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RAFI notes
The Role of Financial Institutions

Issue 3

Financial institutions are in the business of lending money and providing financial services. How well can this business serve rural and agricultural clients? What new approaches and mechanisms can mitigate credit risk and improve the profitability of rural financial services?

Farmers, rural residents, and rural businesses historically have had limited or poor access to financial services because of specific constraints to serving rural and agricultural markets. To succeed in promoting agricultural enterprise development or, more broadly, rural development, we must address the inadequacy of financial service in these areas.

This note reviews the risks and problems that financial institutions (FIs) face in trying to provide rural and agricultural financial services, and highlights new approaches and mechanisms to mitigate credit risk and improve the profitability of rural lending. This issue also discusses the potential for historically urban-focused microfinance institutions (MFIs) to provide services in rural areas, including to farmer clients.

Why Focus on Financial Institutions?

FIs are in the business of lending money and providing financial services. They can provide a range of credit services, including short- and long-term loans for business and personal use. This range allows them the opportunity to serve rural, agricultural, and agribusiness clients. Financial intermediaries can mobilize deposits—deposit and transfer services need to be available to allow low-income, rural, poor people to maintain liquid, monetary savings.

While there has been some interesting work in providing credit through nongovernmental organization (NGO) MFIs and project-created entities, ultimately no project, NGO, or donor has

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the resources, long-term orientation, or sustainability of a financial system. Another alternative, value chain finance, can address some of the short-term financial needs for agriculture, but is limited by the resources within the value chain itself, and does not address term funding or any financial services needs unrelated to a particular agricultural product. Agricultural enterprise development, or rural development more broadly, will be well served by a financial sector that provides a wide range of services to the agricultural sector and in rural areas.

A number of constraints limit the provision of services by FIs to the agricultural sector and rural areas. These include:

- **Higher transaction costs** of serving dispersed populations and poorer households. FIs generally do not have branch locations in rural areas.
- **Seasonality of agriculture.** Lack of understanding of agricultural producers' needs and ability to pay is also a problem.
- **Loan collateral issues.** For example, poorer land records, fewer land sales (harder to establish value of land), and lack of movable collateral registries.
- **Asymmetry of information.** Less likely for credit bureaus to operate in rural areas; client recordkeeping is usually poor.
- **Legacy of failed state-subsidized directed credit programs for agriculture.** Often a culture of non-payment developed because clients assumed that loans were actually grants, and that interest rates should be low. A concern that the government may choose to interfere with bank lending policies for political gain is still a major issue in many countries.
- **Covariant risk.** High concentration of farmers growing the same crop in the same area, subject to the same risks such as weather and the high volatility in the crop's sales price.

Given these constraints, it is not surprising that FIs have tended to avoid rural and agricultural sectors. Considering the importance of agriculture and related rural activity in most developing countries, however, these sectors can be attractive to local FIs. Removing and mitigating constraints, then, can be the focus of interventions aimed at encouraging FIs to enter these markets. In doing so, donors are supporting a range of activities, including expansion of MFIs into rural areas and development of new bank and non-bank financial institution (NBFI) products and procedures to increase lending to agriculture and agri-business. There is also renewed interest in state agricultural banks—donors are supporting their restructuring and revitalization efforts.

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Financial Institutions and Potential Financial Flows

Financial Institution Suppliers		Typical Clients	Typical Products	Potential Market Niche
Commercial Banks	**Commercial Banks**	Large enterprises	Short- and medium-term loans, depository services	Medium, long-term lending to medium-large processors, exporters, producer groups; lending to MFIs; term deposits
Non-Bank Financial Institutions	**Non-Bank Financial Institutions**	Micro and small enterprises	Short- and medium-term loans	Lending to small farmers and groups, remittances, insurance
Grassroots MFIs NGOs, Co-ops	**Community-Level MFIs**	Microenterprises, poor households	Short-term loans	Lending to micro-producers and MSEs, savings
	Credit Unions and Ag Co-ops	Rural households, micro and small producers	Short- to medium-term loans, savings	Lending to micro, and small producers, savings

Support to Microfinance Institutions

The development of MFIs to serve the financial needs of poor and low-income households, including microentrepreneurs, has been a major success story in development and finance over the past 20 years. MFIs have demonstrated that poor people can be good FI clients—that, indeed, they do repay loans and save money. Further, the alternative credit technologies that MFIs have used, such as character-based lending and alternative collateral do address the information and collateral constraints cited above. Those involved in this expansion of services to rural clients face three specific challenges: serving clients at a distance, management at a distance, and the agricultural dependence of rural households.

Serving Clients at a Distance

MFIs have been able to sustain delivery of microfinance products in urban areas because they can reach many clients at the same time; hence, the per capita cost of service is relatively low when compared to costs in rural areas. MFI rural lending to date has been targeted at market traders in villages or small towns, or lending to small-scale service providers (retailers, restaurants, beauty shops), and has been designed for working capital and consumer needs. To ensure fuller provision of rural services and lending to agriculture, however, MFIs must develop new credit products and technologies that minimize the higher transaction costs of rural markets, including dispersed populations.

