RAFI notes
Conflict-Affected States

Issue 10

Conflict-affected states are part of a much broader category of states called fragile states. USAID describes fragile states as failing, failed, or recovering. Within fragile states, vulnerable states are those states that are failing or recovering from crisis—where government legitimacy is questionable and the ability of the state to ensure the provision of security and basic services is unclear. States in crisis are those states plagued or threatened by violent conflict and where the central government is ineffective at controlling its territory or providing vital services to a significant portion of its population. Although this note focuses on rural and agricultural finance in post-conflict environments, the considerations described may apply to fragile states more broadly.

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Conflict can devastate rural and agricultural development. It may result in the loss of productive assets and inventory; the destruction of marketplaces, telecommunications, roads, and other distribution channels; and the breakdown of enabling environment institutional infrastructure. Because of limited resources and market opportunities in conflict affected areas, farmers, traders, processors, and rural microenterprises struggle to generate income. As loan delinquency rates rise due to economic dislocation, and as those with money flee with their capital, financial institutions that provide rural and agricultural finance may collapse.

Considering the role that rural and agricultural finance can play in rebuilding the economic and social fabric of states following a conflict establishing or rebuilding financial service provision in rural areas is an important intervention as a country moves toward recovery. Access to financial services can help reduce dependency on relief aid, and jump-start crisis-affected economies. It can provide working capital, replace lost productive assets needed to re-establish rural and agricultural businesses, and strengthen household coping mechanisms. By building trust through the economic interaction between groups, it can encourage social and political reconciliation.

Implementing rural and agricultural finance programs in post-conflict settings, however, is not easy. It requires a willingness to face higher costs and risks, and to innovate and adapt continuously in a changing environment. States rarely travel the linear path from pre-conflict, to conflict, to post-conflict. Once conflict has subsided, unresolved problems may persist in new forms. States sometimes revert to a state of conflict after a short period of peace.

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When designing rural and agricultural finance development or recovery interventions, practitioners must consider the status of a state along the continuum of vulnerability to crisis to recovery. This placement may influence the success of the selected interventions.

This RAFI Note explores the challenges of developing rural and agricultural finance in conflict-affected states. It describes some of the necessary preconditions for rural and agricultural finance development and highlights some of the implications for program design and implementation. The Note concludes by outlining some of the considerations for donors and practitioners interested in supporting finance programs in conflict-affected states.

The Challenges of Working in a Conflict-Affected Environment

There is a unique set of challenges to working in conflict-affected states, with many of these challenges having a profound impact on the provision of financial services to agricultural sectors and in rural areas. The presence and impact of these challenges may depend upon a host of factors, including the duration and magnitude of the conflict; how the conflict ended; the continued presence of arms and former combatants; the level of destruction of physical infrastructure; and the absence or presence of trained/professional staff to implement provision of financial services.

Like a natural disaster, conflict can destroy lives, livelihoods and the assets that support livelihoods. In contrast to a sudden-onset natural disaster, however, prolonged conflict often destroys communal norms, social capital, and trust within communities as well. This breakdown of trust is especially problematic for community-based financial institutions—institutions that rely on social guarantee as a form of collateral—and for supplier credit and other forms of value chain finance, which is similarly based upon trust relationships.

Timing and Sequencing

Given the unpredictability of events in conflict-affected states, determining the appropriate timing and sequencing of rural and agricultural finance interventions is difficult. Although definitive guidelines do not exist, the following preconditions have become a financial services industry-recognized way of assessing environmental readiness.[1]

Essential Preconditions are those preconditions deemed necessary for rural and agricultural finance development to succeed in a particular target area**.** First, there needs to be sufficient economic activity in the area to warrant the provision of financial services. Second, the economic and financial prospects of potential clients or beneficiaries must be relatively stable.[2] Rural finance programs will not work under conditions of hyper-inflation, for example. Third, a reasonable level of safety and security should exist.

Preferred Preconditions, on the other hand, are those preconditions that are not necessary but certainly help to ensure the success of rural and agricultural finance development. These preferred conditions include the presence of a functioning banking system and supportive enabling environment for financial service provision; low inflation; availability of a skilled and educated workforce; and increasing levels of trust within communities and in financial institutions.

Increasingly, leaders in the field of post-conflict microfinance argue that practitioners and donors must intervene earlier in order to preempt poor program design and lay the foundation for sound, market-

[1] See MBP Microfinance Following Conflict, Brief No. 4 for a detailed description of the environmental preconditions for successful post-conflict microfinance.

