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FINANCE FOR SMALL-SCALE COMMODITY PROCESSING:
FROM MICRO TO MESO FINANCE

AN INTERNATIONAL WORKSHOP

ORGANISED BY
THE COMMON FUND FOR COMMODITIES (CFC)

IN COLLABORATION WITH
THE GOVERNMENT OF SUDAN
AND
THE ARAB ORGANIZATION FOR AGRICULTURAL DEVELOPMENT (AOAD)

Commodity finance: a commercial proposition?

Micro- and Mesofinance for Agricultural Commodity Production, Processing and Trade

A baseline paper
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Abbreviations and acronyms

ACC	Agricultural Credit Corporation, Jordan
AFR	Agricultural Finance Revisited, FAO & GTZ
AgDB	Agricultural development bank
ANED	Asociación Nacional Ecuménica de Desarrollo, Bolivia
AOAD	Arab Organization for Agricultural Development
ASA	Association for Social Advancement, Bangladesh
AsDB	Asian Development Bank
AU	African Union
BAAC	Bank for Agriculture and Agricultural Cooperatives, Thailand
BK	Bank Keshavarzi/Agricultural Bank, Iran
BNA	Banque Nationale Agricole, Tunisia
BNDA	Banque Nationale du Crédit Agricole, Mali
BRI	Bank Rakyat Indonesia
CARD	Center for Agriculture and Rural Development, The Philippines
CECAM	Caisses d'Epargne et de Crédit Agricole Mutuelles, Madagascar
CFC	Common Fund for Commodities
CHF/JACP	Cooperative Housing Foundation /Jordan Access to Credit Project
CMF	Commercial Microfinance Ltd., Uganda
CNCA	Caisse Nationale du Crédit Agricole, Burkina Faso
COMESA	Common Market for Eastern and Southern Africa
CRDB	Centenary Rural Development Bank, Uganda
EBS	Equity Building Society, Kenya
EC	European Community
EKI	Ekonomska Kreditna Institucija, Bosnia
FAO	Food and Agriculture Organization of the United Nations
FECECAM	Fédération des Caisses d'Épargne et de Crédit Agricole Mutuelles du Bénin
FINCA	Foundation for International Community Assistance
GBA	Grameen Bank Approach
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH
HIID	Harvard Institute for International Development
IGA	Income-generating activity
IFAD	International Fund for Agricultural Development
IFI	Informal financial institution
IPC	Internationale Projekt Consult, Frankfurt
LDCs	Least Developed Countries
MABS	Microcredit Access to Banking Services
MEB	Micro Enterprise Bank, Bosnia
MFI	Microfinance institution
NABARD	International Bank for Agriculture and Rural Development, India
NGO	Non-governmental organization
NWFT	Negros Women for Tomorrow, The Philippines
PCFC	People's Finance and Credit Corporation, The Philippines
PAR	Portfolio-at-risk
R/MF	Rural and microfinance
ROA, ROAA	Return on (average) assets
ROE, ROAE	Return on (average) equity
SACCO	Savings and Credit Cooperative Organization
SHG	Self-help group
T-bills	Treasury bills
UMU	Uganda Microfinance Union
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UNCTAD	United Nations Conference on Trade and Development
USAID	United States Agency for International Development

1. Commodities and the role of the Common Fund for Commodities

Commodities, a mainstay of the economy

Commodities are a mainstay of the economies of most developing countries, providing food, income-generating opportunities and export earnings to at least 2.4 billion people directly employed in agriculture. LDCs are highly commodity-dependent; in Africa, more than half of the countries derive over 80% of their merchandise export income from commodities. Commodity-dependence has been aggravated by adverse trends: declining prices for primary commodities, higher input prices, deteriorating terms of trade, and high price volatility: a major factor of the steep rise of the numbers of poor particularly in sub-Saharan Africa during the 1990s. In its report on World Agriculture towards 2030[1], the FAO states that,

> *Seven out of ten of the world's poor still live in rural areas. Growth in the agricultural sector has a crucial role to play in improving the incomes of poor people, by providing farm jobs and stimulating off-farm employment.*

These adverse trends can only be reversed if more emphasis is placed on value addition, particularly through agricultural processing and efficient trade in commodities. Finance, ie, access to sustainable financial services, has a crucial role to play. All this falls under the mandate of the Common Fund for Commodities.

The CFC, promoting commodities[2] with a special emphasis on LDCs and the poor

The Common Fund for Commodities, based on an agreement concluded within UNCTAD in 1980, was established in 1989 and started operating in 1991 to address issues related to more efficient production, processing and trade in commodities. The Common Fund is an autonomous intergovernmental financial organisation of 106 country members and three institutional members (EC, AU and COMESA) within the framework of the United Nations. In contrast to most other international bodies, the CFC focuses on commodities, rather than countries or rural development and livelihoods enhancement in general. The Fund's comparative advantage of supporting solutions applicable on a wider scale has resulted in a large multiplier effect of each dollar spent.

Its main instrument are grants, which account for 84% of its overall assistance, supplemented by loans (16%). The Fund has played a catalytic role in attracting additional funds from other development institutions, the private sector and civil society organizations. This has resulted in a co-financing ratio of 51%.

Since 1991, the Fund has approved 114 regular projects, averaging US$ 3.0 million, and 43 fast track projects (mainly studies and workshops)[3]. The projects fall into four broad categories, the majority of them with an emphasis on the enhancement of value addition:

- Pre-harvest productivity improvement including research (35%)
- Post-harvest processing, marketing and quality testing (36%)
- Market expansion (26%
- Price risk management (3%).

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[1] Executive Summary, p. 2.

[2] The Fund lists 93 commodities that may be promoted. Among the 89 agricultural and related commodities are bamboo and rattan, bananas, citrus fruit, cocoa, coffee, cotton, fish, grains, hard fibres, hides and skins, jute, oils and oilseeds, rubber, sugar, tea, and tropical timber. There are four non-agricultural commodities: copper, lead, nickel and zinc.

[3] November 2002 data. The overall project cost are US$ 342.9 million, of which the Fund financed US$ 166.9 million.

Since 1998, the Fund has concentrated on the commodity concerns of LDCs and the poorer strata of the population, including smallholders and small enterprises. The projects have operating sites in approximately 100 countries:

- 43% in Africa,
- 26% in Asia
- 27% in Latin America and the Caribbean
- 4% in industrialised countries, with an emphasis on research and technology transfer.

The current Five-Year Action Plan, 2003-07, reconfirms the commodity focus and the concentration on LDCs and the poor. New elements include a supply-chain approach, impact orientation, diversification, more dissemination activities, an international advocacy role, and the establishment of Trust Funds and Partnership Agreements.

Completed projects have generally been found to have achieved their intended objectives, as for example in India where the Fund supported the adoption of new processing technologies by registered manufacturers of diversified jute products (DJP). This has resulted, over a four-year period (1992/93-1996/97), in an increase in turnover from $15m to $87m; and of employment from 21,000 to 53,000. More than 1000 small enterprises are now involved.

2. A conference at a crossroads: the old and the new world of agricultural credit and rural micro- and mesofinance

The old and the new world of rural finance: customer perspectives

You can tell a bank, or MFI, by looking at its customers: Does the bank make its customers unbankable, eg, by providing oversized medium-term loans and no deposit products as many agricultural development banks do? Does it keep them in poverty through standardized group loans without opportunities for accumulating voluntary savings or graduating to larger individual loans as many MFIs do? Or does it contribute to poverty alleviation and development by offering small and large loans, in addition to deposit facilities, along the commodity chain and for other purposes according to its customers' capacity?[4]

The first case is a customer of Centenary Rural Development Bank in Uganda. Centenary is a particularly interesting case because it took over 10 branches from Cooperative Bank, a failed government-owned AgDB. Where the AgDB failed, Centenary is making a profit – for its own benefit and that of its customers:

> ***The woman-entrepreneur who financed diverse micro-enterprise start-ups along the commodity chain through savings from farming and their expansion through credit:*** *Nandina Zauma is 35, married and has four children, 13-20 years old. In 1983, she started with a small rice farm. To protect her savings from inflation, she put up a building for a rice mill in 1992, continued saving and actually installed a mill in 1996 – all self-financed from the proceeds of her farm. Since 1999, she received four loans from Centenary, each amounting to Ush 2 million ($1,150). She first purchased a second mill, then expanded her produce trading operations, and finally bought two minibuses. During this 2½-year period, the total value of her business operations grew from Ush 6 million to 14 million ($8,000). She has two full-time employees and several contract laborers.*

[4] The case studies were done in 2001 as part of an IFAD study of *Women and Men in Microfinance* in Jordan, Syria and Uganda.

