34195

DONOR BRIEF
No. 15, October 2003

Helping to Improve Donor Effectiveness in Microfinance

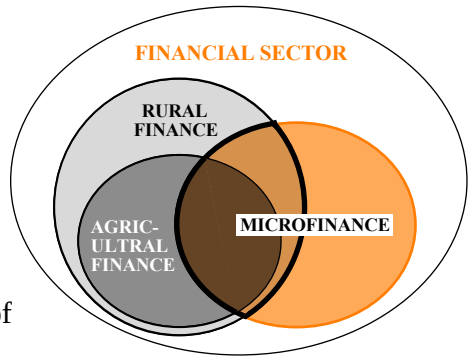
FINANCIAL SERVICES FOR THE RURAL POOR

The majority of the world's poor live in rural areas.Yet most lack access to the range of financial services they need.Financial services available to them are relatively costly or rigid, whether from formal or informal financial providers or traders and agricultural processors offering input credit. Financial institutions seeking to work in rural areas face numerous constraints, such as poor infrastructure and low education levels. Moreover, the main products of many microfinance institutions—short-term working capital loans with frequent expected repayments—are not well-suited to seasonal or longer-term agricultural activities.

The recent introduction by some donors of the financial systems approach in micro and rural finance—which emphasizes favorable policy environment and institution-building—has improved the overall effectiveness of rural finance interventions. But numerous challenges remain, especially in agricultural finance.

Financial services in rural areas—the terminology

Microfinance means financial services (savings, credit, payment transfers, insurance) for poor and low-income people. Rural finance refers to financial services offered and used in rural areas by people of all income levels. Agricultural finance is a sub-set of rural finance dedicated to financing agriculture-related activities, such as input supply, production, distribution and wholesaling, and marketing.



Financial services for the rural poor are represented by the shaded overlap of microfinance with rural and agricultural finance on the diagram. It includes financial services for all purposes and from diverse sources tailored to the needs of poor people in rural areas. Providers include both financial institutions, such as banks and credit unions, and non-financial mechanisms.

What are the constraints to financial services in rural areas?

- *Dispersed demand* for financial services due to low levels of economic activity and population density
- *High information and transaction costs* linked to poor infrastructure (roads, telecommunications) and lack of client information (no personal identification or functioning asset registries)
- *Weak institutional capacity of rural finance providers* related to the limited availability of educated and well-trained people in smaller rural communities
- *Crowding-out* effect of subsidized and/or directed credit from state-owned banks or donor projects
- *Seasonality of many agricultural activities and long maturation periods for others*, resulting in variable demand for savings and credit, uneven cash flow and, lags between loan disbursal and repayments
- *Risks linked specifically to farming*, such as variable rainfall, pests and diseases, price fluctuations, and small farmers' poor access to inputs, advice, and markets
- *Lack of usable collateral* due to ill-defined property and land-use rights, costly or lengthy registration procedures, and poorly functioning judicial systems

What challenges do donors face in supporting financial services for the rural poor?

- *Assumption that credit is a binding constraint.* Donor agencies have traditionally equated rural finance with agricultural credit, seeing it as an "input" to achieve agricultural production targets or other project objectives. Credit is therefore offered on a supply-driven basis with only superficial analysis of true market demand, and often at subsidized interest rates through unsustainable agricultural banks or project implementation units.

CGAP 1818 H Street, NW Washington, DC 20433
Tel: 202 473 9594 Fax: 202 522 3744 E-mail: cgap@worldbank.org Web: www.cgap.org
CGAP European Office c/o The World Bank 66, avenue d'Iena 75116 Paris FRANCE

- *Lack of cross-sectoral collaboration.* Within donor agencies, there are insufficient incentives (e.g., instruction from management, rewards) for financial sector and rural/agricultural specialists to work together. Agricultural finance projects, or rural development projects with finance components, are thus often designed, implemented, and monitored without financial sector expertise.
- *Inadequate options.* Donors are frustrated by the lack of alternative models to replace the discredited approach of cheap credit through agricultural development banks and other failed agricultural credit schemes. New microfinance technologies do not provide responses to all the challenges of rural areas. As a result, agricultural finance is virtually ignored in many agencies.

What can donors do to improve access to financial services for the poor in rural areas?

1. ***Build staff capacity.*** Donors should encourage greater interaction between financial sector and rural development staff to ensure that financial sector expertise is included on any rural project that has a finance component. For instance, the World Bank now actively promotes links between rural and financial sector staff, including a recent joint microfinance and rural finance review in Central Asia.
2. ***Help improve the enabling environment.*** Donors with policy expertise and influence with governments should work to (i) enhance the transparency and efficiency of court systems and strengthen land and property registries; (ii) eliminate government interest rate subsidies for agricultural lending; (iii) remove policy biases against the agricultural sector, e.g., price controls on staple crops; and (iv) invest in communications, physical infrastructure, and services such as health and education.
3. ***Build on existing institutional infrastructure*** rather than create new and costly delivery mechanisms that may never be viable. Financial services designed for the poor could be introduced through existing agricultural development banks that meet basic pre-conditions (e.g., AgBank in Mongolia and Banco de Nordeste in Brazil), the postal system, or even retail stores.
4. ***Determine the appropriate role for subsidies.*** Instead of subsidizing interest rates to the end-clients, donors should use grants to build institutional capacity and promote innovation. Donors should also resist political pressure to include targeted or subsidized credit in agricultural projects.

> DFID's Financial Deepening Challenge Fund provided a grant to the Equity Building Society (EBS) in Kenya to roll out and adapt its mobile banking product. Mobile banking units visit rural locations once or twice weekly, bringing to clients in difficult rural areas a range of financial services, with a special emphasis on savings. The flexible nature of the grant, and DFID's tolerance for innovation risk was vital for EBS to move forward with this new product.

5. ***Explore possibilities of technology.*** Where appropriate, donors with experience in technical innovations could help reduce the costs of operating in rural areas and improve services provided to rural clients by introducing new technology. Examples include ATMs linked to smart cards, and palm pilots for rural loan officers. A careful cost-benefit analysis of any technology and assessment of institutions' information systems should be conducted prior to commitment.
6. ***Fund innovations in delivery mechanisms and products.*** Donors should offer flexible grant funding to financial institutions seeking to adapt or introduce new financial products, or to reduce delivery transaction costs. Innovative solutions are especially needed to better fit the income and investment cycle of agricultural activities. For example, important non-credit financial services include domestic and international money transfers to help smooth seasonal income flows, and deposit services to access in times of low income or high expenditure. Donors should also explore ways to support financial institutions to build on trader and processor client knowledge and introduce more diverse and transparent financial services for farmers.

Author: Douglas Pearce, with CGAP staff. **Source:** CGAP conducted agricultural microfinance research in 2002-2003, supported by IFAD. **Where to go for more information?** See GTZ and FAO's *Agricultural Finance Revisited* series at www.gtz.de/themen/economic-development/english/financial-systems/services/fs-agric-finance-revisited.htm. Forthcoming from CGAP are an Occasional Paper on rural finance, rural finance case studies, and four World Bank-CGAP Operational Notes. Of the papers on the USAID/WOCCU Rural Finance Conference website (www.basis.wisc.edu/rfc/agenda.html), see specifically E. Bryla, et al, *Innovative Approaches forImproving Access to Agricultural Lending: The Use of Price and Weather Risk Management Instruments;* D. Pearce, *Buyer and Supplier Credit to Farmers: Do Donors Have a Role to Play?;* and H. Fleisig and N. de la Peña, *Legal and Regulatory Requirements for Effective Rural Financial Markets*.