University of Cologne
Development Research Center
Universität zu Köln
Arbeitsstelle für Entwicklungsländerforschung

RURAL FINANCE FOR THE POOR: FROM UNSUSTAINABLE PROJECTS TO SUSTAINABLE INSTITUTIONS

by

Hans Dieter Seibel

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Rural finance for the poor: from unsustainable projects to sustainable institutions[1]

The large majority of the poor and poorest are rural

That has to be uppermost in our minds as we think about what microfinance means. For IFAD, the finance issue is crucial to the task of reducing rural poverty. We do not insist on any particular institutional model. The demand for financial services is very diverse even among the poor, and we believe that any sustainable response will have to be pluralistic. Some require access to more capital than local savings systems allow. I am thinking about those who face clear investment opportunities that will allow a sustainable improvement in food security and income. For this sort of effective demand to be met, it is essential that we foster linkages with upstream financial institutions with a much larger capital base. Support can take a wide variety of forms, from intense training of qualifying microfinance institutions, so they may become viable partners with the private sector, to taking equity stakes in private-sector institutions to increase their rural outreach. We have to keep in front of us how the rural poor make their livelihood. If we do that we can begin to chart the concrete means of reducing poverty – and understand the challenges that microfinance and microfinance institutions must confront.

– From a presentation by IFAD to a regional microcredit summit, October 2000

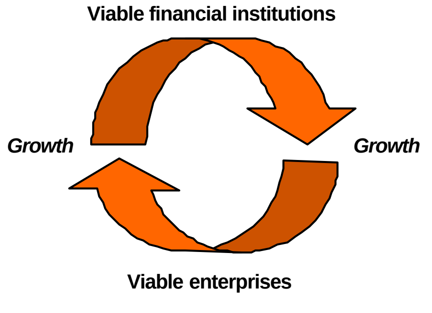
Sustainable poverty reduction builds on self-help

The poor have demonstrated, time and again, that they are able to save or borrow and invest their funds profitably. Since the start of its operations in 1978, IFAD has helped the poor help themselves:

- providing loanable funds
    - creating access to financial services
        - assisting the poor to establish their own financial institutions.

Given its mandate of sustainable rural poverty reduction, IFAD strengthens the self reliance of the people and their self-help institutions. Viable farm- or non-farm microenterprises and viable local institutions are inextricably bound together. Aid must strengthen both, individual self-help capacities and institutional viability; it should not weaken them through well-meaning but inappropriate interest-rate subsidies.

The virtuous circle of institutional and enterprise viability



[1] This paper has been published by IFAD (Rome 2001) as a brochure.

The poor need sustainable financial services…

- *microsavings* deposit facilities for:
  - safekeeping of savings
  - consumption-smoothing
  - emergencies
  - accumulation of resources
  - self-financing of investments

- *microcredit*, with access to loans of various sizes and maturities for:
  - external financing of investments
  - consumption-smoothing
  - emergencies

- *microinsurance*, including specialized services (life, health, accident or cattle insurance) and nonspecialized services (providing social protection through access to one's savings or to credit in cases of emergency) for:
  - risk management
  - social security
  - loan protection

plus other financial services, for example *microleasing,* supplemented by nonfinancial services.

…and microfinance institutions (MFIs)…

- *formal MFIs,* regulated by the financial authorities of a country (rural banks, agricultural development banks and some commercial banks and finance companies with special microfinance windows)
- *semiformal MFIs* under the control of nonfinancial authorities (savings and credit cooperatives, unregulated village banks and credit NGOs)
- *informal MFIs*, controlled by customary law and peer pressure (the ubiquitous rotating savings & credit associations (RoSCAs), savings and credit associations with permanent loan funds, doorstep deposit collectors, and the large number of self-help groups with some limited financial activities).

…to provide these services reliably and cost-effectively:

- mediating between savers and investors
- allocating scarce resources for various purposes with different returns
- lowering transaction costs
- widening and deepening financial services to the poor.

With assistance by IFAD, the services of these institutions all strengthen the self-help capacity of the poor and complement existing networks of mutual obligations.

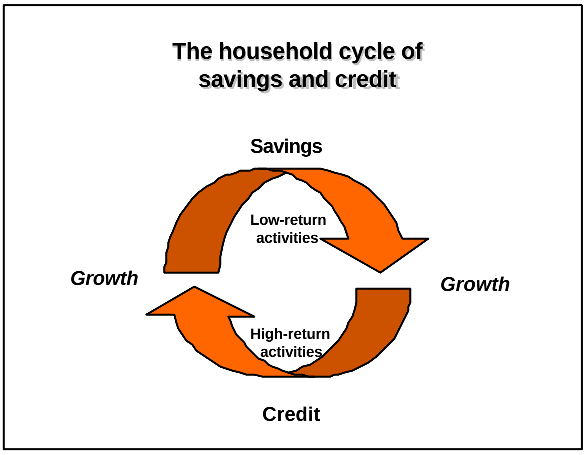
Savings first or credit first?