The following two case studies are from an agricultural finance institution in transition, ACC in Jordan, owned by the government. [5]The first case shows how supervised credit (for olives, in Tafila District) can go wrong, without repercussions on the prospects of the borrower to obtain further loans; the second case shows how credit from the same institution (for vegetable production, in Karak District) can be profitably used by a capable small entrepreneur:

> ***The man who keeps planting olive trees, which all dry up***
> *Omar* is 55 years old. He has seven children, 16-23 years old. In 1991 he received a first loan of JD 4,500 (US$ 6,345) with a maturity of 12-15 years from ACC for planting 300 olive trees and building a two-room house. The land is located on a dry plain, and the olive trees died. In June 1992, he received an 8-year loan of JD 6,000 from an ACC goat smallholder project, which is now fully repaid. In the same year, he planted another 250 olive trees – from his own funds, he says. These also dried up. In 1999, at a time of continued drought, he replanted another 150 olive trees, again from his own resources. In May 2000 he received a third loan from ACC: JD 1,500 to add two rooms to his house. Why does he keep planting olive trees which all die? "Without an olive tree project, I have to return the loan at once," he explained.

> ***Tamam, a successful horticultural entrepreneur***
> *Tamam* is 40 years old and unmarried. In the village of Zahoum, she plants vegetables in several large plastic-covered greenhouses, which she transports to the market in her own truck and sells to wholesale traders. She employes three workers. In 1995 she received a first mid-term loan of JD 4,000 from the ACC/IFAD Income Diversification Project to build the greenhouses. JD 800 remain outstanding. In 1997 she took a seasonal loan of JD 2,000 to plant vegetables. She has paid the interest; but as the loan fell under two government-directed reschedulings in 1998 and 2001, she has not repaid the principal. In May 2001, she took an Islamic (profit-sharing) loan of JD 8,543 with a maturity of 8 years to buy a tractor and install an irrigation system. Monthly payments are JD 45 for the 1995 loan and JD 116 for the 2001 loan. She lives on the income from her greenhouse operations. Due an oversupply on the market, prices for vegetables are currently (*mid-2001*) low, with monthly net profits of only JD 80 per month. At times of high prices, her monthly profit is between JD 300 and JD 500. She estimates the total value of her investment at JD 20,000 (US$ 28,200).

The old world of agricultural credit

During the first 10 or 12 years of its existence, the Fund has provided finance for the promotion of the commodity sector; but it has not directly supported local financial institutions to enhance their capacity of providing commodity finance from domestic resources. At the Fund's inception in 1980, commodity finance was largely in the hands of agricultural development banks. Many of them had been set up during the 1960s as instruments of capital transfer, with massive donor assistance – on the mistaken assumption that capital was all that was lacking.

At the time, during the 1950s and 60s and well into the 70s, there was international agreement on how to deal with low levels of agricultural productivity:

- Given the level of poverty in the underdeveloped world, international experts advised governments to subsidize interest rates.
- Given the level of illiteracy, international experts also advised government administrations to guide production through directed credit, with a strong emphasis on self-reliance in staple crops, supplemented by an emphasis on cash crops for export.

Thus, governments owned AgDBs, subsidized interest rates and prompted production decisions. In many cases, crops were planted because of the availability of inputs including

[5] The Agricultural Credit Corporation, is now in the process of being transformed into a bank, benefiting from Nenaraca's program on AgDB reform and the experience of other member institutions.

credit, not because soils were suitable and production was profitable. As a result commercial thinking was lacking, both in commodity production and commodity finance. Credit was scarce and was grabbed by small numbers of bigger farmers; outreach to the poor remained far behind expectations. Frequently, credit was provided to the wrong people (eg, with political connections) at the wrong time (eg, after the planting season) for the wrong purposes. Neither bank staff nor the farmers took agricultural credit seriously, which had evolved into a political affair. Repayment rates turned out to be abysmally low – except when tied directly to outgrower schemes and marketing boards - and became an eternal drain on government and donor resources. In the process, banks, farmers and agricultural credit were seriously and permanently discredited.

Due to the dismal performance of commodity finance and agricultural banks, many of the major donors, around 1980, were pulling out their support. They left a void; no other type of institution seemed ready to take over. The rural banking (*unit desa*) program[6] of Bank Rakyat Indonesia (BRI), successfully reformed into a self-reliant financial intermediary as of 1984, appeared promising, but was a singular case; its transformation from a sinking ship to a flagship of *rural* finance came only later to international light.[7] Approximately at the same time, the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, today the only flagship of *agricultural* finance, was neither viable nor self-reliant in terms of resources.[8] The newly emerging microfinance industry (a term that was only created in 1990) was neither ready nor significant. At the time, it had an urban bias and a donor bias towards credit NGOs. These belonged to the nonformal sector, were not authorized to mobilize savings as a source of loanable funds, and had therefore little potential for growth. Commodity finance was rarely on their agenda; not was it on the agenda of most emerging deposit-taking rural and microbanks The Fund was well-advised to stay away from that world of finance. Meanwhile, times have changed.

The conference on commodity micro- and mesofinance

Many commodity producers, processors and traders still lack access to microfinance services. The International Fund for Agricultural Development (IFAD) and the United Nations Capital Development Fund (UNCDF), for example, estimate that 500 million economically active people worldwide still lack access to financial services. Concerns regarding access to credit of small commodity producers, processors and traders were raised by the Common Fund's Working Group on Loans which met in the summer of 2000 to operationalise the Common Fund's loans policy. One of their subsequent recommendations was that a seminar should be organised by the Secretariat of the Common Fund on microfinance: "to put into place a mechanism to deal with all relevant issues of microfinance by the Common Fund and to elaborate how the Common Fund could best use the instrument of microfinance to assist small commodity producers."

In cooperation with the Arab Organization for Agricultural Development as host, the CFC is now holding this international conference in Khartoum on *Commodity Finance: From Micro- to Mesofinance for Agricultural Commodity Production, Processing and Trade*. The conference brings together existing positive experience in rural and microfinance and

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[6] Now reorganized and renamed as Microbusiness Division, the only (highly!) profitable division of BRI, with 3 million borrowers and 27 million savings accounts, to which the bank owed its survival during the Asian Financial Crisis.

[7] H. D. Seibel & P. Schmidt, How an Agricultural Development Bank Revolutionized Rural Finance: The Case of Bank Rakyat Indonesia. IFAD Rural Finance Working Paper No. B-5, Rome 1999/2000; K. Maurer & H. D. Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia. IFAD, Rome 2001

[8] K. Maurer, H. D. Seibel & S. Khadka, Agricultural Development Bank Reform: The Case of the Bank for Agriculture and Agricultural Cooperatives (BAAC), Thailand. IFAD Rural Finance Working Paper No. 6-B. Rome 2000.

addresses the challenge of how to extend that experience to the commodity sector in a regional dimension, particularly – but not exclusively - in Africa and the Near East.

The **focus** of the conference will be on new experience with *adding value* through finance for micro and small enterprises engaged in commodity production, processing and trade, with particular emphasis on agroprocessing. It is geared to two mutually reinforcing **objectives:**

- ✓ making agricultural and agribusiness enterprises more efficient and more profitable;
- ✓ making financial institutions more efficient and more profitable in providing financial services to the commodity sector.