Some donor-funded experiments in technology address distance service delivery. Bolivian MFIs are working with stored value and automated teller machine cards. A Hewlett-Packard initiative in Uganda is experimenting with point-of-sale technology and remote transactions through handheld devices. In India there has been work with rural technology kiosks. Commercial players are also experimenting with technology solutions. Visa has collaborated with BNDES of Brazil and the Economic Development Bank of Puerto Rico to develop loan products for farmers using smart cards. Card-based and mobile phone technology is also being used by money transfer companies and banks to facilitate rural remittance services. Much of this work is still in the pilot stage.

There have been some imaginative solutions to the absence of branches in rural areas. In Kenya, the Equity Building Society (EBS) has developed mobile branches—modified Toyota Land Cruisers—which operate in a 30 to 40 kilometer radius of existing branches and visit the branch one or two days per week. These mobile branches provide a full range of financial services including deposit, credit, and payment services. The mobile unit has a very high frequency global system for mobile communications (VHF/GSM) communication facility, and uploads its transactions to the central database at the end of each day. EBS has found this to be a cost-effective way to reach dispersed clients.

Service to rural clients may also hinge on the need for flexible service. Several border points between Mongolia and China are only open for 20 days each quarter for herder sales and other trading. To accommodate their clients' needs, Khan Bank of Mongolia has branches at each of these border points which are also only open on those days.

Management at a Distance

Expanding services to rural areas means that MFIs may be dealing with governance and management issues that were not an issue when delivering products in the same city. Management either has to be decentralized or must use technology to maintain a centralized system. For example, loan approval procedures are often centered on a loan committee meeting, with approvals dependent upon credit review by one or two people. Providing quick service at a distance means that greater lending authority must be delegated to the branch level. This decentralization increases the importance of internal controls, internal audit, timely loan payment, and other systems processing for effective monitoring.

Agricultural Dependence

Rural households are, almost by definition, agriculturally dependent. Most rural people engage in agricultural activities as all or part of their livelihoods. In general, the more rural the household, the more dependent it is upon agriculture. Even those who do not engage in agriculture, such as small shop owners and service providers, sell to a clientele that earns its income from farming.

The usual microfinance loan terms, such as weekly or monthly installments of the same amount over a period of weeks or months, are not always suitable for agriculturally dependent clients, whose incomes are typically irregular and tied to the production and sale of crops or animals. Loan terms need to be structured around household cash flow and crop cycles, often with bullet principal payments rather than weekly or monthly installments. Loan officers also need to have substantial knowledge of local crops and crop prices to properly evaluate credit applications and monitor loan performance. In short, lending to agriculturally dependent households requires a different approach to analyzing creditworthiness.

Agriculture commands the highest share of rural GNP in many developing countries, and most of the poor still live in rural areas. Most rural households derive the predominant share of their income from agriculture and related input and output industries and services. Other economic sectors depend more or less heavily on agriculture through forward or backward linkages. The savings and loan portfolios of rural financial institutions can therefore be affected by agriculture even if their clients earn their income in other sectors.

Manfred Zeller, "Models of Rural Financial Institutions", Paving the Way Forward Rural Finance Conference, 2003.

Lending to agriculturally dependent households exposes MFIs to levels of liquidity risk and co-variant risk that they have not experienced before. Liquidity risk is greater because of the seasonality of crops, and the likelihood that all farmers in the region will seek a loan or access to their savings at the same time. The MFI will also have greater exposure to co-variant risks such as climatic risk and market risk (selling price of crops) that are endemic to agriculture and that affect all who borrow for similar purposes. MFIs serving rural markets must mitigate these risks by diversifying their portfolios or limiting the percentage of crop production loans that they will make. Traditional crop insurance is not an easy solution as it has weaknesses such as adverse selection and moral hazard. Another experiment in this risk mitigation is with indexed insurance to cover co-variant risk.[1]

New Products and Procedures for Commercial Banks and Non-Bank Financial Institutions

Many of the approaches to addressing constraints listed above are applicable to commercial banks and NBFIs as well. These institutions may not have rural branches, even if they have extensive branch networks, and loan officers rarely have experience in agricultural lending. Interestingly, larger banks may have an advantage to expanding into agricultural lending as a way to diversify a large credit portfolio. Instead, loan collateral issues and asymmetrical information are bigger constraints for these larger FIs—in addition to the need to know more about the agriculture and agribusiness sectors. At an institutional level, these problems are being addressed by encouraging FIs to do more cash flow lending, particularly lending into the value chain and taking assignment of accounts receivable and contract proceeds as collateral.[2] Other approaches include term lending through value chains, lending through producer associations, and accepting new forms of collateral, such as warehouse receipts.

