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Transforming Rural Finance in Africa

The role of AFRACA in Linkage Banking and Financial Systems Development

by

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The Legacy of Financial Repression

By the mid-1970s, in virtually all of Africa, strategies of modernization and technology transfer had clearly failed to initiate self-sustained processes of development. Government intervention and centralized planning had spurred economic disaster, rather than growth.

In the world of finance, preferential credit had suppressed national resource mobilization and created external indebtedness without concomitant increases in productivity. In the rural economy, agricultural development banks channeled targeted credit through cooperatives and thereby undermined their potential as viable financial intermediaries between savers and investors - borrowers. Informal finance and other indigenous self-help institutions were ignored by policy makers.

Among researchers, practitioners and donor agencies, the recognition spread that a new approach was needed: one that builds on the strength of private enterprise, albeit in the informal sector, non governmental actors and the strength of indigenous human and institutional resources - to be innovatively combined with external modernization inputs.

Origins and History of Linkage Banks and Self Help Groups

The linkage banking approach proper, with its double emphasis on linkages between self-help groups and between savings and credit, emerged in 1984 as a result of the interaction between BMZ ES 31, GTZ, FAO, UN and University of Cologne.

Subsequently, feasibility studies were carried out in Nigeria, Togo, Ivory Coast and PR Congo (Seibel 1984, 1987a, 1987c) Only one of them, which had aroused the interest of a cluster of local self-help groups in the Nsukka area in Eastern Nigeria and eventually attracted EZE support, led to a self organised linkage project, namely in the Nsukka area in Nigeria.

In 1986, the linkage banking approach was adopted in Asia by APRACA as its first program area and supported by GTZ through a sectoral project. Bilateral pilot projects ensued in Indonesia, the Philippines and Thailand (Kropp et al. 1989), which then spread to India and a number of other Asian countries. This experience, plus the promise of some modest support from GTZ, in turn inspired AFRACA to organize seminal workshops in Harare and Abidjan in 1987 and 1989, respectively, and to support linkage banking initiatives of member institutions, notably the Central Bank of Nigeria, CNCA in Burkina Faso and AFC in Zimbabwe.

In its origin, the linkage banking approach was the result of a compromise: between the recognition that self-help groups are very widespread in Africa, functioning as informal financial institutions, and the necessity for donors to collaborate in bilateral projects with government institutions such as development banks. In the mid-80s institutional rural finance was virtually everywhere in Africa in an archaic state. Therefore, development banks in Africa were not prepared for a financial innovation such as linkage banking.

Since the 90s, Africa has been in a state of transition, and its institutions are wide open to suggestions for transformation. But starting from widely varying departure points and within divergent political systems, the actual process has been, and will be, of widely varying speed and intensity, to be measured in decades, not years. Donors should note that AFRACA as an interested association of banks with a rural and agricultural mandate may have a crucial role to play in the process.

AFRACA's Linkage Banking Initiative

AFRACA has 45 member institutions. Through executive committee meetings, the AFRACA Newsletter, workshops and short-term consultancies, all of them have been exposed to the linkage banking approach. Three institutions decided to take the lead with pilot projects, two solely with their own resources, one (Burkina Faso) with a small direct contribution from AFRACA/GTZ: CNCA (Caisse Nationale du Credit Agricole) in Burkina Faso; CBN, the Central Bank of Nigeria; and AFC, the Agricultural Finance Corporation in Zimbabwe.

In Burkina Faso, CNCA (Caisse Nationale du Credit Agricole) identified 185 groups since 8/1993 for pilot-testing in two project locations. Groups save regularly and, as a prerequisite for credit eligibility, deposit part of their savings in CNCA as partial collateral. CNCA then refinances the groups as autonomous financial intermediaries, which in turn onlend to their members. End-user loan average about F CFA 25,000 (DM75). According to CNCA repayment performance has vastly improved over previous group lending experiences. With 50% of CNCA's loan portfolio channeled through village groups and cooperatives as credit conduits, it would be a major challenge to convert CNCA into a refinancing institution of autonomous local financial intermediaries. By strengthening autonomous village groups and cooperatives and giving them access to a source of refinance, CNCA may reach that part of the population which presently is still beyond the reach of banks.