A number of critical **issues** will be presented, such as the financing of institutions vs. the financing of activities; conducive policies for both the financial and the commodity sector; self-financing vs. debt-financing; scaling up from micro to small enterprise and from micro- to mesofinance. Participants will have the opportunity of discussing in depth how to match demand-side strategies for the enhancement of commodity-related enterprises with supply-side strategies for the enhancement of financial institutions and products. On that basis, we hope to arrive at new insights for local financial institutions as well as donors how to promote financial services for the benefit of hundreds of millions involved in the commodity chain and the local institutions financing them.

What at first sight appears as a return to the old world of agricultural credit with its focus on specific activities and commodities rather than financial institutions, regardless of profitability considerations, might turn out to be a major step in a new direction: exploring options for the new breed of sustainable financial institutions to finance profitable value-adding activities along the commodity chain that benefit both the investors and the financial institutions.

Among the supporting **financial instruments** are equity, quasi-equity, loans, leasing, warehouse receipts, guarantees and commodity price insurance. Other support may include research, capacity-building, and the establishment and enhancement of commodity-related networks and associations, and information dissemination through conferences and ICTs.

Together with the other participants, the Fund hopes to learn how the experience of institutions involved in microfinance could be applied to the further development of commodity production, processing and trade.

The conference comes at a time of reorientation from the old world of directed credit to a new world of sustainable financial institution building. Since the 1960s, directed agricultural credit has brought doom to many of the implementing agricultural development banks, failed to generate rural development and alleviate poverty, and undermined the emergence of sustainable national and rural financial markets. There is hardly a country which does not suffer the consequences until today.

Defining micro- and mesofinance

Microfinance is a term first introduced in 1990. Originally the term was meant to refer to small-scale financial intermediation comprising both microsavings and microcredit, moving away from a sole emphasis on credit. Meanwhile, the term has been used in many different ways, connotating, eg, microcredit, group credit or Grameen banking. To avoid this confusion, some, eg, CGAP, now prefer *microbanking* to connotate small-scale financial intermediation, but along commercial lines.

To the extent that only relatively poor people avail of small-scale financial services and bother to spend their time on weekly meetings or take repayments worth a few dollars directly to their MFI, microfinance also refers to the provision of financial services to low-income individuals, households and enterprises. For reasons of cost effectiveness, small

loans under microfinance are usually secured by collateral substitutes, including joint liability for group loans and informal, unregistered mobile collateral for individual loans. As collateral is informal, so is frequently the process of seizure. This represents one of the strengths of MFIs, as claims to formal collateral such as land can rarely be enforced through the judiciary.

MFIs are defined here as *formal, semiformal or informal institutions* providing financial services (microsavings, microcredit, microinsurance) of a scale significantly below those of commercial banks and to customers normally considered unbankable. Formal financial institutions, among them banks and finance companies, fall under a financial institutions law and are supervised by a financial authority such as the central bank or bank superintendency. Semiformal institutions, among them credit NGOs and most savings & credit cooperatives, are registered or otherwise officially recognized, but not financially regulated and supervised. Informal institutions of traditional or recent origin, among them self-help groups (such as rotating or accumulating savings and credit associations) and individual lenders or deposit collectors are neither officially regulated nor recognized, but may fall under customary law. Any such institution is referred to as a *financial intermediary* if it mobilizes deposits and transforms them into loans. An MFI is thus not a particular type of institution, but any type of institution offering small-scale financial services, usually to the poorer sections of society. Microfinance is thus not synonymous with credit NGOs!

With regard to loan size, there is usually a wide gap between MFIs and commercial banks, the former most likely averaging in the hundreds and sometimes lower thousands of USD and the latter in the tens or hundreds of thousands of USD and above. Agricultural and other development banks frequently offer medium or large-scale as well as microfinance services. There is no way of generally defining microfinance in terms of size, as there is wide variation between countries.

Mesofinance is a new term suggested here to connotate the next rung on the ladder of institutional size, referring to financial services beyond the scope of most MFI but still far below that of commercial banks. One implication is that, given a general reluctance against joint liability beyond a certain magnitude of loans, mesofinance mostly refers to individual loans backed by collateral rather than peer guarantees. Collateral may be formal or nonformal, but is likely to be more formal if larger and longer-term loans are involved.

The new world of rural and microfinance: institutional perspectives

In an increasing number of countries, there have been notable changes to varying degrees from the old world of directed credit to a new world of sustainable institution building. In this new world, governments make determined efforts to create conducive policy environments:

- with new legal forms for local financial institutions,
- deregulated interest rates, and
- prudential regulation and supervision of financial institutions,
- paralleled by a deregulation of foreign exchange and the trade regime.

Responding to the demands of their customers, institutions undergo reform and provide an array of savings and credit products for a wide range of income-generating activities, thereby generating the loanable funds and the profits needed for expansion. A number of agricultural and rural banks, cooperatives and other MFIs have learned to manage their risks by:

- diversifying their portfolio,
- analysing the investment and repayment capacity of the entire household,
- providing a range of appropriate financial services,
- starting small and granting repeat loans of increasing size,

- providing incentives to both staff and borrowers to enforce timely repayment,
- changing from group to individual loans and offering opportunities for graduation to larger loans as need be, and
- expanding into remote areas through linkages with self-help groups.

The transition from the old to the new world of rural and development finance, as described in the following matrix, is a challenging framework to any institution and donor agency aiming at sustainable development, including the promotion of commodities.

Table 1: From the *old world* of directed credit to the *new world* of financial systems development and institution-building in rural and microfinance

	Don't support :: *The old world of directed credit*	***Do support:*** *The new world of institution-building*
Policy environment	Financial repression	Prudential deregulation, fin. system dev
Legal framework	Lack of private local R/MFIs	New legal forms for local R/MFs
Develop't approach	Supply-driven	Demand-driven
Institutional focus	Monopoly institutions	Various competing financial institutions
Clients perceived as:	Beneficiaries	Customers
Selection of clients	Targeting by donors and governments	Self-selection
Outreach	Limited outreach to groups	Potentially all segments of the economy
Incentives	Perverse: leading to fund misallocation	Efficient allocation of funds
Non-formal FIs	Millions of informal MFIs ignored	Opportunities for mainstreaming
Semiformal FIs/NGO	No standards, no deposit mobilization	Conversion to deposit-taking formal FIs
Financial coops	Unsupervised, ruined by governments	Self-reliance; low costs, expansion
AgDBs	Lack of viability and outreach	Reforms towards autonomy, viability
Rural banks (RBs)	Lack of opportunities for private RBs	Legal framework for private RBs
Regulation and supervision (R&S)	Coops, MFIs, AgDBs unsupervised; donors keep distressed institutions alive	MF units in CBs; regulation of RBs/ MFIs; closing of distressed FIs
Commercial banks	Unable to lend to a variety of sectors	Some outreach to commodity producers and microentrepreneurs
Agricultural finance	Lack of self-financing; restricted credit according to government directions	Self-financing from savings; external financing for profitable investments
Commodity finance	Restricted to production of selected crops	Available for profitable production, processing, trade
Remote and marginal areas	Futile attempts of donors to drive ill-suited MFIs into remote areas	Self-managed savings-based SHGs and cooperatives operating at low cost
Individual and group technologies:	Rigid replications without growth of outreach and sustainability	Both can be profitable and reach microentrepreneurs and the poor
Non-financial services	Maximalist approach without cost coverage undermines FIs	Provided by SHGs, other agencies, FI subsidiaries; balance of objectives
Targeting	Undermines outreach and viability	Differentiated financial products
Linking banks and SHGs/MFIs (LBS)	Lack of healthy banks with a mandate to be of service	Spectacular increase in outreach to the poor; profitable if interest rates are free
Interlinked schemes	Lack of institutional sustainability	Ltd.success under controlled conditions
Self-reliance	NGOs, AgDBs barred from deposit-taking; donor and gov. dependency	Self-financing through deposits and profits; institutional autonomy
Sustainability	Donors, gov. fail to insist on perform-ance standards and sustainability	Increasing numbers of self-sustaining institutions of any type and ownership
Access to financial services	No access of many poor and non-poor to savings, credit, insurance	Sustainable access of the poor as users and owners of R/MF institutions

The challenge:
taking commodity finance into the new world of micro- and mesofinance

This transition to a new world of finance, as promising as it looks, has only just started. Neither does it cover all developing countries; not does it cover all institutions and spheres of

the economy in those countries where it has commenced. In most countries, the situation is highly complex and frequently contradictory. Eg, failing and prospering institutions may exist side by side; governments pass laws on market-driven institutions, yet continue subsidizing the interest rates of others; agricultural development banks and commercial banks – facing high minimum reserve requirements and and high T-bill rates and plagued by weak lending technologies - may produce huge amounts of excess liquidity, yet the government borrows money from international donors and increases its external debts. On the whole, despite all the promising beginnings, the rural areas and the wide field of commodity finance have been least touched by these changes. Once it was savings[9], now it is agricultural credit that is *the forgotten half of rural finance*. There lies an enormous underutilized potential!

