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# RAFI notes

## Legal and Regulatory Foundations for Rural and Agricultural Finance

### Issue 5

*An appropriate legal and regulatory framework for rural and agricultural finance lowers transaction costs and risks, broadens the range of acceptable collateral for secured lending, boosts secured and unsecured lending by making it easier and less costly for lender to make and enforce credit decisions, and allows regulated financial institutions to intermediate savings.*

Poor and inadequate legal and regulatory frameworks frequently constrain financial service provision in rural areas and to the agricultural sector. These legal and regulatory frameworks—defined as systems of laws, government policies, and regulations—often over-regulate financial institutions and subject non-financial firms that incidentally extend credit as a part of their operations to financial regulation.

Although a proper legal and regulatory framework, accompanied by an appropriate and functioning institutional infrastructure, is not the only element required to ensure the facilitation of a wide range of financial services, it is a necessary prerequisite for expanding financial service provision. An appropriate legal and regulatory environment can help to lower transaction costs and risks associated with rural and agricultural lending, promote high volume lending to rural and agricultural enterprises by broadening the range of acceptable collateral for secured lending, boost both secured and unsecured lending by making it easier and less costly for lenders to make and enforce credit decisions. Also, it can allow regulated financial institutions to intermediate savings, with savings being an important financial service for rural clients and a source of lending capital for the institutions.

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This note seeks to outline those elements of a legal and regulatory framework needed for well-functioning rural and agricultural finance markets. The institutional infrastructure required to support this framework is addressed in RAFI Note #6.<sup>1</sup> The laws, policies and regulations that encourage or inhibit rural and agricultural finance are organized into three categories. The first category covers the legal foundations that regulate institutional actors involved in direct financial service provision, particularly in rural areas. The second category includes those laws that directly and indirectly influence the supply of secured and unsecured credit for rural and agricultural finance. The third category contains those legal framework elements that affect clients and non-financial value-chain actors. The table provides an overview of some of the

specific laws, policies, and regulations relevant to rural and agricultural finance, broken down by category. This list is not exhaustive.

## FINANCIAL SERVICE PROVIDERS

Agricultural enterprises and the rural poor need access to a wide range of financial services delivered cost-effectively and efficiently by an array of institutional actors. Excessive financial institution regulation constrains the availability of rural and agricultural finance, by making it more difficult and costly for a variety of institutions to deliver a broad range of services. The legal and regulatory framework should allow different types of institutions to exist, with each type subject to different levels of regulation and supervision, depending upon the risk that type of institution poses to depositors in particular and to the financial system as a whole.

## PRUDENTIAL VERSUS NON-PRUDENTIAL REGULATION

**Prudential regulation** protects the financial system and the safety of deposits in individual institutions by closely monitoring the health of an institution. If, for example, a large deposit-taking institution becomes insolvent and cannot repay its depositors, its failure can undermine confidence in the banking sector and could lead to a run on deposits. Because prudential regulation involves closely monitoring the health of an institution, it is often difficult and expensive to do.

**Non-prudential regulation**, on the other hand, is easier and less costly to administer. It involves those rules and regulations that affect an institution's business operations and does not aim to protect the entire financial system. Issues covered by non-prudential regulation include, among others, interest rate policies; limitations on foreign ownership, management, and sources of capital; consumer protection; and tax and accounting.

FINANCIAL SERVICE PROVIDERS (exit, entry, operations, prudential regulation)	CREDIT TRANSACTIONS		GENERAL BUSINESS ENVIRONMENT (laws affecting clients and other non-financial value-chain actors)
	Secured	Unsecured	
<ul style="list-style-type: none"> <li>• Banking Laws</li> <li>• Cooperative Laws</li> <li>• Microfinance Laws</li> <li>• Laws on Insurance and Securities</li> </ul>	<ul style="list-style-type: none"> <li>• Secured Transactions Law (Collateral Law)</li> <li>• Property Rights</li> <li>• Contract Enforcement</li> </ul>	<ul style="list-style-type: none"> <li>• Privacy and Credit Reporting Laws</li> <li>• Contract Enforcement</li> </ul>	<ul style="list-style-type: none"> <li>• Usury Laws</li> <li>• Homestead and Exempt Property Laws</li> <li>• Commercial Laws</li> </ul>

<sup>1</sup> RAFI Note No. 6, Institutional Infrastructure

## Who Should Be Regulated?

Only those institutions that pose a risk to financial system stability should be subject to the prudential regulation. These institutions are typically larger financial institutions that accept public deposits. Banks engage in non-restricted deposit-taking activities, accepting major deposits from the general public, and should be subject to prudential regulation. They may be tiered, with different capital requirements for each tier. Non-bank financial institutions, including leasing, insurance and finance companies, may be licensed and subject to some financial regulation.