[2] American Refugee Committee has developed a successful model for working with mobile populations. See Refuge to Return (R2R) in MicroNOTE #1, "Refuge to Return: Operational Lessons for Serving Mobile Populations in Conflict-Affected Environments," by Tim Nourse.

oriented development.[3] What does "earlier" mean? Even before the environment has transitioned from relief to development, donors and practitioners can begin to educate relief-oriented stakeholders on the advantages and disadvantages of grants vis-à-vis loans, and advocate for an enabling regulatory environment that will promote development of rural and agricultural financial markets. Governments should be educated to avoid subsidized loan programs. If governments get involved in implementing or guaranteeing loan programs, they should plan to phase out operations within a tightly defined period, ceding this role to private sector actors. The more preferable role for government is to secure and hold the peace, enabling the private sector.

Demand Considerations: Financial Needs and Client Identification

To restart income-generating activities, farmers, traders, processors, and rural entrepreneurs frequently need both long-term credit to replace lost fixed assets and core levels of inventory, and short-term credit for working capital. If they are operating in rural areas at all, financial service providers are likely only to offer small, short-term loans due to the higher level of risk and typical liquidity constraints, especially for long-term capital. While these short-term loans can fill a gap in financing current operations, they are not suitable for asset replacement. Where providers are unable to extend longer-term loans and there has been significant fixed asset loss, donors or governments may want to consider one-time grants for asset replacement as a way to restart economic activity.

The conflict-affected environment is comprised of various populations, each with a different risk profile related to their transience, asset base and background. It is generally believed that inhabitants, who have not been displaced by the conflict and who have been able to maintain their usual livelihoods, as a group carry the least risk. Providing credit to internally displaced populations residing in camps within state borders or to refugees abroad involves considerably more risk since displaced populations often lack employment, access to land or other resources for income generation. As a group, demobilizing soldiers are usually considered the greatest risk, because many do not have any experience or skills beyond being a solider.[4]

The American Refugee Committee has developed an innovative model that has worked well in West Africa. This model, called Refugee to Return (R2R), addresses some of the key challenges of providing credit to displaced populations in post-conflict environments. Since the group-guarantee mechanism used by many microfinance institutions is often ineffective in conflict-affected areas and refugee camps due to weak social cohesion, R2R relies on smaller groups and stricter selection criteria. Refugees who repay their loans are issued certificates with their names, loan information, and credit ratings that they can use as proof of credit history at lending organizations established by the American Refugee Committee when they return home.

In addition to credit, refugees, displaced persons and others affected by conflict may need other financial services, including means to receive remittances and access to savings services. It is remarkable that remittances, as compared to investment and other capital flows, tend to increase in times of and following crises. But recipients need a safe and cost effective mechanism for receiving remittances. As the post-conflict situation improves, access to secure and convenient savings services also becomes important.

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[3] See microNOTE #24, "Early and Broad Sectoral Interventions for Rapid Microfinance Development: Evidence from West Africa," by Tim Nourse, American Refugee Committee.

[4] In many developing country conflict situations, soldiers may be drawn from the ranks of very young adults and sometimes even children. By the time the conflict ends, many ex-combatants have spent fomative years doing nothing but fighting and are ill prepared to enter other types of employment or start their own business.

Savings mobilization may add to the costs of operating financial institutions, and if the threat of recurring conflict is present, it can be risky. However, taken together, savings and remittances, especially if intermediated within the community, can provide a powerful resource for economic recovery and growth in conflict affected areas.

Supply of Rural and Agricultural Finance: Value Chain Enterprises and Retail Providers

Access to rural and agricultural finance is limited in conflict-affected states. Value-chain finance, which relies upon relationships between chain actors, is especially limited and sometimes non-existent because key actors are missing from the chain, trust has deteriorated between actors, and/or market opportunities are poor. For example, farmers in southern Sudan are only able to sell their produce directly in local market places as there are no traders or processors operating in the area. As a state starts to rebuild, market opportunities increase and more actors enter the value-chain, finance may begin to flow between value-chain actors. The value-chain can be an important channel for finance once recovery begins to take hold, and donors can support these relationships by facilitating dialogue between actors, and by providing technical assistance and market information. However, donors and practitioners' support to financial sector development in conflict-affected areas frequently focuses on supporting existing financial service providers or building new institutions, where they do not exist already.

With the deterioration of the legal and regulatory environment and of the institutional infrastructure that mediates that environment, rural and agricultural financial service provision can be even more costly and risky than it usually is. Also, financial institutions' operating costs tend to rise as providers spend more on the security of staff and funds, and transportation costs to monitor clients and branch offices. In addition, for financial institutions, insufficient liquidity can be a serious issue, especially if borrowers begin to default on loans and if savers withdraw deposits to meet their financial needs or move funds off shore for protection from collapsing financial institutions.