3. Lessons taught by international experience: What matters in micro- and mesofinance?

Due to the overall failure of donor-driven directed credit, the emphasis in development policy has shifted to (rural) financial systems development and the building of self-reliant, sustainable institutions. Regardless of ownership, type of institution, rural or urban sphere of operation and target group, financial institutions ultimately all have to accomplish the following:

- mobilize their own resources through savings
- have their loans repaid
- cover their costs from their operational income
- earn enough profits to offset the effects of inflation
- finance their expansion from their profits and savings mobilized.

Box 1: Requirements of sustainable micro- and mesofinance
Sustainable financial institutions mobilize their own resources, provide financial services according to demand, cover their costs from their operational income, have their loans repaid, make a profit, and finance their expansion from deposits and retained earnings. *Resource mobilization* comprises equity, savings deposits, retained earnings and commercial borrowings, augmented by external resources such as soft loans and grants. Of these resources, three are fundamental to self-reliance and dynamic growth: savings deposits and equity including retained earnings. *Financial services* comprise credit for various purposes and savings deposit facilities; they may further include money transfer, check clearing and insurance. Insurance may serve the triple function of borrower protection, loan protection and resource mobilization. *Sustainable institutions* need an appropriate legal status which authorizes them to carry out all these functions; and they need to be properly regulated and effectively supervised. *Financial systems development* comprises processes of establishing a conducive regulatory environment (including a legal framework, prudential norms and effective supervision), an adequate infrastructure of viable small and large financial institutions, adequate demand-oriented financial products and good operational practices.

In addition to these fundamentals, a wealth of lessons have been taught by international experience, but not always learned by donors and governments. The lessons are complex and are presented in more detail in the background paper, but for actual implementation require further reading of the reference literature and selected exposure visits.

What matters to the poor:

- *First of all, client experience matters.* Clients have experienced in projects that credit can make them poorer or richer
- *The poor themselves matter … and so do the non-poor.* Their autonomy in self-selection, instead of targeting, should be respected, also on separate vs. mixed institutions of women and men

[9] Robert Vogel, Savings Mobilization: The Forgotten Half of Rural Finance. Pp. 248-265 in: D.W.Adams, D.H. Graham & J.D. Von Pischke, Undermining Rural Development with Cheap Credit. Westview Press, Boulder 1984.

- *Access to savings and credit matters* – far more than interest rates.
- *Rural enterprise viability matters* and is mutually reinforcing with R/MFI viability.
- *Household portfolio diversification matters*; but group enterprises have usually failed.

What matters in terms of origin, history and culture:

- *Informal finance matters,* particularly in the form of self-help groups (SHGs). Upgrading and mainstreaming through networking and linking them to banks are two ways in which donors can support expansion of outreach and financial deepening.
- *History matters.* MFIs in Europe, since 1720, have started from informal beginnings and evolved, through appropriate regulation and supervision, to cooperative banks and savings banks. Microfinance is not a poor solution for poor countries!
- *Crisis matters.* Financial innovations typically emerge in response to crisis.
- *Development matters:* Microfinance is no panacea; it requires a climate of broader development to be fully effective
- *Culture matters.* Development from above, through the established authorities, is more effective in hierarchical or closed societies; development from below, through participatory processes, is more effective in segmentary or open societies.

What matters at the level of financial systems:

- *Financial systems matter.* Donors can contribute to that evolution, but only in a long-range perspective and in a donor-coordinated and goal-oriented manner.
- *Financial sector policy matters,* particularly interest rate deregulation.
- *The legal framework matters.* Appropriate legal forms allow people to establish their own financial institutions in private, cooperative or community ownership.
- *Capital matters,* but should be mainly used in bridging temporary shortages in funds
- *Savings matter,* as a service to the poor and as a source of loanable funds.
- *Financial intermediation matters:* savings-first for low-yielding activities; and credit-first for high-yielding activities - depending on the rate of return.
- *Interest rates on deposits matter*, preventing the erosion of capital
- *Interest rates on loans matter*, covering all costs.
- *Institutions matter* (projects don't, providing continuity and efficiency. Donors must abstain from perverse incentives which enable institutions to maintain unviable operations.
- *Competition matters*, entailing institutional diversity and pressures to perform.
- *Prudential regulation and supervision matter*, requiring the political will and institutional capacity to enforce standards in rural banks, SACCOs, AgDBs, other R/MFIs.
- *Knowledge matters.* Effective knowledge management Is urgently needed.

What matters at the level of institutions:

- *Institutional reform matters:* There are striking cases of reform of very different types of institutions, with great benefit to the poor, leaving no excuse for continual support to unviable institutions.
- *Ownership and institutional autonomy matter;* but management autonomy in terms of customer selection and loan decisions may be more important than ownership
- *Viability, efficiency, sustainability and self-reliance matter.* Donors should support domestic resource mobilization, cost-effectiveness, and profitability.
- *Saver and borrower outreach matter,* which is compatible with sustainability.
- ***Sustainable outreach to marginal rural areas*** requires support for the primacy of savings and self-financing; and of member-owned SHGs operating at low costs.
- *Lending technology matters* – and should not be a matter of ideology: *g*roup technologies for the very poor; Individual technologies for *graduating* to larger loans .
- *MFI portfolio diversification matters* as a risk management strategy.
- *Good practices matter, not best practices,* which lead to inappropriate replications.
- *Institutional size matters.* There is no *best practice* in terms of size, both small and large institutions can be feasible.
- *Profits matter,* as a source of capital and a major determinant of growth of outreach.

- ➢ *Incentives matter, as* a major determinant of quality of performance and profits.
- ➢ *Repayment matters.* Many institutions now know how to reach repayment near 100%.
- ➢ *Financial products and delivery systems matter:* demand-oriented and cost-effective.
- ➢ *Loan protection matters.* Insurance is a service, but also part of loan protection.

4. Financial technologies: group vs. individual

The financing of agricultural processing and its related activities – production and trade – faces two technologies: group or individual. Lending technology is widely a matter of ideology, each with its own adherents, justifications, donors and conventions. Prominent proponents of the individual lending technology are USAID and HIID (with BRI as one of their disciples, after a disastrous experience with group lending during the days of directed credit) and Frankfurt-based IPC with its microenterprise banks (with Centenary RDB as one its disciples and numerous offsprings in Eastern Europe and the Balkans). Among the proponents of the group technology are the Grameen Bank and replicators, FINCA's village banks, the majority of NGOs, and, still to a large extent, the Microcredit Summit. However, choice of technology should not be a question of ideology but of proven practice. Either one can be done well or poorly; each is a particular form of social capital, with has its strengths and weaknesses – and its realm of applicability.

Sound individual technologies are based on the following: the analysis of the total household as a complex IGA entity; an incentives-driven repeat loan system, providing access to lower-interest *automatic loans*; flexible but comprehensive loan security requirements, including mobile and immobile collateral; and stringent enforcement of timely repayment, backed up by a system of computerized daily loan tracking, instant recovery action and seize of collateral (such as a cow, refrigerator, bicycle), customer incentives, and staff performance incentives at all levels of the bank.

An example is Centenary RDB, which was reformed by IPC . There are numerous other examples, including Equity Building Society in Kenya and most rural banks in Indonesia and the Philippines. One of them is **New Rural Bank of Victorias** on Negros Island, which has experimented with AsDB/IFAD-supported Grameen banking and USAID-supported individual lending. Unlike Enterprise Bank (see below), it found individual lending profitable and group lending a failure.