In general, institutions that accept deposits from the public should be subject to some type of external supervision. However, in some cases, a good argument can be made for not regulating very small institutions because the costs of supervision would greatly surpass the potential losses incurred by local communities should those institutions collapse. Member-owned and member-capitalized organizations that only take deposits from members and not the public are not usually supervised.

## Non-Prudential Regulation

Non-prudential regulation can also have a large impact on the provision of rural and agricultural finance in that it regulates how financial institutions conduct their business. Regulations covering branch requirements and interest rate caps can have particularly significant ramifications. Inflexible branch requirements concerning security standards, working hours, and use of mobile banking and other technologies may discourage institutions from implementing innovations that reduce costs and bring more convenient service to clients. Interest rate ceilings will almost always disadvantage the rural poor by reducing the availability of small loans in rural areas. Administrative costs are often higher for institutions delivering small loans to geographically dispersed populations in harder to reach areas. In order to continue to deliver this type of finance, institutions must be able to charge cost-recoverable rates of interest.

## Responding to Market Demands

Tight control on granting licenses limits competition and creates legal barriers that hinder the expansion of non-deposit taking institutions. The legal and regulatory framework should permit banks and non-bank finan-

cial institutions to respond to market demands. Further, as markets and loan transactions become more sophisticated, the legal and regulatory system must keep pace. For instance, financial products that are new to the market such as lending against warehouse receipts, indexed insurance, and payment through mobile phones require appropriate laws and regulation that should be developed in tandem with supporting enabling institutions and other market elements.

## SECURED CREDIT TRANSACTIONS

Most agricultural enterprises need access to working capital and term credit suited to seasonal or long-term agricultural activities. However, rural and agricultural lending is perceived both as costly and as risky. In general, financial institutions mitigate risk by taking collateral. But because rural and agricultural enterprises cannot meet conservative collateral requirements, financial institutions cannot provide them with affordable

### ROMANIA: BENEFITS OF SECURED TRANSACTIONS REFORM

In late 2000, Romania reformed its laws on secured transactions for moveable property, dramatically expanding access to credit. During the first year, 65,000 security interests were filed, increasing to about 200,000 filings each following year. Private credit grew by about 5% of GDP, with Romania offering more secured transaction loans than the rest of the Balkan nations combined in 2005.

loans that meet their business needs. In most developing countries, and particularly in rural areas, property cannot be titled, or registered to a particular person or business, which limits this person's ability to use assets to secure credit. Establishing a comprehensive secured transaction framework—one that clearly defines property rights and broadens the range of collateral used to access credit—can facilitate the provision of supplier and bank credit to rural and agricultural enterprises.

Secured lending includes any transaction in which a lender has a lien on the borrower's property to collateralize a loan. A borrower gives a lender a property right (or security interest) in the borrower's property (or collateral for the loan). If the borrower defaults, that security interest gives the lender the right to seize and sell the collateral to pay the loan. If the legal framework and registration system allow for it, collateral can include both immovable and moveable property. *Immovable property* includes real estate—parcels of land, the buildings or permanent facilities attached to the land, and units within a building. *Movable property* includes all property other than land and the buildings attached to the

land. Examples include agricultural products, cars, furniture, equipment, and jewelry, but can also include less tangible items such as account receivables, securities, insurance policy benefits, and intellectual property.

A good secured transactions framework for rural and agricultural development will include laws that clearly define property rights and broaden the range of acceptable collateral. In many countries, titled urban real estate and new vehicles are acceptable collateral, but rural and agricultural enterprises often do not possess either. They have rural land that may not be titled and rarely have new vehicles. Instead, rural and agricultural enterprises have equipment, accounts receivable, inventory, livestock, and future crops—moveable property that could be used as collateral if the appropriate legal framework for secured transactions is in place.

