good consultants from bad ones, let alone managing their work.

In many donor agencies, even those with in-house financial specialists available, most of the credit is done as a component in a non-financial project (e.g., a social or community development fund). The staff designing and managing many of these project either do not know their agency's financial specialists, or consciously avoid involving them because the specialists' input tends to constrain the project designers' choices and makes it harder to get a project approved. The staff who are most likely to draw on help from good financial specialists—direct hire or consultant—are those who have had some basic orientation to good financial practice.

Such orientation makes a demonstrable difference. Without imagining that all problems have been solved, it seems fair to say that there has been a palpable improvement in the quality of USAID's credit projects over the past decade. I am aware of no great change in the agency's incentive structure that would explain this improvement. Rather, I think the improvement has been mainly due to the fact that large numbers of USAID staff have had some basic formal orientation—from a few days to a few weeks—in good financial practice.

Top managers of development agencies quickly learn that such agencies are hard to change, and in particular that new policy and strategy documents may be more likely to change the names than the substance of projects. The World Bank's decade-long struggle over its financial services policy directive is a sobering case in point. When I scratch my head for reforms that seem relatively practical to implement, training comes out high on the list. If I were the administrator of an agency and I were really serious about improving financial project quality, my first step would be to enforce a rule that no project that involved using donor money for credit could advance even to the earliest concept-paper stage unless the direct-hire staff responsible for the credit component had a minimum of two days of orientation to sound practice principles. (The marvelous CD-ROM-based course developed by Heather Clark at UNCDF would be an excellent vehicle for such training.)

Incentives. Even while arguing for more training, I fully accept JD's diagnosis that incentives are an enduring core problem. For donors who work with governments as clients, there is no getting around the fact that those clients need to worry about a lot of factors that have nothing to

do with good credit practice. And the rewards/penalties for good or bad project outcomes still pale in comparison with the incentives that individuals and offices have for getting projects approved. These incentive problems have been recognized and decried for years, but I know of no donor agency that had great success in altering them.

I agree with JD that improved transparency is the only avenue that offers much hope for changing this incentive structure. The two prongs of a transparency strategy would be reporting and external review.

If credit projects components were required at all their stages to report credibly on loan loss rates and financial sustainability, behavior would change.

External review can be powerful. By shining a spotlight on a hitherto-neglected aspect of our projects, private environmental organizations managed to force serious changes in the ways we donors do business. JD wonders (somewhat wistfully?) whether some external group such as a public-policy “think-tank” might take on such a role for financial activities. One wonders whether the issue of good financial practice will have enough appeal for such an organization to motivate it to embark on a crusade.

The dream that I prefer—though it is at least as subject to political feasibility questions as JD’s suggestion—involves the heads of a few agencies agreeing to establish and fund an external agency that regularly audits a random sample of their finance projects for compliance with some written set of sound practice principles, and publishes the results. Once a critical mass of donors joined such an effort, it would be politically embarrassing for the others to stay away.

Either way, those of us who have worked in donor agencies know that avoidance of public criticism is a powerful and effective incentive.

One thing is clear. If the staff and leadership of our agencies are not able to implement structural changes in the *rules* by which our financial-services business is done, then any rural finance conference reviewing our performance a decade from now will be telling a variant of the same sad story. If nothing changes, nothing changes.