Sound g**roup technologies** vary widely. Many so-called group lending approaches do not involve lending to groups as legal borrowers, but lending to individuals through solidarity groups with joint liability, as in the case of BAAC in Thailand. The group technology with the widest outreach world-wide is *Linking Banks and Self-Help Groups,* practiced in various countries in Asia and Africa, linking either existing SHGs (as in Indonesia and Nigeria) or newly established SHGs (as in India) to banks. In Indonesia, by 1998, 800 rural banks and 16,000 SHGs of both men and women, poor and non-poor, were involved, without external capital funds. The largest outreach is in India, again without external capital influx, involving 702,000 newly established SHG (predominantly of very poor women) with 12 million members and a population of 60 million of India's poor behind them, linked to some 20,000 bank branches refinanced by NABARD (*March 2003 data*). What distinguishes linkage banking from other group approaches is the treatment of SHGs as autonomous local financial intermediaries, selecting their borrowers, carrying out creditworthiness examinations and determining their own interest rates and other loan terms. Linkage banking is closely related to upgrading of SHGs to semiformal or formal financial institutions as a follow-up strategy.

The best publicized group approach is that of the Grameen Bank, which evolved in Bangladesh under conditions of financial repression. Its success is explained by its social capital, a self-regulated normative framework which prescribes its operations in detail[10]:

- a focus on poor women, gathering detailed target group information and using rigid selection criteria to bar the non-poor from access to its services
- organizing the prospective borrowers in groups of five and centers of about six groups each which in turn come under a Grameen branch
- a credit-first program design, initially financed with donor or government funds
- internal resource mobilization through a compulsory savings component, supplemented by external donor or commercial resources
- reliance on peer pressure and joint liability of solidarity groups as a special type of risk management, which allows Grameen to lend without collateral
- strict credit discipline with absolute insistence on timely repayment (except during natural disasters)
- weekly center meetings with compulsory punctual attendance, where a pledge is sung and payments are transacted with a Grameen branch officer in the presence of all members
- special conditions of financial contracts, comprising a series of one-year repeat loans to individual borrowers at market rates of interest, starting small (around $50) and, contingent upon the group members' repayment performance, growing bigger in predetermined steps and amounts, repayable in weekly instalments, with a five percent up-front deduction to be paid into the group's emergency loan fund
- adoption of Grameen's *Ten Decisions* of personal discipline to be followed in one's daily life, such as growing fruits and vegetables in the backyard; abstention from drinking, smoking and gambling; improving one's housing; building latrines; safe drinking water for better health; investing in the children's education
- intensive training of members and staff to adopt the attitudes, practices and underlying norms and values of the Grameen approach.

Many NGOs in various countries have replicated Grameen, none with Grameen's national scale and legal status of a national bank; only few have achieved satisfactory outreach and sustainability. Grameen replication in the Philippines during the first half of the 1990s was largely a failure. This changed after PCFC, with support from AsDB and IFAD, provided liquidity amounting to $34.1m to replicators, comprising NGOs, cooperatives, rural banks, rural cooperative banks and thrift banks. Lending is for productive purposes only, with a main emphasis on rural microenterprise activities such as ***processing and trading***. 162 MFIs have adopted GBA as a financial product, on-lending funds at widely varying commercial interest rates designed to cover all costs and allow for a profit. For 436,000 microenterprise clients – 98% of them women, –, they provide access to financial services. Most collection rates of participating MFIs are in the range of 94%-100%, averaging 96.2%. The original emphasis on NGOs and cooperatives has shifted to banks, particularly rural banks, while some of the major NGOs involved have themselves established banks. Much of the success is due to three factors: the insistence on profitability resulting from high interest rates, high repayment rates and large outreach; flexibility and innovation; and a shift to rural banks as the strongest intermediaries.[11] (IFAD 7/2002)

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[10] From CARD Operations Manual. CARD Research Unit, San Pablo City, The Philippines, 4/1998
[11] An example is Producers Rural Banking Corporation with12 branches. In four years, it built up a clientele of 12,519 Grameen borrowers with loans outstanding (73% of its total borrowers; 13% of total

Beyond ideology: The evidence from various developing countries shows that both individual and group technologies can either fail or succeed; each one can be done well or poorly. The two technologies are complementary, as each has its own weakness:

- in the case of Grameen banking (but not linkage banking): limitations of loan size and resistance against joint liability for other than very small loans;
- in the case of individual lending: limitations of outreach.

Group technologies with joint liability function only at the level of small loan sizes. A way out found by banks and cooperatives in the Philippines is graduation, combining initial group lending with opportunities for graduating to larger-scale individual loans for the more enterprising poor.

5. Supply-side issues: lack vs. abundance of finance for commodity-related investments

Lack of finance for commodity-related investments in most cases…

There are stark contrasts in the problem situation between different areas and institutions. The first issue pertains to the availability of finance for activities along the commodity chain. There are two basic problems here: one is the lack, the other one the abundance of financial resources, both resulting, paradoxically, in a lack of resources for commodity finance.

In many areas, there is:

- *a lack of loanable funds,* or an absence of financial institutions willing or able to lend for agriculture and the commodity chain; if one of the major rural market segments – commodity producers, rural industries, or traders – has no access to finance, the whole rural economic sector suffers.

Most AgDBs and credit NGOs are not authorized to collect voluntary savings; others have an inadequate branch and agency network, like the Agricultural Cooperative Bank in Syria; or they refuse to accept savings because they are afraid of losing them, like ACC in Jordan. As FAO & GTZ stated, just at a time of expanding market conditions for agriculture, "the number of donor-supported agricultural credit programmes is in decline and there is little evidence, in many countries, that governments or commercial financial intermediaries are compensating for the reduction in supply of loanable funds to agricultural production, processing, and marketing."[12] As noted by the Common Fund, agricultural input finance has been declining since the early 1990s as a result of liberalisation and the dismantling of commodity boards. This has led to a reduction in agricultural production and yields, deterioration in quality,

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loans outstanding) and 21,000 Grameen depositors (41% of its depositors; 4% of total deposits). Producers Bank is one of the few which has calculated the profitability of the Grameen product: its ROA on Grameen operations is 5.3%, and on non-Grameen 1.5%; its ROE on Grameen is 105.6% and on non-Grameen 11.2%. Producers Bank uses Grameen banking as an instrument for the vigorous expansion of its branch network and has proposed *Franchising Grameen* as a BOT strategy. Another case is Enterprise Bank, with 8 branches and 10 satellite offices. Like New Rural Bank of Victorias, it has experimented with both individual lending under USAID/MABS and Grameen lending under PCFC, but with different results: Among its 20,944 borrowers are 14,540 under GBA (69%; 41% of loans outstanding) and 842 under MABS (4%; 5% of loans outstanding); past-due rates are 1.0% under Grameen and 5.6% under MABS (3.2% consolidated); in 2001, 60% of profit were derived from microlending, virtually all of this from Grameen banking.

[12] FAO & GTZ, Agricultural Finance Revisited: Why? AFR No. 1, June 1998, p. iii

reduced investments, a decline in income of small producers, and an aggravation of poverty.[13] In many cases, rural financial institutions give preference to financing those commodities which allow for deduction at source within a single-channel marketing system; among them are BNDA in Mali, CNCA in Burkina Faso, FECECAM in Bénin and the SACCOs in Kenya. Once the single-buyer privilege (*monopsony*) is abolished, seasonal finance dries up. There is anecdotal evidence (as in our first case study above) of a tendency for farmers to finance (low-yielding) agricultural investments from savings and use expensive credit for high-yielding non-farm investments, including agricultural processing. We hope that institutions or countries will learn from conference participants:

- How to mobilize savings as a source of loanable funds
- How to access capital markets as sources of refinance
- How to introduce competitive rates of interest on deposits and loans
- How to have their loans repaid and make a profit
- How to manage their risks through portfolio diversification (including commodies), total household analysis, and instant information and action on arrears.

