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Rural and Agricultural Finance Institutional Infrastructure

Issue 6

It is the institutional infrastructure, together with the legal and regulatory framework, that enables the growth of a variety of viable financial institutions that are client oriented, mobilize deposits effectively and provide access to loans to a full range of farmers, agribusinesses, and other rural clients. Some institutions work directly with the financial sector to support their operations and services. Others provide services directly to rural enterprises, improving their access to finance.

Vibrant rural financial markets require a supportive legal and regulatory framework as well as the necessary institutions to bring that framework to life. For example, agricultural enterprises do not benefit from secured lending laws if the necessary moveable or immovable property registries do not exist, or operate ineffectively. It is the *institutional* infrastructure, together with the legal and regulatory framework, that enables the growth of a variety of viable financial institutions that are client oriented, mobilize deposits effectively and provide access to loans to a full range of farmers, agribusinesses, and other rural clients.

The rural and agricultural finance institutional infrastructure implements and enforces the legal and regulatory framework[1], and provides support and other services to the agricultural and financial sector. These institutions include both public and private institutions[2]. Some work directly with the financial sector to support their operations and services to rural and agricultural clients. Other institutions provide services directly to rural enterprises, improving their access to finance and their bankability.

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[1] See RAFI Note #5, *RAF Legal and Regulatory Framework*. This Note is best viewed as complementary to the information provided in Note #5.

[2] See RAFI Note #4, *Role of the State*.

The purpose of this Note is to provide an introduction to the types of institutions that comprise the supportive infrastructure for rural and agricultural finance, identification of how these institutions address various constraints to rural and agricultural finance, and the lessons learned from developing these institutions and their operations.

RURAL AND AGRICULTURAL FINANCE INSTITUTIONAL INFRASTRUCTURE

It is impossible to discuss an institutional infrastructure for rural finance without including supervisory and regulatory institutions that govern suppliers of financial services. This includes ***central banks*** and self-governing bodies of financial institutions (such as ***apex organizations***). Among other things, these institutions establish requirements for (and monitor compliance with) the entry into and exit from financial markets, set reserve requirements, and help define regulations that enable secured lending including laws on collateral, mortgage, priority of claims, moveable property. Their role in establishing and enforcing these requirements can help facilitate the flow of capital into rural an agricultural markets, or can restrict financial institutions from offering innovative products and additional services to those clients.

Beyond institutions that establish and regulate the financial sector as a whole, when assessing the legal framework and the institutional infrastructure that enable rural and agricultural finance specifically, it is important to identify the underlying constraints that inhibit a farmer's or processor's access to finance. Generally, reduced access to rural and agricultural finance reflects one or more of three broad sets of constraints: lack of collateral for secured lending; lack of access to information to facilitate lending decisions; and weak enforcement and other constraints that increase risk. For each of those sets of constraints, there are multiple possible solutions depending on the local context, institutional capacity, and demand for services. Below are examples of the types of institutions whose function can help address the constraints to finance for rural and agricultural clients.

Institutions that facilitate secured lending.

Secured lending has the potential to significantly reduce risk, thus facilitate more rural and agricultural lending. Lenders want assets that they can take and auction off if the borrower defaults. Secured lending legislation is imperative, but insufficient unless the necessary institutions (registries and databases) exist that allow for collateralized lending.

Such registries include basic ***commercial registries*** that allow a lender or enforcement agent to locate and identify a borrower. Enterprise registration processes often point to significant barriers to formalization. For rural and agricultural enterprises in particular, inclusion in the database would be increased by locating registry facilities in rural and remote areas (to reduce transactional costs), minimized informational requirements and reduced formal registration fees. Reducing the informational requirements need not reduce the quality of the databases; some databases currently attempt to collect more information than is needed or is easily captured.

More commonly, ***land registries*** are the focus of secured lending assistance programs. These registries may include land as well as fixed property (houses, physical building structures), but are not always combined into a single registry. These registries are most often government operated, and usually by local governments. In more established markets titled land is not the only important land right—more comprehensive systems can incorporate long term leases, casements, rights of way, etc., to allow for a broader range of land rights as collateral. These are often particularly relevant for rural residents and agricultural enterprises.