The growth of outreach for sustainable poverty reduction is contingent upon the dynamic growth of self-reliant institutions. The essence of self-reliance of the poor and their institutions is local resources:

- savings deposited and accumulated by the poor in local financial institutions are the basis of self-financing and household risk management

- savings mobilized by local financial institutions are the main source of growth of funds and bring independence from external subsidies and interference.

Savings are a liability of the institutions collecting them, but an asset of the poor depositing them. In contrast, loans are assets of the institutions providing them, but a liability of the poor acquiring them. Yet, the priority of one over the other – savings first or credit first – is a pragmatic, not an ideological issue. The crucial criterion is the rate of return: *savings first* is more appropriate in subsistence agriculture and low-return activities; *credit first* is more appropriate in high-return activities. A household is the setting of complex, interlinked low- and high-return activities: savings-driven investments in low-yielding activities may generate the start-up capital for credit-financed activities with high returns. These, in turn, may generate profits and savings to be plowed back into low-return activities, including subsistence agriculture. IFAD's help speeds up the savings-and-credit cycle, with growing amounts of both. This may result in an increasing share of self-financing in security-oriented households, but in a larger share of external financing in entrepreneurial households.



Only viable institutions can continually increase their outreach to the poor

To contribute to sustainable poverty reduction through increasing outreach, MFIs themselves must be viable, sustainable, and growing. Microfinance is business, not charity. This means:

- MFIs must offer attractive interest rates or profit-sharing margins on savings with positive real returns (preventing the erosion of the value of savings) and mobilize their own resources
- Rural MFIs must charge rural market rates of interest on loans (which are considerably above commercial prime rates of interest!) and cover all their costs from the interest-rate margin
- MFIs must make a profit and finance their expansion from their returns.

Only those MFIs that have demonstrated their capacity for resource mobilization, cost coverage, profitability, and dynamic growth deserve assistance. Such institutions may be found in all financial sectors – formal, semiformal or informal. Governments, with the support of donors, should be encouraged to provide an adequate legal framework for the upgrading of informal to semiformal and semiformal to formal MFIs; and for the establishment of networks and their apex organizations for guidance, training, consultancy services, self-regulation and supervision, liquidity exchange and refinancing.

Key concepts of rural finance

- VIABILITY

Cover your costs from the margin

- SELF-RELIANCE

Mobilize your own resources

- SUSTAINABILITY

Preserve the value of your resources

- OUTREACH

Broaden your services for the poor

- IMPACT

Help the poor help themselves

Recent developments and continuing shortcomings

Much progress has been achieved in rural and microfinance, particularly during the 90s. But many shortcomings continue to hamper outreach and sustainability:

Topic	Developments	Shortcomings
Policy environment	Macroeconomic stability; interest rate deregulation; ease of setting up banks or branches; low minimum capital requirements for MFIs	Inadequate policy and legal environment; slow implementation of deregulation; inadequate property rights and judicial procedures
Microfinance institutions	New legal framework for commercially-operating MFIs; privately financed start-up; increasing numbers of self-sustaining MFIs.	Lack of an appropriate legal framework; excessive capital requirements
Non-formal financial institutions	New legal framework provides opportunities for upgrading to formal levels and for financial market integration	The potential for upgrading millions of informal financial institutions remains largely untapped
NGOs	Innovative approaches to poverty lending in repressive environments; some successful conversions to formal intermediaries	NGOs are slow in mobilizing domestic resources and in striving for self-reliance; donors support unviable NGOs
Agricultural development banks	Incipient reforms towards autonomy, viability and self-reliance, with or without privatization	Political interference; lack of viability; failure to meet demand for credit and deposit services
MFI regulation and supervision	Controversial discussion on the need for effective regulation and supervision of MFIs	Financial authorities unable to supervise MFIs; agricultural development banks (AgDBs) escape supervision; lack of MFI self-regulation
Agricultural finance	Self-financing from profits and savings plus non-targeted commercial credit replaces preferential sources	Self-financing and commercial credit insufficient to meet the demand for short- and long-term finance; inadequate savings mobilization
Access of the poor to financial services	Outreach of viable MFIs (including rural and other banks) to the poor as users and owners drastically increased	Vast numbers of poor people, particularly in marginal areas, lack access to savings and credit services

Stakeholder participation

One of the main challenges in assisting in the creation and strengthening of rural financial services is ensuring participation by all concerned. IFAD identifies three key components to promote stakeholder participation. They are:

- Involvement of the poor in developing rural finance, through their representatives in self-help groups, networks and NGOs
- Stakeholder coordination at the national level, to ensure an integrated approach to developing an effective financial system
- International dialogue on rural finance policies, to lay the groundwork for innovative approaches where more-traditional systems may have broken down and to provide back-up to national project coordination and strategic linkages.