… vs. abundance of finance in some cases

In contrast, in a number of other cases, there is

- *an abundance of loanable funds* due to successful savings mobilization.

In many rural institutions offering financial products without a credit bias, the ratio between borrowers and savers is between 1:6 and 1:10; and deposits exceed loans outstanding. This excess liquidity, though generated in rural areas, is thus not available for commodity finance and other purposes; instead, it is siphoned off to urban areas.

> *The case of BRI:* A prominent case in Asia is the Microbanking Division of Bank Rakyat Indonesia, a government-owned AgDB. Reformed in 1984, it shifted from social to commercial lending and from group to individual technologies. Thereby, it expanded its outreach from 700,000 subsidized borrowers in 1983 to 3 million borrowers at market rates and 27 million savings accounts in just 20 years. The Division is highly profitable: Its portfolio-at-risk (PAR) is a mere 2.3%, its return on average assets (ROAA) 1.6%.[14] However, since the mid-1990s, its excess liquidity has exceeded one million US$ every year; its lending ratio (loans/deposits) in 2001 was 41%.[15] Profits and deposits generated at village level are siphoned off.

> *The case of Centenary Rural Development Bank:* CRDB in Uganda, with a sizeable agricultural lending program, has a similar experience. With reforms started in 1993, it has mastered the art of rural banking, with a portfolio-in-arrears ratio (PAR) between 2.1% and 3.1% during 2000-02 – and a lower-than-average PAR in its chief agricultural branch in Mbale, which focusses on coffee; its ROAA in 2002 was 4%, its return on average equity (ROAE) 27**%.** It has 31,500 borrowers with a volume of $ 23.05m loans outstanding and ten times as many depositors, namely 316,650, with $ 48.7m in deposits (Dec. 2002). In 2002, the bank added mesofinance to microfinance and succeeded in increasing its lending ratio from 35% in 2001 to 47% in 2002, while 99% of its customers remained in the micro bracket.[16]

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[13] CFC Annual Report 2001, Amsterdam, p. 159.
[14] H. D. Seibel & P. Schmidt, How an Agricultural Development Bank Revolutionized Rural Finance: The Case of Bank Rakyat Indonesia. IFAD Rural Finance Working Paper B5, 1999/2000;
W. Hiemann, Case Study BRI, Indonesia. Pp. 71-134 in GTZ, The Challenge of Sustainable Outreach. GTZ, Eschborn 1/2003.
[15] Eg, US$ 1.27 billion in 2001 (deposits US$ 2.16 billion; loans outstanding US$ 0.89 billion).
[16] H. D. Seibel, Centenary Rural Development Bank, Uganda: A Flagship of Rural Bank Reform in Africa. Small Enterprise Development Journal 14, no. 3 (Sept. 2003), pp. 35-46

We hope that such surplus institutions will learn from conference participants:

- How to combine group and individual technologies (like Commercial Microfinance Ltd. in Uganda) or to link up with SHGs to increase outreach to both the poor and the non-poor (like the rural banks in India and Indonesia and Union Bank in Nigeria)
- How to develop appropriate financial products, including tied savings-cum-credit products (like the Banque Nationale Agricole in Tunisia), term loans (like BAAC in Thailand), leasing (like agricultural banks in Sudan), warehouse receipt-financing (as in Ethiopia and Zambia, with support from the CFC)
- How to diversify their portfolio to include commodity finance (like Equity Building Society, a commercially operating MFI in Kenya)
- How to move from micro- to mesofinance to increase the lending ratio (like Centenary RDB).

In sum, the major outstanding supply-side issues are:

- ✓ How to step up savings mobilization as a source of self-financing for financial institutions as well as for farmers and microentrepreneurs
- ✓ How to increase outreach to the poor and non-poor, including producers along the commodity chain
- ✓ Portfolio diversification of institutions and of farmers and microentrepreneurs, comprising activities along the commodity chain and non-farm activities
- ✓ Extension of deposit mobilization and lending from micro- to mesofinance, including the flexible use of group and individual technologies for commodity finance
- ✓ How to manage commodity-related risks.
- ✓ How to build links with non-financial institutions to ensure the availability of inputs, output marketing and other support services
- ✓ How to use non-conventional forms of collateral, such as warehouse receipts and crop hypothecation in an era of economic liberalisation.

As an outcome, different bundles of lessons might emerge for different stakeholders: producers, agribusiness, financial institutions, governments, donors and farmer organizations.

6. Agricultural finance: how to manage its risks

Is agricultural (micro- and meso-) finance really risky and unprofitable?

There is no doubt that agricultural and commodity finance face high levels of risk: climatic, economic, technical and political. These risks may be covariant, affecting many borrowers in a given area. For reasons of risk management, farmers may prefer traditional agricultural varieties and practices which less profitable but also less hazardous. These may be paralleled by modern cash crops which promise higher profits but are also more hazardous. Furthermore, the budgets of farmers and microentrepreneurs are integrated into their household budgets, and expenditures for agricultural and non-agricultural, consumption and social purposes may be closely linked. In a number of cases, the belief of CEOs and donors in unsurmountable problems of rural and commodity finance has turned into a *self-fulfilling prophecy*, either by categorically excluding this type of finance, or when giving it a try, failing because loan officers are not experienced and not convinced.

If one moves up the scale from micro to meso, the situation changes. There is a trade-off between diversification and specialisation. Access to global markets requires producers to specialise, adopting high-yielding varieties and benefiting from economies of scale. They may have to adopt risk pooling mechanisms (eg, insurance, price stabilisation funds, futures) instead of diversifying into a range of small scale activities. Non-financial institutions and governments may have an important role to play in this kind of risk management to facilitate

investments in the commodity sub-sectors and to stimulate the flow of finance from the private sector.

Some flagships of rural and agricultural micro- and mesofinance[17]
Experience around the developing world shows that virtually any type of financial institution, including commercial banks staying away from agriculture, can fail in the face of bad policy or bad management. On the other hand, experience also shows that any type of rural financial institution, once reformed and well-managed, can provide finance in a profitable and sustainable way for a variety of activities including those along the commodity chain – some with a stronger emphasis on commodity production, others on processing and trade. Among these are:

- ✓ AgDBs like BNDA in Mali and CNCA in Burkina Faso (both with monopsonistic relations to organised commodity sectors), BNA in Tunisia, BK in Iran, BRI in Indonesia, BAAC in Thailand
- ✓ Rural and community banks, eg, in Nigeria, Ghana, Tanzania, the Philippines and Indonesia
- ✓ Commercial mesobanks like Centenary RDB in Uganda, CMF in Uganda, EBS in Kenya, Banco Caja Social in Colombia, Bank Dagang Bali in Indonesia, Micro Enterprise Bank (MEB) in Bosnia
- ✓ Financial cooperatives like SACCOs in Kenya and Tanzania, credit unions in Madagascar, People's Credit Funds in Vietnam, savings and credit cooperatives in the Philippines
- ✓ NGOs like CHF/JACP in Jordan, UMU in Uganda, EKI in Bosnia, ASA in Bangladesh
- ✓ Credit-NGOs establishing banks like K-Rep in Kenya, CARD and others in the Philippines, Bina Swadaya, Purba Danarta and others in Indonesia, and, soon, in Uganda
- ✓ Member-owned village funds like sanadiq in Syria and SHGs linked to banks in India and Indonesia.

Finance as a commercial proposition

For these institutions and their customers, rural and agricultural finance has turned into a commercial proposition. Their experience has demonstrated that the social and economic objectives of rural and agricultural development are best achieved not by charity, but by financial relations between institutions and their customers based on commercial principles: mobilizing financial resources locally; having their loans repaid; covering their costs; and financing the expansion of outreach from deposits and retained earnings. Such institutions may profitably include commodity finance: not as their sole objective, but as part of a commercially balanced portfolio. The frontier of finance lies in a progressively extended balance between purely commercial and developmental objectives. It is hoped that, as financial institutions contribute to the growth and profitability of small and microenterprises along the commodity chain, their loans to that sub-sector increase in size and profitability; and what may appear as social banking at the onset turns into commercial banking.