The types and capacity of the existing institutions influence how donors and practitioners can and should intervene. Where financial service providers exist, practitioners and donors should assess institutional capacity, systems, and structures, before selecting program beneficiaries.[5] When services are needed but not available, donors and practitioners can help establish financial service providers. For example, in 2003, USAID helped establish the first microfinance institution in southern Sudan, Sudan Microfinance Institution (SUMI), to provide financial services to rural entrepreneurs. By February 2007, SUMI reached more than 5,200 clients, which is impressive given that Southern Sudan suffered from challenges such as a primarily barter-based economy, no banking system, limited physical infrastructure, and low staff skills.

Whichever approach they are taking, donor supported programs should be designed with several key goals/principals in mind.

- Long-term, sustainable service provision;
- Use of market interest rates (recognizing that interest rates are often higher in post-conflict environments);
- Financial Service provider's independence from donor assistance;
- Transparent financial reporting by financial service providers; and
- A healthy repayment climate—in which loans are not treated as grants by borrowers.

Donors and practitioners must decide the appropriate mix of grant and loan funding for financial service

[5] See Concern Worldwide and Springfield Centre, "Towards Good Practice Principles for Microfinance in War-Affected Contexts," 2004 for more information on institutional assessments.

providers. American Refugee Committee found that it is best to allocate at least two-thirds of initial grant funding to support technical assistance and operations. The remaining funding may go toward capitalizing the institution's loan portfolio. In general, it is better to emphasize strong institutional capacity first and expanded outreach second. As institutional capacity and the environment improve over time, the funding mix can shift toward increased funding for loan capital and the provision of loans, rather than grants, to financial institutions.

Enabling Environment

In addition to supporting financial institution development, donors and practitioners can help create an appropriate enabling environment for rural and agricultural finance as well. Even before the transition from relief to development programming, donors and practitioner can initiate dialogue among government representatives, relief organizations, financial service providers, and other key stakeholders on the importance of rural and agricultural finance and the appropriate role that various stakeholders can play in its development.

Program Design Considerations

When considering rural and agricultural finance development in conflict-affected states, donors and practitioners should consider the following emerging best practices:

Intervene Early and Broadly. The line between a relief environment and a development environment is sometimes blurred, especially where states cycle in and out of conflict. It is not necessary for donors and practitioners to wait until the environment has fully shifted to a development context. Rather, donors and practitioners should focus not only on building sustainable financial service providers but on developing the enabling environment architecture for a robust rural and agricultural finance sector as well.

Promote Best Practices. Even in conflict-affected states, donors and practitioners must adhere to industry best practices concerning financial services. They should apply market pricing and should not subsidize loan interest rates. The credit appraisal process must be rigorous and transparent to ensure that borrowers can repay, and the loan collection process must be consistent and strict to build a culture of repayment. By not complying with best practices, implementers could undermine the development of a thriving rural and agricultural finance market.

Use Grants Carefully. In certain immediate post conflict situations, loans may not be the best solution to addressing the financial needs of traders, farmers, and processors. Grants may be a more appropriate intervention. For example, it may be appropriate to "recapitalize" a farm business by giving fixed-cost farm equipment. It is important, however, that such grants do not undercut the existing or rebuilding marketing networks. Grants should be one-time interventions, and the difference between a grant and a loan should be emphasized. Grants should not be provided by the financial lending institutions, but by some other agency or organization.

Collaborate with Other Stakeholders, such as the government, relief agencies, donors and practitioners. Together, stakeholders can agree to set standards for the provision of grants and loans. Such stakeholder groups can also develop joint funding mechanisms, such as the Microfinance Investment Support Facility for Afghanistan (MISFA). Upon the invitation of the Afghan government, various donors, including the World Bank and USAID, established MISFA as a way to avoid working at cross-purposes and to ensure that all the microfinance programs and institutions operating in the country were adhering to international best practices. MISFA, a permanent Afghan institution, provides direct support to a wide range of financial service providers, including NGOs, commercial banks, cooperatives, and insurance companies.

Rural and agricultural finance, which is sometimes difficult to implement in "normal" development environ-

ments, is more challenging in conflict-affected areas, where stakeholders may argue that because of the challenges, they do not need to follow best practices. It is critical that donors and practitioners encourage inter- and intra-organization collaboration and commitment to best practices. Working together, starting early, and taking into account best practice considerations in program design, donors and practitioners can promote the development of market-oriented rural and agricultural finance that will, in turn, support recovery and growth in conflict-affected areas.

Recommended Reading

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