

Rural finance remains very challenging and in developing countries it is generally weak, despite the efforts of donors, governments and private investors to improve it. However, important lessons are emerging from these experiences that provide useful guidelines on how to expand and make more effective the provision of rural financial services.

This report examines these lessons about rural finance. It identifies the recent advances, current debates, major gaps, challenges and opportunities that confront efforts to expand and strengthen it. This review, conducted between June and November 2004, is based on the latest literature available and on discussions with various donors, practitioners and researchers active in this field.

Throughout this review, the term 'rural finance' refers to the provision of financial services to a heterogeneous rural farm and non-farm population at all income levels. It includes a variety of formal, informal and semiformal institutional arrangements and diverse types of products and services including loans, deposits, insurance and remittances. Rural finance includes both agricultural finance and rural microfinance, and is a sub-sector of the larger financial sector.

The authors utilize a conceptual framework based on the new rural financial paradigm that considers rural populations as bankable through effective institutions. Twelve key issues in rural finance are analyzed and discussed within this framework:

Advances in Institutions

- Reforming state-owned development banks
- Member-owned institutions: SACCOs and credit unions; self-help groups
- Expansion of microfinance institutions (MFIs) into rural areas
- Informal finance provided through buyers and input dealers via value chains
- Apex institutions

Advances in products

- Savings: flexible savings products for smoothing incomes and asset creation

- Term loan products: housing loans and leasing

Advances in services

- Methods of risk reduction: crop, livestock, and health insurance for client protection; credit guarantee schemes for expanding outreach and institutional protection
- Remittance and transfer services

Advances in processes

- Technological advances to reduce transaction costs and improve information

Outreach and Sustainability

- Reaching in a sustainable manner both economically active, very poor populations and remote areas with appropriate institutions, products, services, and technology

Enabling environment

- Advances in regulation, supervision, and legal reforms

This report discusses these 12 issues in detail in order to identify recent advances, emerging lessons and remaining gaps in knowledge. Finally, the report provides general suggestions for donors in subjects such as knowledge generation and dissemination, operations and advocacy, emphasizing that more rigorous longer-term studies are necessary, in order to advance knowledge and develop new ideas for extending the financial frontier.

A. Emerging Lessons in Rural Finance

The key lessons learned from the literature review undertaken for this study can be summarized as follows:

Institutions

- The “technology” of reforming agricultural development banks (AgDBs) is well understood, but there is no clear road map for obtaining the political commitment required for success.
- When governments are blocked from using AgDBs to allocate subsidies for economic and political interests, they may seek other channels, such

as cooperatives, provincial banks, and village or community funds. Therefore, political commitment to reform may be needed to extend beyond the specific AgDB being reformed.

- There is no assurance that a reformed or privatized AgDBs will strive to expand its agricultural and rural outreach aggressively.
- Demand for microfinance exists in rural areas, and the current microfinance technology can be adapted to provide services to rural clients. However, rural operations are expensive and risky so increasing scale and cross subsidization with robust urban operations is often required.
- Local cooperatives such as SACCOs appear to be suitable for remote rural areas if access to external funds is feasible and governed well.
- SHGs may be used to provide services to the poor in rural areas that are well connected to formal financial institutions. SHGs located in remote areas and farther from formal institutions are limited in their capacity to grow without receiving continuous support from external sources, especially additional funds and technical assistance.
- Important issues of governance, regulation, and supervision remain to be resolved for SACCOs and SHGs in many countries
- Trader credit is still very important in rural areas. It is useful to foster greater linkages between traders and the financial and real markets

Products

- A proper balance may be required between urban and rural operations to reduce costs so that efficient and good services can be offered to rural poor.
- Savings products intended for asset building must provide attractive returns in addition to flexibility and easy accessibility.
- Reducing transaction cost is very important for populations that are highly dispersed and that save only in small quantities. Mobile deposit collectors who collect deposits at the savers' doorsteps, increased points of sale, and collecting savings during periodic group meetings are effective ways of reducing saver transaction costs. Mobile banks may also reduce transaction costs for financial institutions if they help increase the size of transactions. Also, electronic innovations may help drive down the costs of handling many small transactions in areas where high-tech alternatives are feasible.
- Rural housing finance is still very rare. Experiences of few providers of housing finance indicate that homelessness is not necessarily the biggest

problem in rural areas but there is a demand for expansion and improvements as a means to enhance their assets; a strict focus on the housing niche market might be too risky at this stage; linkages with input suppliers and housing developers are required to be developed for clients to effectively utilize the loans.

- Leasing may provide a viable financial option for the rural poor and those engaged in agriculture-based enterprises. Leasing may offer fewer options for remote areas, however, because of high costs of transporting equipment and machinery and the lack of servicing stations for the leased equipment. Also, the vulnerable poor may seldom require assets that are suitable for leasing for their income generating activities.
- Leasing products are suitable for individual- based transactions but require a significant down payment or collateral for reducing the risks for the lessor. Many legal and tax issues must also should be resolved before leasing can become an attractive alternative for loan products.