In Nigeria, the Central Bank of Nigeria (CBN) acts as coordinator of the linkage program. Under conditions of extreme political and economic instability, eight commercial banks have been effectively involved through 54 participating branches in 22 states. 313 group have directly been involved, comprising 137 cooperatives and 176 informal groups. While rural lending is compulsory for every bank in Nigeria, commercial banks have no commercial interest of their own in that field. However, being forced into rural lending, they find the AFRACA approach considerably more effective and efficient than other approaches. UBA, one of major banks, expects to convert all its lending through 8,000 farmers groups to the AFRACA model.

Commercial banks are unwilling brides of self-help groups in Nigeria, bound to them through a marriage arranged by CBN. On the other hand, around 900 community banks have emerged over the past three years, which mobilize their own resources within a community and provide a full range of financial services to the local population. By love and law, they are tied to local self-help groups, who own approximately half of each community bank. The National Board of Community Banks, which is a second-tier regulatory authority, has shown strong interest in the linkage approach and has been invited to become an AFRACA member. It is expected that linkage banking through community banks will be infinitely more effective than through commercial banks (cf. Seibel 1994).

In Zimbabwe, the Agricultural Finance Corporation (AFC), inspired by the 1987 workshop on linkage banking in Harare, has converted most of its retail lending through more than 1,000 self-help groups. Through its expanding branch network, AFC has built up the capacity for linkage banking on a rapidly increasing scale. It has also built up an internal capacity for training staff in linkage banking as well as training self-help groups in finance and production. With some indirect AFRACA/GTZ technical inputs, its group lending activities have expanded rapidly, and repayment performance has improved substantially from 50% to 86% and is expected to further improve. For further expansion and financial deepening, it has entered into bilateral agreements with NGOs, who are to provide guidance and consultancy, instead of financial intermediation, services to groups while at the same time expecting financial management training from AFC. Weaknesses include that as a credit delivery institution AFC has lacked experience in savings mobilization; and that it is still not a commercial bank.

In an improving policy environment, AFRACA has made a notable impact on AFC in its transition from retail to wholesale lending; and from an agricultural credit institution channelling subsidized government funds, towards a commercial bank with sustainable financial services.

AFRACA's Concern for the Development of Rural Financial Systems

Through its promotion of linkage banking, AFRACA has provided a service to its members, but within a narrow scope that now needs to be widened. Innovative institutional developments were noted by AFRACA at least as early as 1986, including rural banks in Ghana, Banques Populaires in Rwanda and the transformation of Zambia Cooperative Federal Financial Services into a fully-fledged bank. Rural finance from a systems perspective was studied by AFRACA in 1992, namely in Cameroun, Ghana, Kenya, Mali and Zimbabwe. Country reports and a synthesis were presented at a seminar in Harare in 11/1992. This was followed by a workshop on performance upgrading of rural financial institutions in July 1993.

According to these studies, rural finance in most African countries was still in an archaic state during the 1980s and not generally amenable to financial innovations such as linkages of banks with informal financial institutions and links between savings and credit. This explains the delays in adopting the linkage approach in Africa as compared to Asia, where policy changes had been introduced earlier and more consistently in a number of countries including Indonesia.

Around 1990 the policy environment in many African countries started to change, centering around financial liberalization with structural adjustment, a growing emphasis on national resource mobilization including deposit taking by agricultural development banks, and a widening of rural delivery networks. The awareness grew that if banks are to extend their services to all segments of the rural population on a sustainable basis, steps must be taken to assure the viability of rural banking.

The AFRACA studies in six African countries note that most agricultural development banks in Africa have been slow in making the transition from an emphasis on credit only to also include saving mobilization; from financing agriculture only to also include nonagricultural lending; from a narrow centralized target group approach to broad coverage through a decentralized branch network; and from social banking to viable and sustainable financial operations. At the same time, many countries have started to establish networks of local financial institutions,either in the form of community banks (e.g., Ghana, Nigeria) or of savings and credit cooperatives (including COOPEC and Caisses Populaires).