Moveable property registries, such as those that record pledges of farming equipment, are another institution that can increase the secured lending options for rural and agricultural borrowers. Movable property registries benefit not just farmers or producers groups but also input suppliers, feedlot operators, grain silo operators, processing plans and other actors in the supply chain. USAID has invested considerably in efforts to develop moveable property registries in the Balkans, including Albania and Romania.[3]

Less extensive than some ***pledge registries***, some countries have had success in building ***notice filing archives***, which store a notice of an existing security agreement. This is in contrast to a registry of the entire security agreement, and does not include a check on the legal accuracy of the agreement. This type of archive is much less expensive to establish and maintain, and access is often less restricted because of the limited information contained in the archives. The World Bank has supported an Internet-based notice archive in Romania, which has met that market's need for a lower-cost mechanism for assigning rights to assets.

ESTABLISHING COLLATERAL INSTITUTIONS

Albania established a pledge registry in 2001. As a result the authors estimate that the risk premium on lending fell by half, the interest rate spread by 43 percent, and the interest rate on lending by 5 percentage points. By 2006, the pledge registry receives roughly 40 pledges a day, and Albania now ranks fourth out of 154 countries in *Doing Business* on the strength of legal rights for borrowers and lenders.

(Chaves, de la Peña, and Fleisig 2004)

Registries, generally speaking, should be easy to access and use, at a low cost. This is all the more important when considering rural and agricultural finance with borrowers in remote locations. The registries can be private or public operations. For example, Colombia allows for private operation of the pledge registry. Regardless of whether the registry is publicly established and/or managed, the registries need to follow best practices in establishing and making public the priority rankings of the security interest.

Another way of increasing collateralized rural and agricultural lending is a warehouse receipts system. A farmer or processor deposits goods (inventory) in a warehouse and is given a receipt indicating quantity and quality of the commodity, typically using a grading system or accepted quality standards. The receipt can then be used as collateral to secure financing, and the proceeds from the sale of the commodity are paid to the lender. There are multiple institutions required to enable a warehouse receipts system. This includes the moveable property registries discussed above, but also ***bonded (insured) warehouses***, a government body or private ***certification board*** to issue licenses and conduct regular inspections of the warehouses, and ***insurance providers*** who offer a reserve insurance fund for the inventory. Recent examples of building the necessary institutions to support warehouse receipts include Bulgaria and Lithuania, the latter which focused particularly on grain warehouse receipts. Zambia also recently established a grain warehouse receipts program through the Zambian Agricultural Commodities Agency.

Institutions that improve information. Better information on payment rates and credit history can allow lenders to offer their rural and agricultural clients better terms and greater access to services. ***Credit bureaus*** can fill an information 'gap' because they enable better screening and scoring of prospective borrowers. Credit bureaus around the world demonstrate variations in the quality and availability of data. The more comprehensive the information, the more benefit to rural and agricultural clients. In fact, such databases can also reduce the collateral constraints faced in rural and agricultural markets. Bureaus that include payment history on consumer debt and public utility payments offer small-scale entrepreneurs another means to demonstrate the potential for repayment and counterbalance the risk posed by unsecured lending. Credit bureaus can be established as either public or private operations, though a critical factor as to whether the credit bureau actually increases financing options for the smaller borrowers is the extent to which the financial community 'buys-in' to the concept and utilizes the bureau. For this reason, the most comprehensive credit bureaus, which draw information from a range of sources (banks, MFIs, utilities, etc.), are the most effective.

An interim solution is to establish a ***default registry***, sometimes referred to as a 'bad debtor list' or a 'black list.' While a system that relies on the most comprehensive set of data is ideal—including positive information about loan size and repayment history – an alternative is to have a bad debtor list managed by and shared among financial institutions. This was the option pursued in Haiti, and was actually managed by the microfinance association. In Moldova, while the financial community pursued the creation of a more comprehensive credit bureau, individual banks initially began posting lists of bad debtors that they circulated among banking institutions.

Institutions that reduce risk. Rural financial markets operate with higher risk than more urban, industrial lending, and reducing or mitigating that risk can result in more financial services offered to rural and agricultural clients. Key among the institutions that reduce lenders' risk is the ***judiciary*** and its ability to enforcing contracts, laws on collateral and priority of claims. This can be particularly challenging in more remote rural communities. Key among the judicial operations should be a professional cadre of enforcement agents, preferably with provisions that permit non-judicial repossession where possible, and court efficiencies such as fast-tracking, small claims courts, and/or arbitration that avoid the need for lengthy judicial proceedings.