Where the legal system allows borrowers to offer a broad range of property as collateral and provides efficient enforcement mechanisms, borrowers receive larger loans, at lower interest rates, repayable over longer periods of time, and lending volume increases. The more uncertain and expensive the legal process is to register and enforce claims, the less value lenders will place on the collateral offered. Lenders can cover some of the costs associated with an un-

certain legal process with higher interest rates. However, as risk and cost rise, lenders will reduce the loan term and amount lent relative to the value of the collateral; or they will ration credit, serving mainly wealthy borrowers with low probability of default. In general, the more uncertain and expensive the process, the less often lenders will offer loan terms that are better than those available for unsecured loans.

To be effective, the laws must allow lenders to create claims against property, determine the priority of one claim against other claims, publicly establish the ranking of priority, and, if the borrower defaults, enforce the claims against the property serving as collateral. To facilitate and enforce transactions, appropriate enabling institutions, such as a working court system, easy to use registries, and collections agencies, must exist.

## Creating a Security Interest

The framework must allow parties to enter into legally enforceable security agreements that pertain to all parties, collateral, and transactions that have economic importance. Requirements should be clear and easy to follow. While it is reasonable to require specific identification for large single items such as vehicles, specific identification for property such as livestock, crops, or inventories of agricultural inputs is difficult at best, and rather than risk not being able to foreclose, financial institutions will simply not use this moveable property for collateral. General descriptions of generic

assets such as inventory, livestock or crops have been proven to be most efficient and flexible in meeting the needs of borrowers and lenders.

## Establishing Priority and Publicity of a Security Interest

A lender must be able to establish the order, among any other claims against the collateral, in which that lender will be paid from the proceeds of the sale of the collateral. To assign *priority* to a lender's claim, secured transaction laws generally require *publicity*—that the lender's claim against the collateral be made public. When the lender keeps the collateral (*possessory collateral*) until the loan is paid—such as the case with pawnshops and warehouse receipts, most laws regard that possession by itself as providing enough publicity. However, when the borrower keeps the collateral (*non-possessory collateral*), most laws require that the lender register the existence of this otherwise hidden claim. The lender does this by filing a notice of the security interest in the public archive or registry.

## Enforcing a Security Interest

Lenders' willingness to take a range of goods as collateral depends largely on the speed and ease with which

they can repossess and sell the collateral. Slow and expensive enforcement procedures particularly diminish the value of movable property as collateral, because, unlike real estate, movable property usually depreciates over time. In El Salvador, because it can take up to ten years to repossess and sell collateral, lenders only deal with borrowers who own real estate or are known to be very wealthy. In some cases, foreclosing on certain types of collateral may be banned, as a result of "homestead" provisions in the law that make it illegal to repossess and sell small parcels of land or workers' tools.

## UNSECURED CREDIT TRANSACTIONS

Many small rural and agricultural enterprises rely on unsecured credit from microfinance institutions and input suppliers. Because of this reliance, it is important that the legal and regulatory framework support unsecured lending. Laws that enable credit information sharing and effective contract enforcement make it easier and less costly for credit providers to make and enforce credit decisions, and can, as a result, increase the availability of credit to agricultural enterprises and the rural poor.

Without the financial protection that accepting collateral affords, lenders providing

unsecured credit need access to reliable borrower credit history information on which to base sound credit decisions. Access to this type of information helps lenders to mitigate the risk associated with unsecured lending and reduce transaction costs. Laws governing bank secrecy, data protection, and company information disclosure all influence the amount and degree to which credit information is shared. For credit reporting agencies to exist, it is imperative that laws support information sharing.<sup>2</sup>

Cost-effective contract enforcement is critical for unsecured lending. Lenders are more likely to issue credit when they can expect compensation in the case of default. The legal framework for unsecured loans should allow for the creation of a judgment lien against the borrower's property or salary as part of the problem loan collection process. To be effective, this process must not be prohibitively expensive—more than the claim is worth—and must take place within a reasonable amount of time. Because working contract enforcement systems do not exist in many developing countries, legal reforms may be needed to enact effective arbitration laws, establish small claims court procedures, and revise civil procedure laws to reduce the cost and time of litigation.

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<sup>2</sup> RAFI Note No. 6, Institutional Infrastructure for Rural and Agricultural Finance, discusses credit reporting agencies in greater detail.

## **CLIENTS AND NON-FINANCIAL INSTITUTION ACTORS**

Rural and agricultural finance provision is also largely affected by a broad range of laws pertaining to non-financial institution actors—namely agricultural and rural enterprises and other value-chain actors.