Term Lending Based on Value Chain Relationships

While value chain finance is mostly limited to funding for current inputs, some term lending can also be done through the value chain, by lending based on expected cash flow stream from a contractual relationship. For instance, in Croatia, Erste Bank is making term loans for equipment and building additions, as well as for cows, to dairy farmers who sell to Lura, a major dairy processor, based on Lura contracts to buy milk over several years. It appears that this structure is the most feasible for farmers who make a series of sales, rather than the sale of a single annual harvest, to finance equipment and investment needs for activities such as dairy and swine farrowing.

[1] Weather related risk and price risk will be covered in depth in forthcoming RAFI Notes.

[2] See RAFI Note 2, Value Chain Finance, for an extensive description of the potential for an FI to leverage value chain relationships.

Lending to Producer Associations

Due to transaction costs, commercial banks often have difficulty serving smaller clients. In these cases, lending through a producer group is another approach to lending into the value chain that can address the needs of smaller producers more directly rather than the larger value chain players. This approach does require having relationships with effective producer associations. Further, there may be legal and collateral issues in lending to or through producer associations for on-lending.

Warehouse Receipts Systems

In the development of new financial instruments, a growing area of interest is warehouse receipts, which allow the transfer of ownership of a commodity without physical delivery. While FIs historically have made loans secured by inventory stocks, warehouse receipts systems make banks more willing to lend because they are more liquid than inventory, and quality and monitoring standards have been established and are no longer the responsibility of the lender.

USAID has supported the development of warehouse receipts systems in Zambia, Bulgaria, Ukraine, and elsewhere. Work is also being done to improve the quality and reliability of warehouses and storage facilities, so that lending against a crop inventory is a more attractive option. The availability of reliable warehouses—especially those with systems sophisticated enough to offer receipts rather than the inventory itself—address collateral constraints as well as price risk.

State Bank Turnarounds

State agricultural and development banks were created largely because agriculture was not being served by private FIs. Many of these institutions failed because of unsustainable practices, including directed credit, subsidized interest rates, and debt forgiveness. As a result, donors redirected their support into microfinance development and non-financial interventions. While there is little interest by most donor organizations in revisiting the problematic interventions of the past, many are increasingly faced with requests to support existing or new state development banks.

Interestingly, there have been some success stories in the rehabilitation of state banks that serve rural markets, including BRI in Indonesia, Crediamigo in Brazil, Khan Bank in Mongolia, and the National Microfinance Bank in Tanzania. Providing rural financial services through state banks does capitalize on existing institutional strengths which are very expensive to create in a greenfields operation. These strengths include sunk costs in branch networks, an often substantial customer basis, and trained staff. However, a state bank turnaround requires substantial investments for recapitalization and a hands-off attitude by the host government so that the bank can operate on a commercial basis, targeting the natural constituencies, rural citizens, businesses, and agriculture.

Other Interventions

Interventions to strengthen the institutional infrastructure and broader policy environment that support financial sector development can also improve the enabling environment so that FIs find the sector more appealing. Collateral, for instance, can be addressed by liberalizing the definitions of assets that can be pledged, and by creating land registries and movable collateral registries that make it feasible to pledge these assets. Donors can also address policy issues that shape the profitability, thus bankability, of agriculture. These may include such issues as higher taxation of agriculture or the legal status of family-owned farms.[3]

Challenges to Providing Finance Through Financial Institutions

The interest in working with FIs at all levels to provide finance to rural and agricultural clients—as opposed to a more direct value chain approach that works with producers and processors—is that FIs have much greater financial resources, and a much

[3] These topics will be covered in greater depth in forthcoming RAFI Notes on Legal and Regulatory Environment and Secured Lending.

greater range of financial products that can serve all clients. Working with FIs, however, takes time. MFIs will have a learning curve as they expand services to rural areas and commercial banks are inherently conservative and often unwilling to adopt new lending approaches—although in many countries, they will acknowledge a desire to serve the agriculture and agri-business sectors because the business potential is so great. All FIs are obsessed with risk, whether real or only perceived. Donors and implementers, thus, must recognize that working through FIs to increase the availability of rural and agricultural finance is a longer-term strategy that requires commitment and persistent engagement. The ultimate payoff is that the resources of the financial system will be leveraged for the benefit of rural and agricultural development.

Recommended

"Models of Rural Financial Institutions", by Manfred Zeller for the USAID-sponsored conference Paving the Way Forward for Rural Finance http://www.basis.wisc.edu/rfc

"Warehouse Receipts: Facilitating Credit and Commodity Markets", by Giovannucci, D., Vargas and Larson 1999 http://lnweb18.worldbank.org/ESSD/ardext.nsf/11bydocname/warehousereceiptsfacilitatingcreditandcommodity-markets

"State-Owned Retail Banks (SORBS) in Rural and Microfinance Markets: A Framework for Considering the Constraints and Potential", microREPORT by Robin Young and Robert Vogel http://www.microlinks.org, AMAP Research, Financial Services, Theme 1.

"Introduction to the Rural and Agricultural Finance Initiative", RAFI Note No. 1 by Geoffrey Chalmers et al http://www.microlinks.org, AMAP Research, Financial Services, Theme 3.

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