Services

- Insurance services are important for rural areas, but it is very challenging to provide them at an affordable cost to rural clients without massive subsidization.
- Index-based weather insurance is ineffective and too costly in marginal farming areas and in areas where weather trends are changing.
- Credit guarantees function as a kind of insurance for financial institutions. However, designing sustainable credit-guarantee schemes for rural financial institutions is complicated. Even when they are sustainable and are used to guarantee loans, there is no clear evidence that they contribute much to additionality in rural lending.
- Training and technical assistance may do more than guarantees to induce lenders to become more involved in serving some under-served segments of the rural market.
- Successful remittance services require listening to the clients to design appropriate products and choosing strategic partners to affect transfers at both sides of the remittance.
- The use of formal international remittance services with service points in both receiving and remitting countries is shown to be safe, costefficient, and time -efficient. This is because remittance operations require volume in order to reduce costs and make profits.

- The market for supplying remittances is generally much more competitive than the market for loan and deposit services in many Asian and Latin American countries that receive remittances.

Technology for reducing transaction and risk costs

- Banks tend to make greater use of information technology in countries where the technology industry is less regulated than the financial sector.
- Electronic banking is not appropriate for all financial institutions, especially in countries with abundant labor supplies. Also, electronic banking may not suit all clients, especially the vulnerable poor. It may provide convenience and security for slightly larger depositors and might lower the costs for financial institutions, but may not be relevant for many smaller depositors, especially in rural areas.
- For electronic banking to be cost-effective, economies of scale and scope are necessary.
- To reduce costs of information technology, it is important to bundle financial services into the physical infrastructure and to widen the client base through strategic partnerships with service providers.
- Credit scoring can be efficient in reducing information costs for financial institutions only when there are credit bureaus capable of providing reliable historical data on clients.

Reaching the vulnerable poor and remote areas sustainably:

- Rural finance is currently mostly inaccessible for the economically active, vulnerable poor and for populations living in remote areas.
- Member-owned institutions, such as autonomous cooperatives and SACCOs, can viably serve remote areas if they can access external sources for excess liquidity, keep costs low, and achieve good governance.
- The use of mobile banks to reach remote areas is context -specific and depends on the status of security, law and order in rural areas, the availability of good roads for transport, and regulatory issues regarding the collection of savings.
- Serving environmentally sensitive areas may become important, but there is little documentation of successful efforts to date.

Enabling environment

- Insecure land titles still limit the use of land as collateral

- Strict regulation of rural financial institutions at the very early stages of institutional and process development tends to curb innovations.
- The effectiveness of self-regulation and peer monitoring as means to supervise rural financial institutions is still unclear.
- What is the feasibility of piggybacking rural finance services with non-financial providers to increase outreach at reduced costs, especially in remote areas?

D. General Suggestions for Donors

The recent donor reviews conducted by CGAP partners concluded that five core elements are needed to improve the effectiveness of support for microfinance at the individual agency level. These elements also help determine a donor agency's comparative advantage in supporting financial services for the poor.

Fig. 2: Core Elements of Effective Support



Source: CGAP (2004)

The five core elements include (see Fig. 2 above): (i) **Strategic Clarity and Coherence**: The extent to which an agency-wide vision of microfinance exists and whether this vision and agency policies are in line with accepted good practice; (ii) **Strong Staff Capacity**: Whether the microfinance focal unit has sufficient capacity and resources to provide skilled technical support to operational colleagues. Also, whether the overall level of technical capacity is adequate to ensure quality operations; (iii) **Accountability for Results**: The level of knowledge of the microfinance portfolio (e.g., whether it is "visible" to the agency) and transparency of portfolio performance; (iv) **Relevant Knowledge Management**: How well the agency learns from its own and others' experience through the creation, dissemination, and use of practical, user-friendly knowledge; and (v) **Appropriate Instruments**: Whether an agency has instruments that allow it to work directly with the

private sector, a critical pre-condition for effectiveness in rural and microfinance. The quality, range, and flexibility of instruments are also crucial. The findings from these CGAP microfinance peer reviews are highly relevant for rural finance. Indeed, developing a clear rural finance strategy is a prerequisite for engaging in rural finance.

Broad suggestions for donors to consider in advancing rural finance are discussed below. The donors can expand, consolidate, delegate, collaborate with others, or phase out of rural finance based on their own vision and comparative advantages.

Knowledge generation and dissemination:

- Encourage and facilitate the documentation of emerging best practices in the provision of agricultural and rural finance and disseminate them broadly to the stakeholder community.
- Encourage research and pilot testing of innovative types of collateral substitutes for the rural sector that will help asset-poor, economically active, low-income people qualify for loans.
- Encourage rigorous studies that use a sound conceptual framework to examine the feasibility of institutions, products, and services for rural clients, especially for those who are very poor or live in remote areas.