Mediation/arbitration institutions, which can be either public or private, offer an alternative to full judicial proceedings and often at a lower cost and more quickly. Establishing these institutions often depends on provisions in the civil code, and should include requirements on binding arbitration, appropriate insulation from the judicial system, and competing/multiple arbitrators to reduce the potential for abuse. Alternative dispute resolution (ADR) as it applies to commercial disputes has been growing in popularity in most regions. For example, both Albania and Bosnia have judicial systems that recognize privately mediated rulings. In 2001 Jordan adopted a Law on Arbitration (based on an earlier Egyptian law) and in Latin America, Mexico, Argentina and Brazil recognize arbitration and mediation settlements.

Licensed debt collection agencies, which are increasingly privately operated, can reduce the costs of enforcement in case of default. Although the existence and operations of such agencies can reduce a lender's potential risk and increase their ability to claim collateral, regulations that dictate the means and ease of seizure balance the potential for abuse.

Last, another type of institution that can reduce lending risks in rural and agricultural areas is ***government or parastatal insurance providers***. These institutions can stabilize farm income in some areas, and minimize the risk of operating in rural financial markets. In the developing country context, this usually means indexed based insurance which is based on measurable indicators such as rainfall and commodity prices. The resulting index allows insurers to essentially calculate the risk of a particular grower of a particular product in a particular region, that season. Examples include a crop insurance program in Mexico and on-going efforts in Peru.[4]

CHALLENGES TO ESTABLISHING THE INSTITUTIONAL INSTRASTRUCTURE THAT SUPPORTS RURAL AND AGRICULTURAL FINANCE

Institution building is not a linear process, and there are many challenges to effective institution building in developing countries. A helpful starting point when considering the rural and agricultural finance enabling environment—comprising both the legal framework and the institutional infrastructure —is to determine which of the following conditions are applicable to the particular country:

1. The necessary laws or institutions don't exist at all;
2. The appropriate laws exist but are not carried out—perhaps because of weak or missing institutions;
3. The laws (or institutions) that exist are the wrong ones—that is they actually inhibit the development of viable financial service provision to rural areas and agricultural enterprises.

Whether the challenge is to build an institution from scratch, or to reorient the services of an existing institution, there are two critical lessons to be considered. The first is to maintain focus on the constraint to increased rural and agricultural finance, rather than on the institution itself. As demonstrated in this note, there are usually a variety of institutions that can be a response to a single constraint and in some cases there are institutions that represent a first step towards creating a more comprehensive response. Working together with local country practitioners and the financial community, donors can often identify multiple institutional solutions, and may have to change course mid-stream depending on events in the country. The goal is to make financial services more available to rural and agricultural clients, not to build a particular institution.

Second, there are very few lessons with regard to sequencing and prioritization. Sequencing and prioritization lead many practitioners to think and operate in terms of discrete interventions and very linearly, when in fact institution building is almost never linear. More recent attention has been placed on incentives in institution building – who has the incentives and of what type, and how to use those (or create new) incentives to change institutional behavior. Growing consensus is that institution building and strengthening requires:

- a clear legal operating environment (see RAFI Note 5);
- clear incentives for the institution to function (in part this related to RAFI Note 4 and the Role of the State, but more important, it speaks to both public and private sector buy-in and support)
- and, there must be demand for the services of the institution (primarily from the financial services industry in a particular country, although also from enterprises to the extent that the institutions directly service rural and agricultural borrowers).

Determining where the incentives lie—both for reform and for status quo—and assisting the financial community and enterprises in effectively articulating their demand for the services of the institutions addressed in this Note becomes as important a task as the nuts and bolts of legally establishing the institution, hiring and training its staff, etc. Donor supported programs that fail to identify demand and re-

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[4] There are additional efforts underway on weather and flood insurance for small holder farmers. See 2006 World Bank presentation on India, Nicaragua, Malawi, Ukraine, Morocco and Zambia, among others. (http://siteresources.worldbank.org/INTTHAILAND/Resources/333200-1089943634036/475256-1151398840534/May1306_Weather_Index_Insurance_Dick.ppt#287,15,The global market)

align incentives often face considerable hurdles in establishing the institution, much less improving its operational effectiveness and, ultimately, facilitating increased rural and agricultural lending.

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