The Challenge to AFRACA: Transforming Rural Finance in Africa

In the future, AFRACA has one prominent task: the transformation of rural finance in Africa. This covers at least six broad interrelated objectives:

(1) **The transformation of the policy framework:** not just through financial reform as seen from the conventional macroeconomic perspective, but rather from a grassroots microeconomic perspective as based on,

- (a) the actual experience of financial institutions, comprising the whole diverse infrastructure of formal, semiformal and informal institutions; and
- (b) the requirements of the people in all segments of the population: as savers, borrowers, investors and owners of local financial institutions.

With this grassroots perspective, AFRACA with its member institutions could make a fundamental contribution **from below** to the policy dialog of African governments with IMF and World

Bank, who are usually criticized for their lofty imposition of macroeconomic policies and reforms **from above.**

(2) **The transformation of the legal framework:** In most African countries the legal framework is modeled after the banking law of former colonial powers. Not only have legal stipulations been slow in adjusting to present-day conditions; almost invariably are they inappropriate in terms of the requirements of a segmented financial environment in Africa: a small, legally recognized formal financial sector, serving perhaps 20% of the population, juxtaposed to a vast and evergrowing sector of nonformal financial institutions, which do not fall under the banking law and central bank supervision. The latter in turn comprises semiformal financial institutions with special legal (e.g. by decree) or extralegal status, and informal financial institutions, among them the ubiquitous indigenous rotating and nonrotating savings and credit associations. From AFRACA's grassroots perspective and the experience of its members with financial self-help groups, AFRACA can contribute to,

a. the creation of appropriate forms of legal status of self-help groups in their capacity as informal local financial institutions;
b. the creation of special laws for formal or semiformal local financial institutions, with special provision for various forms of ownership, including self-help groups, community development associations, cooperatives and individuals as owners. Such a law must also include stipulations such as equity capital requirements far below that of commercial banks; and for a second-tier regulatory authority, as the central bank will not have the supervisory capacity for vast numbers of small institutions;
c. special provisions for linkages between formal and nonformal financial institutions;
d. adjustment of the law to financial innovations appropriate to the African environment.

(3) **The transformation of the financial infrastructure:** Past financial and development assistance has usually ignored and bypassed by financial infrastructure. International development banks set up national development banks utilized as channels of subsidized targeted credit for defined purposes and beneficiaries. This has undermined the evolution of a sound and diversified institutional infrastructure. Starting from the needs and demands of the rural population in all its diversity, comprising all branches of economic activity, men and women, as well as the poor, AFRACA makes it its task to contribute to the transformation of the financial infrastructure comprising, formal, semiformal and informal financial institutions, in order to substantially increase outreach to all segments of the rural population.

(4) **The transformation of institutions:** Formal institutions providing financial services in rural areas usually provide credit only, at the neglect of savings deposit facilities; they confine their lending to agricultural purposes, at the neglect of lending to microenterprises and the usually more profitable non-agricultural income-generating activities; and they charge interest rates insufficient to cover their costs. As a result, institutions lack their own resource base; banking is unviable; and their capital is further eroded through losses caused by specialized lending with a narrow focus and unbalanced risk management. As institutions are not viable, they reach but a minute proportion, and their services to these are not sustainable. Institutions therefore make every effort of transfering transaction costs to the borrower. It is the task of AFRACA to contribute to institutional viability trough institutional transformation comprising,

a. enhancing savings mobilization and thereby strengthening the resource base of rural financial institutions;
b. charging interest rates which cover costs and risks;
c. broadening the scope of lending to encompass both agricultural and nonagricultural lending, thereby spreading the risk and increasing profitability;
d. lowering both borrower and lender transaction costs.

(5) **The transformation of the terms and conditions of banking:** As a result of interventionist rather than marketing oriented strategies, many banks provide for inappropriate terms and conditions of loan contracts. As a result, financial services are not sustainable. It is AFRACA's task to promote the exchange of experience among banks on appropriate and effective terms and conditions as well as sustainable services, which are also crucial dimensions of risk management. This includes maturities, grace periods, repayment modalities, timely disbursement, interest rate structures, margins, forms and procedures.