Operations:

- Support experimental designs for supplying financial services in rural areas, and especially to finance populations in remote areas and for agricultural production. Options could include creative uses of local institutions, including member-owned institutions, community-based organizations, post offices, retail stores, lottery outlets, and schools.
- Fund innovative pilot projects that may generate breakthroughs for rural finance. Examples
- include smart cards and credit cards for farmers, rural housing finance in South Africa, index-based crop and livestock insurance in Mongolia, financial extension workers in Uganda, and the Hewlett-Packard experiment to create an electronic identification system for MFI clients in Uganda.
- Support curriculum development for client education programs.
- Support feasibility studies to assist RFIs in making informed decisions about the adoption of new information technologies.

Advocacy

- Encourage better accountability for results through improved transparency of rural finance institutions by providing incentives to share information and follow industry standards.

E. Conclusion

Most rural areas are still underserved with regard to financial services, but financial and non-financial service providers are entering in field to expand services. In addition to donors, several rural-finance practitioners and private investors are attempting to advance the field by using advanced technologies to efficiently provide innovative products and services. Still, several large challenges remain. One is to develop an enabling macro-policy environment. Another is to integrate rural finance into the broader financial sector so donor funds finance those things that the private sector considers too risky and unprofitable. Others include bridging the digital and information divide for knowledge sharing and enhancement and extending financial services to remote areas and economically active, very poor populations to ensure that relatively few economically active clients are left behind.

Several studies now inform our understanding of rural finance. However, many gaps remain. Part of the problem is due to donors' almost universal focus on producing brief, descriptive, state-of-the-art studies and toolkits at the expense of supporting rigorous studies to advance knowledge and develop new ideas for extending the financial frontier, as envisioned by J.D. Von Pischke (1991). These briefs and toolkits help summarize experiences and lessons for immediate consideration in the field by donor staff. However, they often lack the theoretical and empirical rigor needed to address important issues regarding product and institutional design and to carefully assess the impacts of the ideas being tested. A more balanced approach is needed between supporting short-term summary documents and rigorous longer-term studies.

III

Conclusions, recommendations and options

(1) Sustainable development requires:

- ✚ continual growth and diversification of the rural economy;
- ✚ access of all segments of the population including rural microentrepreneurs, farmers and the poor to sustainable financial services such as savings, credit and insurance;

- ✚ provided by self-reliant, sustainable financial institutions, adjusted to the cultural and socio-economic conditions in their area of operation, in a conducive macroeconomic policy environment.

(2) Sustainable rural microfinance requires local initiative and careful donor support for the development of institutions, enabling them to:

- ✚ offer both savings and credit services,
- ✚ mobilize their own resources,
- ✚ have their loans repaid,
- ✚ cover their costs from their operational income
- ✚ finance their expansion to the poor and non-poor from their profits.

(3) Governments, with prudent donor assistance, have to provide,

- ✚ a conducive policy framework with deregulated interest rates,
- ✚ an appropriate legal framework for competitive local and national financial institutions with different forms of ownership, including private, cooperative, community and also government ownership
- ✚ a system of prudential regulation and effective direct or delegated supervision.

(4) Donors may contribute to the development of rural financial systems through:

- ✚ experts for R/MF units in central banks, R/MF networks and leading R/MFIs
- ✚ regional R/MF experts for consultancy, training, information exchange and supervision of donor-supported projects and MFIs
- ✚ policy dialogue
- ✚ social and human capacity building in financial authorities, R/MFI networks and R/MFIs
- ✚ equity investments with leverage through deposit-taking, clear ownership and an exit option
- ✚ no credit lines, except for bridging temporary liquidity gaps of (emerging) sustainable R/MFIs
- ✚ financial and technical assistance for the transformation of MFIs into regulated financial institutions such as rural banks,

- community banks, thrift banks, commercial banks, finance companies or similar institutions;
- ✚ technical and financial assistance for the promotion of ownership of financial institutions by the poor as shareholders, particularly in the process of transforming credit NGOs into regulated institutions;
 - ✚ donor coordination of financial and technical assistance, cooperation and co-financing making good use of the comparative advantages of multilateral and bilateral donors.

(5) Supporting self-help groups as autonomous local financial institutions in marginal areas

If a donor decides to promote rural finance in marginal areas with a focus on the poor, **two basic strategies** are suggested, both directed at indigenous or new SHGs as autonomous local financial institutions:

Through networks or federations of SHGs, implying that both SHGs and their networks are being promoted in the framework of a project

Through linkages of SHGs with regulated financial institutions like AgDBs, rural banks or other types of deposit-taking financial institutions.

This option would require a thorough feasibility study in each case, a long-term perspective or support, long-term experts, the willingness to work, in the longer run, towards a legal status for the SHGs or their networks or federations, and cooperation with other donors and regional organizations.

Appropriate partners for the first approach may comprise AgDBs and development NGOs, which will eventually transfer their institution-building and –maintenance functions to networks of SHGs²².

Partners for the second approach may include AgDBs, rural banks or other types of deposit-taking financial institutions. Manuals exist, but would have to be adjusted.²³