Risk management strategies in rural and agricultural finance

The issue is thus not whether rural and agricultural finance face particular problems, but that these problems are surmountable and have in fact been solved by a number of institutions, some of which are present in this conference. These institutions have developed a range of risk management strategies for the financing of agricultural and other rural investments,

[17] In this context, the term microfinance institution (MFI) covers all institutions which provide microfinance services; in addition, such institutions – eg, AgDBs – may also serve big customers such as big farmers, plantations and rural industries.

including those along the commodity chain. A detailed list, which should be of particular interest to rural and agricultural finance institutions, is presented in Annex 1. Some illustrations of risk management strategies are given below:

Managing systemic risks:

Co-variance of risks:	Portfolio diversification
Weather-related risks:	Expansion of outreach to wider area and different crops
Market-related risks:	Contract farming; commodity price risk insurance
Policy –related risks:	Policy dialog and policy adjustment
Political risks:	Insisting on institutional autonomy

Managing idiosyncratic customer risks:

Adverse selection:	Incremental lending based on track record
Moral hazard:	Rigid loan examination, monitoring and enforcement
Financial technology:	Graduating from small group loans to larger individual loans
Investment failures:	Spreading the risk through household diversification
Inadequate customer self-financing capacity:	Providing opportunities for savings accumulation
Inadequate skills:	Linking financial services with training and technical services (BDS)

M***anaging credit risks:***

Loan examination:	Meeting solvent demand only; establishing total track record
Loan terms:	Appropriate loan sizes and disbursement times
Timely repayment:	Customer incentives for timely repayment ; instant recovery action
Lack of collateral:	Warehouse receipts; non-formal collateral; joint liability
Lack of enforcement:	Cooperation with local authorities to enforce repayment
Staff ability:	Capacity building through training, distance learning, exposure training
Institutional efficiency:	Rationalizing products and procedures
Financial innovations:	Market research; pilot-testing of new products
Access to internet resources:	http://www.common-fund.org; http://www.cgap.org; http://www.fao.org/ag/ags/agsm/RuralFinance; http://www.ifad.org

Managing transaction costs:

Remote areas:	Linking with SHGs; outgrower schemes
High operational costs:	Wholesaling; economies of scope through savings, credit and insurance
Tied lending:	Financing provided through corporations

Managing resource risks:

Inadequate equity:	Equity participation by customers
Inadequate funds:	Mobilizing savings; refinancing on national capital markets
Interest rate risks:	Matching fixed vs. variable interest rates of assets and liabilities
Liquidity risks:	Liquidity exchange
Lack of term finance:	Increasing equity and quasi-equity; promoting term savings
Donor funding:	Inviting equity participation, term loans, bridging loans

Managing legal and institutional risks:

Lack of legal framework:	Introducing appropriate legislation for rural banks and other MFIs
Absence of lobbying:	Enhancing networks and associations of financial institutions
Lack of R&S:	Promoting effective regulation & supervision of rural banks, AgDBs, MFIs
Lack of collateral:	Liberalizing collateral legislation

7. Demand-side issues: abundance vs. dearth of opportunities for commodity-related investments

Abundance of opportunities for commodity-related investments…

Similar to the stark contrasts between different areas and institutions concerning the availability of finance, there are equally stark contrasts concerning the ability of rural people to find profitable investments along the commodity chain and others. In many areas, there is:

➢ *an abundance of investment opportunities and entrepreneurship* relative to the available finance.

Of course, this is the same as saying: *there is a lack of finance for the existing demand,* be it ample or limited. Thus, most institutions entering, or willing to expand, rural and agricultural finance will find a considerable amount of unsatisfied actual and potential demand, particularly for micro and small investments along the commodity chain. The challenge is to enhance products and procedures to expand outreach beyond top-level clients. These institutions will greatly benefit from the experience of the institutions and agencies represented at this Conference and their risk management strategies as reported above.

➢ *Spreading the existing experience* is thus the most promising strategy for rapidly expanding outreach to large numbers of the poor and other segments of the rural economy.

…vs. dearth of investment opportunities – a new challenge

Given the growth of savings, profits and other loanable funds in increasing numbers of rural microfinance institutions including some AgDBs, augmented by donor funds for poverty alleviation, there is a new tendency now for existing loanable funds to chase a limited number of rural entrepreneurs and investment opportunities. Thus, in a number of areas, there is:

➢ *a lack of investment opportunities and entrepreneurship* relative to the available finance.

Situations differ widely and pertain to all levels of investment size: from micro to small and medium. In some high opportunity areas, eg, in West and East Africa, MFIs now start reporting "too much competition", which would of course be diminished if new investment opportunities could be opened up. In other areas, as in the Philippines, rural banks and other MFIs engaged in poverty lending on a commercial basis do very well with microloans for microinvestments, using the group lending technology. However, graduating clients to larger individual loans at lower interest rates has proven difficult. Rural banks have a strong interest deepening their outreach by helping clients across the poverty threshold with bigger loans, but are facing a lack of demand. Reasons may be variegated:

- profitable investment opportunities are not directly available;
- the rural poor are unable to take advantage of existing opportunities;
- or they are unwilling to face the substantially higher risks of bigger and longer-term loans;
- processing technologies are either lacking,
- or technological consulting services, agricultural extension services and business development services fail to reach down to the local level;
- financial products are not tuned to the cash flow of investors;
- markets are currently depressed, and investors disinclined to take on new risks.

There is thus an increasing need for developing new technologies, investment opportunities, market linkages, and local entrepreneurship. Over the past decade, microfinance has focused on the supply-side, particularly the enhancement of sustainable financial services. There is some discussion about Microfinance-Plus, ie, financial plus non-financial services. But most MFIs have been hesitant, despite tempting donor offers, to take on non-financial responsibilities, which may range from agricultural and technological advice to health and educational services. They would rather prefer to link up with other agencies supplying such services.

8.. Responding to the challenges of commodity finance and development

In contrast to MFIs, the Common Fund has mainly (though not exclusively) focused on the demand-side, seeking solutions for a range of problems pertaining to pre-harvest productivity improvement, post-harvest processing, marketing and quality testing; and market expansion. This is in line with what we have called:

- *The New Challenge: promoting investment opportunities along the commodity chain.*

How the Common Fund has promoted investment opportunities…

Here are three examples how the CFC has promoted investments along the commodity chain:

- **Improvement of Fonio Post-Harvest Technology:**

Fonio is a neglected traditional cereal grown in Sahel countries like Burkina Faso, Guinea and Mali, where governments are counting on the development of locally-grown food crops to reduce trade imbalances and external dependence. In 1997, the CFC has approved a project to stimulate production and consumption of fonio by improving post-harvest handling and processing. Project components include improvement of post-harvest handling, processing techniques, the local designing and manufacturing of fonio machines, training of operators, urban and export marketing, and the dissemination of information on fonio post-harvest systems at national and regional levels. Beneficiaries have included craftsmen, who ensure local manufacture and distribution of the machinery, and microentrepreneurs, mostly women, who do the processing and marketing in rural and urban areas, furthermore farmers who increase their production and urban consumers.

- **Production and Marketing of Value-Added Fishery Products:**

Nile perch has become a major semi-processed export commodity of the three countries adjoining Lake Victoria, Kenya, Tanzania and Uganda, amounting to 150,000 tons per year. Only higher quality at all stages from catch to end product can improve expert earnings and ensure sustainable employment and income to the artisanal fishermen. In 1999, the CFC has approved a project promoting sophisticated value-added products and processing technologies. This is being complemented by support for market research on commercial production and quality control. In addition, the project supports microfinance for the promotion of processing and marketing of declining traditional species (*dagaa*) for domestic consumption.