(6) **Dissemination of financial innovations:** Countries and institutions in Africa, Asia and elsewhere are presently in a state of rapid transition. More and more countries are in the process of deregulation and structural adjustment. This has created a climate in which financial innovations have flourished in virtually every sphere of finance. As a result, institutions across the world have been experimenting with new schemes, strategies, instruments, products, services and institutional arrangements, which includes such down-to-earth innovations as daily deposit mobilization and cost-effective doorstep services. It is AFRACA's task to identify, package and disseminate financial innovations among member institutions as well as the general banking and donor community.

Institutional Adjustment as a Strategic Approach

While AFRACA may pursue all six objectives, it will have to do so with different intensity. As an association of financial institutions, AFRACA will place a major emphasis on institutional adjustment. This includes four major strategies:

(1) **the adaptation of existing banks to the rural environment,**
enabling them to provide sustainable financial services as viable institutions in appropriate ways with an adequate delivery system for all segments of the rural population including the poor;

(2) **the upgrading of existing nonformal financial institutions,**

- in operational terms, with an emphasis on their enhancement local financial intermediaries between savers and borrowers, as well as adequate and effective products, procedures and services; and
- in legal terms, providing opportunities and services to acquire appropriate legal status as seen fit;

(3) **linkages between existing formal and nonformal financial institutions,**
in order to fully utilize the existing institutional resources;

(4) **institutional innovation**
the establishment of new institutions in countries, areas or market segments where no adequate formal or nonformal financial institutions exist.

Examples

Examples of successful institutional adjustment strategies (Seibel 1996) include:

(1) for the adaption of existing banks to the rural environment:
Bank Rakyat Indonesia and Bank Dagang Bali, both in Indonesia; Northern Mindanao Development Bank , Philipines;

(2) for the upgrading of existing nonformal financial institutions:

Associations of self-help groups such as FADU (Ibadan) and NUSHO (Nsukka) in Nigeria; the upgrading of self-help groups to rural banks (BPR) joint ownership with NGOs in Indonesia;

(3) for linkages between existing formal and nonformal financial institutions: Pilot projects in Burkina Faso, Nigeria and Zimbabwe; India, Indonesia, Nepal, Philippines and Thailand;

(4) for institutional innovation: Community banks and a National Board of Community Banks as a second-tier regulatory authority in Nigeria.

AFRACA as a Lead Agency

The transformation of rural finance is not just the task of African governments or central banks and the IMF. It is first of all the task of all the financial institutions which make up the financial infrastructure ; semiformal institutions are a larger segment; and by far the largest is comprised of informal financial institutions. Since an increasing number of its members have established linkages with self-help groups as informal financial intermediaries, AFRACA has become the advocate of a transformation of rural finance from below, representing the interests of all rural financial institutions, be they formal or nonformal, and all segments of the rural population served by these institutions. It is in response to that gigantic task that banks in Africa have created their own interest association to transform rural finance in Africa - a task far beyond any single central, commercial or local bank. In that endeavour, AFRACA as a lead agency and multiplicator needs all the assistance can get: in along-range perspective and from a variety of donors.

The Challenge to Donors

The transformation of rural finance in Africa will have to be measured in decades, not years. Donors who expect to accomplish a lasting impact within three or five project years cannot be taken seriously and better stay out of that arena. Donors be reminded that the evolution of local and rural finance in Germany from small informal beginnings during the early 19th century has taken about 150 years.

Today, cooperative banks (owned by their members) and savings banks (owned by the community) are the backbone of the German financial system-two different types of local financial institutions both universal banking functions. Providing financial services to all segments of the population down to the smallest town and remotest village, they mobilize 70% of all savings and provide 50.5\5 of all credit, thus outperforming the conventional commercial and merchant banks.

African countries will have a long way to go before they reach such dimensions; but it certainly will not take 150 years. They need all the assistance they can get, particularly from Germany with its deep historical experience in grassroots banking. But this assistance must not be given in isolated projects, but in a systematic and coherent way, combining a lead sectoral program with bilateral projects. All donors, governmental, private and multinational, will have to cooperate.

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