### **Borrowers' Rights**

Most legal systems include a set of rights that protect borrowers. Homestead and exempt property laws are laws that protect the owner against loss of that title through seizure for debt. Unrealistic and carelessly drafted homestead and exempt property laws may prevent lending to certain borrowers because a lien cannot be placed on the types of property these borrowers possess. For example, in Bolivia, agrarian reform, designed to protect beneficiary farmers by making 50 hectares of land exempt from seizure, discouraged formal sector lending to this population. Because banks could not foreclose against this land, they would not accept this land as collateral.

Usury laws, for example laws that set interest rate caps, often do not recognize the higher transaction costs of providing loans in rural areas, where administrative costs are legiti-

mately higher. While intending to protect borrowers from higher rates, they often effectively undermine financial service provision in rural areas.

Other laws that define or identify who may be a borrower can similarly shape the effective demand for credit. State-imposed identification requirements for loans effectively make many indigenous citizens and other rural residents ineligible for formal sector credit. Similarly, signature requirements may disqualify the illiterate. In many instances, such laws are particularly restrictive to rural populations, who may be more likely to be illiterate, less likely to possess the proper identification, etc.

### **Business Registration**

Rural and agricultural businesses may set up their businesses under the rules defined in the commercial laws, or may operate informally. Poorly drafted commercial laws can raise the cost of business creation and expansion, making it more difficult for firms to formalize. This, in turn, may prevent the enterprises from qualifying for larger and more profitable contracts with formal sector firms and receiving financing from formal financial institutions. Farmers may face greater hurdles, as some laws classify them as non-commercial entities that cannot operate as businesses at all. These

burdens can be further compounded by expensive or complicated licensing regimes, which are normally unnecessary and should be eliminated or simplified. Since farmers frequently form operating cooperatives to make bulk purchases of inputs, bulk sales of crops, and to establish community storage facilities, there needs to be an appropriate registration regime so that these entities can enter into contracts and even borrow money.

### **Embedded Financial Services**

Non-financial firms that provide credit as part of product delivery or purchase (like the fertilizer dealer who offers delayed payment terms or the processor who advances seed) should not be subject to prudential regulation. Given that input suppliers are an important source of credit to rural and agricultural enterprises, it is critical that these firms do not bear the cost and inconvenience of unnecessary licensing, regulation, and supervision.

## **CONSIDERATIONS FOR PROGRAM DESIGN**

The appropriate legal and regulatory framework is critical to the success of rural and agricultural finance development efforts. Even in those cases where legal and regulatory reform does not fall within the scope of donor projects, project designers and implementers must understand the potential ramifications that the legal and regulatory environment will have on the implementation of their projects. When

seeking to improve the legal and regulatory framework in a particular country, one must determine whether all the necessary laws exist; the laws exist but are not carried out; or the laws or institutions that exist are the wrong ones. The results of this analysis will shape the type of intervention that might be undertaken to remedy the constraint.

There may be particularly relevant laws or regulations that can be addressed by the project or in partnership with other donor or government programs. Certain reforms are simpler to address than others. For example, reform of the secured transactions framework to allow movable property as collateral is considered one of the easier and more effective types of reform. Improving the system for

using land as collateral is another. Furthermore, in cases where project interests closely align with government interests, reforms may be easier to implement.

It is also important for project designers and implementers to note that efforts to develop model legal clauses are underway. Before beginning work in the legal and regulatory arena, it would be worthwhile to review these model clauses. At present, the International Finance Corporation is completing development of a model leasing law that could be used to benchmark and ensure that all issues are addressed consistently.

### **ALIGNING PROJECT, COMMERCIAL AND GOVERNMENT INTERESTS FOR REFORM**

It is rare that the appropriate legal and regulatory environment will predate the emergence of commercial concerns, and this was no exception in Armenia. The stakeholders of the ACBA Leasing Company determined that they considered the implementation of an appropriate law on leasing as a necessary prerequisite to establishing the company, and started a strong lobbying effort to have the law adopted. Parliament passed necessary legislation within six months, demonstrating that legal reform should go hand in hand with commercial implementation, and that a government is more likely to act if it can see the immediate benefit of its actions.

### **Recommended**

More information on this topic is included on the Paving the Way Forward for Rural and Agricultural Finance conference Website at [www.basis.wisc.edu](http://www.basis.wisc.edu). Other sources include:

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