From unsustainable projects to sustainable institutions

IFAD and other donors have been moving away from unsustainable project interventions to support an amazingly diverse array of sustainable institutions:

- ✓ **Transition to self-reliance in Indonesia.** In the Income-Generating Project for Marginal Farmers and Landless (PK4)P4K – a credit project for small farmers and fishermen – agricultural extension workers helped the very poor form some 50 000 small groups as credit channels. As credit provided through the government-owned Bank Rakyat Indonesia turned out to be inadequate (in terms of amount and timely availability), women in marginal areas were the prime movers in transforming these small groups into larger, self-reliant savings and credit associations. They thus initiated the transition from a top-down credit project to a genuine self-help movement. Many associations are now registering as financial cooperatives, with growing membership and business volume.

- ✓ **Supporting institutional diversity in Guatemala.** Since the end of the civil war in Guatemala, IFAD and other donors have promoted diversity and competition among rural financial institutions (financial cooperatives, credit NGOs, community banks, and Banco Rural, a restructured agricultural development bank). Some MFIs, legally barred from deposit-taking, are now mobilizing internal and donor resources to register as banks or finance companies. Others, like the credit union network, adopt self-regulation and supervision of prudential norms as a means of increasing sustainability and outreach.

- ✓ **Rural financial services in Albania, Armenia and Macedonia.** In the transitional economies of Eastern Europe, rural financial institutions are only just emerging. Through credit lines for investments in fledgling private agriculture, IFAD provides urgently needed liquidity in extremely under-monetized rural economies. Its support to the cooperative village credit funds in Albania may serve as a model for building local financial intermediaries that adhere to basic banking principles and apply simple standardized procedures.

- ✓ **Transforming an unsustainable credit programme into autonomous institutions in Nepal.** Until 1992, IFAD assisted the Agricultural Development Bank of Nepal (ADBN) in establishing an infrastructure of small-farmer groups. They, in turn, formed intergroups and management committees under subproject offices. On that basis, ADBN is now helping the farmers establish autonomous local financial institutions, transforming a credit project into a network of vibrant, self-governed financial cooperatives.

- ✓ **Reforming savings and credit cooperatives (SACCOs) in Tanzania.** In upland areas of the United Republic of Tanzania, IFAD has supported the transformation of SACCOs from credit channels into genuine self-help organizations. They have vigorously mobilized savings and diversified their lending to the agricultural and microenterprise sectors, including women traders. Results in terms of impact include: empowerment of the poor, including women, as user-owners; substantial improvements in food security and income; and enhanced institutional sustainability.

- ✓ **How an unsustainable credit NGO in The Philippines first turned into a Grameen replicator and then into a rural bank.** The Centre for Agriculture and Rural Development (CARD) has changed from an unsustainable credit NGO to a viable rural bank with rapidly growing outreach to very poor women. By mobilizing its own resources from 40 000 poor and non-poor clients, adopting a variety of financial products and enforcing a strict credit discipline, it has substantially increased its lending outreach to its target group: 28 500 very poor women (December 1999). With support from IFAD, CARD disseminates its technology to other MFIs.

- ✓ **Bank Rakyat Indonesia, the AgDB that revolutionized rural finance.** Within a framework of financial deregulation, what is now the Microbanking Division of BRI was cut off from subsidies and granted management autonomy in 1983. Its *good practices* have included: carefully-crafted financial products, high interest rates on savings and loans, staff productivity incentives, rewards to borrowers for on-time repayment, and good governance. As a result, BRI has turned into one of the most successful providers of rural financial services in the developing world. Its 3 700 sub-branches serve 2.6 million borrowers at a one-year loss ratio of 1.35% and carry 25.1 million savings accounts at the village level, testifying to an overwhelming demand for deposit services among the poor (July 2000). Profits in 1999 amounted to USD 150 million, excess liquidity mobilized at the village level to an amazing USD 1.5 billion. This has set new standards for AgDBs – they can be reformed! – and for the microfinance industry: sustainability and wide outreach to the poor are compatible! This has inspired IFAD, the World Bank and FAO to a new intitiative: the transformation of AgDBs into viable and sustainable providers of microsavings and microcredit services.