- **Adding Value to African Leather:**

Leather is an important export product in eastern and southern Africa. Earnings depend very much on the quality of leather and leather products. In 2002, the CFC approved a project to improve processing after the tannery stage in Ethiopia, Kenya, Sudan and Zimbabwe. The project strengthens trainings institutes with special equipment and technical personnel; assists selected production units through quality improvement, enhancement of marketing skills and design techniques; and encourages development banks to provide investment capital. Like all other CFC projects, it is a collaborative effort: It is implemented at the regional level by the COMESA Leather and Leather Products Institute and the Eastern and Southern African Leather Industry Association and at the national level by four collaborating institutions; the Sudan

National Leather Technology Centre is one of them. The FAO Intergovernmental Sub-Group on Hides and Skins supervises the project. Beneficiaries are the small-scale producers, the training institutes, the exporting countries and the other countries in the COMESA Region.

… and how this Conference might open up new avenues for commodity finance and development

This Conference brings together the financial experience of rural and agricultural microfinance institutions and the experience of the Common Fund and other agencies with promoting commodities and small and microentrepreneurs producing, processing and marketing commodities. We expect that this will result in:

- the further growth and development of sustainable financial services; and
- the further growth and development of sustainable commodity-related enterprises.

These two objectives – the growth of profitable local financial institutions and of profitable local enterprises – are interrelated and mutually reinforcing. There is one lesson to be learned from the now developed industrial countries: Focusing in an early stage of development on the poor, who largely depend on commodities, means focusing on a huge future market. We hope to get this message across to large numbers of financial institutions.

Annex 1: Risk management strategies in rural and agricultural microfinance[18]

- ***With regard to managing systemic risks:***

Co-variance of risks:	Portfolio diversification comprising farm and non-farm, rural and urban, short- and medium-term, consumer and emergency loans; financing commodity processing and trade in addition to production; hiring specialist rural and agricultural finance staff
Weather-related risks:	Expansion of outreach to wider area and different crops, including traditional resistant varieties; insurance products; financing irrigation and water management
Market-related risks:	Market information systems; contract farming; commodity price risk insurance (put options); agricultural price stabilisation; post-harvest storage development; warehouse receipts; linking producers, processors, traders; establishing input supply and marketing subsidiaries; tied savings-cum-credit products;
Policy –related risks:	Sound financial sector policies; macroeconomic stability; sound agricultural (price) policies; consistent policies regarding grants (eg, for institution-building) and loans on market terms
Political risks:	Desisting from political interference in operational decisions, insisting on the autonomy of FIs (to be protected by law and controlled by central bank); government or donor minority ownership; disconnecting financing from agricultural support and supervision; separating FIs from agriculture ministries, mass organizations; bringing FIs under the supervision of the central bank.

- ***With regard to managing idiosyncratic customer risks:***

Adverse selection:	Initial loans based on savings record; borrower selection by peers-cum-bank staff; credit information exchange (for larger loans)
Moral hazard:	Repeat loans starting small; rigid loan examination, monitoring and enforcement; formal and informal collateral, joint liability and peer pressure; incentives for timely repayment
Financial technology:	Starting with small loans through joint liability groups; providing opportunities for graduation to larger individual loans
Investment failures:	Spreading the risk through household diversification, comprising farm and non-farm activities; facilitating technical support services and supply chain; providing appropriate technologies for commodity production, processing and inputs; financing storage infrastructure
Inadequate customer self-financing capacity:	Providing opportunities for savings accumulation including term savings; offering savings-cum-credit products; providing incentives for growth
Inadequate skills of farmers and microentrepreneurs:	Linking financial services with training and technical services (BDS); commercialising extension services; focusing on investments based on local knowledge; promoting the exchange of experience among investor-borrowers; adopting a repeat-loan approach, starting small and permitting borrowers to learn through trial and error

- ***With regard to managing credit risks:***

Loan examination:	Meeting solvent demand only; establishing total track record; creditworthiness examination of the whole household with all activities and collateral, ascertaining total repayment capacity
Loan terms:	Appropriate loan sizes and disbursement times; repeat loans of increasing size and decreasing interest rates
Timely repayment:	Peer pressure; customer incentives for timely repayment (interest rate rebates, larger loans, automatic loans); staff performance incentives

[18] The main concern here is with agricultural and commodity micro- and mesofinance. This overlaps widely with risk management strategies in rural and general microfinance.

Lack of collateral:	Warehouse receipts; accepting non-formal collateral; joint liability for smaller loans; improving collateral legislation for R/MFIs (eg, at provincial level) incl. non-judicial foreclosure; improving collateral registration; leasing; partnerships with dealers
Enforcement of timely repayment:	Instant information on loans due and overdue at all levels of the institution through efficient MIS/ICTs; instant recovery action, eg, seizure of non-formal collateral
Lack of enforcement:	Cooperation with local authorities to enforce repayment ; judicial reforms
Staff ability:	Capacity building through training, distance learning, apprenticeship, exposure training in other institutions and programs; special training in commodity finance; setting up staff library; providing access to internet resources; facilitating (UNCDF) Microfinance Distance Learning Course
Institutional efficiency:	Rationalizing procedures to arrive at competitive interest rates, differentiated by product
Financial innovations:	Market research; joint pilot-testing with other MFIs; facilitating internet exchange on financial innovations; participating in networks, associations like Afraca/Apraca/Nenaraca
Staff and management access to internet resources:	CFC : http://www.common-fund.org CGAP: http://www.cgap.org; http://www.microfinancegateway.org/ FAO: http://www.fao.org/ag/ags/agsm/RuralFinance International Food Policy Research Institute : http://www.ifpri.cgiar.org/ International Fund for Agricultural Development: http://www.ifad.org/evaluation/public_html/eksyst/doc/lle/themes/crfs.htm MicroSave Africa: http://www.microsave-africa.com Natural Resources Institute: http://www.nri.org/ UNDP/UNCDF : http://www.uncdf.org/sum/ World Bank Sustainable Banking with the Poor: http://wbln0018.worldbank.org/html/financialsectorweb.nsf/

- ***With regard to transaction costs:***

Low population density, remote areas:	Wholesaling; linking with SHGs as informal financial intermediaries; cooperation with NGOs, CBOs as facilitators; outgrower schemes; financing high-value crops and value-adding processing
High operational costs:	Economies of scope through savings, credit and insurance services combined with wholesaling and linkage banking; lending to individuals through joint liability groups which process loan applications, disbursement and instalments; repeat loans to establish track record; incentives for timely repayment leading to *automatic loans;* improved bank automation software; temporary institutional subsidies for innovations
ICTs	Internet banking; low-cost rural ATMs; Smart Cards
Tied lending through corporations	Financing provided through corporations (eg, sugar companies, seed producers, input suppliers, dairy companies, commodity boards): for inputs, against output, against warehouse receipts

- ***With regard to resource risks:***

Inadequate equity:	Building up equity, including equity participation by customers, commercial banks, others; increasing retained earnings; inviting quasi-equity (long-term refinancing); inviting international equity participation
Inadequate loanable funds:	Mobilizing savings through various products with positive real returns; refinancing on national capital markets; improving liquidity management; promoting refinancing relations between MFIs and commercial banks; providing guarantees from commercial bank loans to MFIs
Interest rate risks:	Matching fixed vs. variable interest rates of assets and liabilities
Liquidity risks:	Establishing vertical and horizontal linkages between R/MFIs to facilitate liquidity exchange; access to lines of credit of commercial banks or rediscount facilities of central banks to cope with liquidity shortages; training staff in liquidity management
Lack of term finance:	Increasing equity and quasi-equity; promoting term savings, savings-cum-credit products, short-term repeat loans

Availability of donor funding:	Inviting equity participation (at investor's risk), term loans as quasi-equity, loans bridging temporary liquidity shortages; offering donor representatives a seat on the board

- ***With regard to legal and institutional risks:***

Lack of appropriate legal framework:	Introducing appropriate legislation for rural banks and other MFIs; bringing AgDBs under banking law
Absence of lobbying:	Enhancing networks and associations of financial institutions; promoting policy dialog with financial authorities, parlamentarians; disseminating information through media
Lack of prudential regulation and effective supervision:	Introducing effective regulation and supervision of rural banks, AgDBs, cooperatives, credit NGOs, other MFIs; enhancing the capacity of financial authorities
Lack of collateral:	Reforming collateral legislation; using movable and nonformal collateral; policy dialog with central bank on joint liability with high repayment as collateral substitute; creating legal framework for leasing