The role of donors

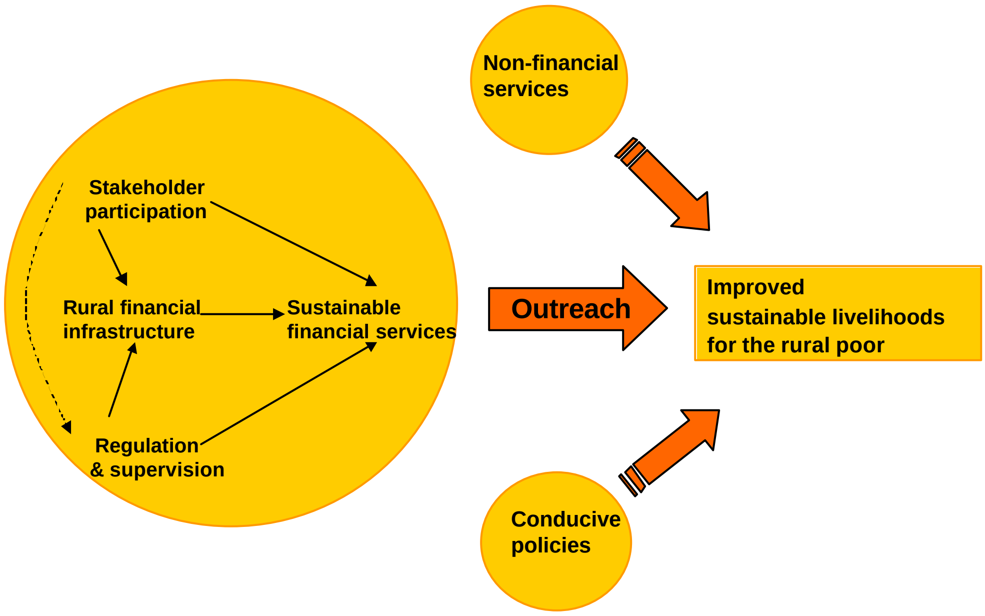
Donors may promote the growth of the rural finance sector through the following measures:

- Credit lines and equity investments bridging short-term liquidity gaps for self-reliant and growing MFIs
- Technical assistance (TA) for institutional development towards viability, self-reliance and outreach
- TA for the establishment and institutional development of national and regional MFI networks
- TA for the establishment of apex organizations of MFI networks (for interest articulation and advocacy, training and consultancy services to member organizations, self-regulation, auditing and supervision services, liquidity exchange, access to last-resort sources of refinance, and the mediation of donor support to MFIs)
- Institutional strengthening and reform of rural and agricultural development banks
- TA to financial authorities to provide an appropriate policy and regulatory framework, including legal forms for local financial institutions (rural banks, financial cooperatives and equity-based savings and credit associations)
- Support for exposure visits and training in innovative programs and institutions.

Policy dialogue

Sustainable poverty reduction requires the political will of governments and a conducive policy framework. No poverty-reduction programme can be sustainable without good governance and adequate policies. Failures in governance cannot be remedied by donor support to poverty-reduction projects. Loans for poverty-reduction programmes to governments that lack political will and fail to provide an adequate policy environment for economic growth and development of the population will only increase external indebtedness without simultaneously strengthening productive capacities. Together with other donors and stakeholders, IFAD, as an advocate of the rural poor, will participate in policy dialogue in order to create a conducive macroeconomic and policy environment.

Graph: IFAD's approach to rural finance



IFAD rural finance policy in a nutshell

In May 2000, the Executive Board of IFAD approved a rural finance policy as a tool for sustainable poverty alleviation:

> *Rural finance is one of several essential tools to be used in combating rural poverty. The purpose of IFAD's rural finance policy is to increase the productivity, income and food security of the rural poor by promoting access to sustainable financial services.* ***IFAD will strengthen the capacity of rural financial institutions to mobilize savings, have their costs covered and loans repaid, and make a profit to increase their saver and borrower outreach.*** *It may also assist in bridging gaps in equity or loanable funds until institutions are fully self-sustained. Creating rural finance systems is not a panacea. Nor is it without its challenges, among them: assuring the participation of all stakeholders; building rural financial infrastructures that are diversified according to local conditions; enhancing institutional sustainability with outreach to the poor; and fostering a conducive policy and regulatory environment. IFAD's policy will support solutions to these challenges and promote a diversity of strategies, among them: networking among microfinance institutions and establishing apex services; upgrading and mainstreaming informal finance; linking banks with local financial institutions and self-help groups; and transforming agricultural development banks. Through its policy and strategies, IFAD confirms its commitment to continually seeking more effective ways of enabling – and empowering – the rural poor to create a sustainable means of livelihood for themselves and for the generations to come.*
>
> – The policy paper is available in Arabic, English, French and Spanish, and also in Chinese and Indonesian.