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Paving the Way Forward for Rural Finance

An International Conference on Best Practices

Washington, D.C., June 2–4, 2003

Synthesis Paper & Conference Proceedings

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JAVIER V

Paving the Way Forward for Rural Finance

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Synthesis Paper & Conference Proceedings

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Foreword

The lack of viable financial institutions and services contributes to the cycle of poverty that traps the two-thirds of people living in rural regions of the world. Rural households often do not have access to common financial services like savings and insurance, making them more vulnerable to shocks such as extreme weather, illness, death, and similar tragedies. Limited access to financing also restricts investment and trade opportunities of agricultural and non-agricultural rural enterprises. Generally, financial services in rural areas are few and costs are high, creating an environment that impedes efforts at poverty reduction and economic growth.

In the early 1980's USAID, like many other donors, moved away from programmatic involvement in agricultural and rural finance. Up until that point, donor programming had emphasized targeted provision of agricultural credit, often creating artificially low interest rates and supporting state-sponsored agricultural banks. That approach was neither sustainable, nor particularly effective at promoting the types of private sector investments in agricultural and rural enterprises so necessary in the rural areas across many developing economies. With a renewed interest in agriculture, USAID has begun to revisit both the need for and its approach to development of financial services in rural areas, incorporating important lessons about working with market forces to create new opportunities.

Paving the Way Forward for Rural Finance: An International Conference on Best Practices—held in Washington, D.C., June 2-4, 2003—has been pivotal in the Agency's stocktaking. This was the largest event that USAID has hosted on this topic in more than 20 years. The purpose of the conference was to provide a forum for donors, private sector practitioners, policy makers, academics and civil society to discuss successes and challenges to developing sustainable financial market services tailored for the specific needs of rural economies. The conference deepened our understanding of the challenges rural households and enterprises face and began to identify innovations and solutions to these challenges. It also invigorated dialogue and collaboration among donors and generated a number of follow-on activities in the area of rural finance.

The conference was a collaborative effort, meant to serve as a cornerstone in the Agency's efforts to promote financial sector deepening and expand innovations in rural finance through program development and training. Moving forward, Agency teams will work with donor organizations and development partners to enhance coordination and collaboration. The intelligence gathered at the conference and synthesized in this book serves as a platform for these activities.

In this book, you will find the ***conference proceedings*—the abstracts[*] of theme papers** and **more than 40 case studies** on some of the most innovative and thought provoking programs in the world today. You will also find the ***synthesis document*** that brings together the conference's vast collection of ideas, innovations and lessons to suggest areas for further development and future direction in rural finance.

While the conference was sponsored primarily by USAID, the participation and case studies spanned the wider donor, practitioner and academic communities. The conference proceedings reflect the breadth and depth of knowledge and experience on this important topic.

We are grateful for the enthusiastic participation of so many that made this a forum rich with innovative ideas. We hope you find these proceedings useful, as we move toward a more robust rural financial sector development.

Emmy B Simmons

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Assistant Administrator
Bureau for Economic Growth, Agriculture and Trade
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[*] For the full-length versions of these documents, please refer to the CD-ROM that accompanies the conference proceedings book.

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RETHINKING RURAL FINANCE: A SYNTHESIS OF THE *PAVING THE WAY FORWARD FOR RURAL FINANCE* CONFERENCE*

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EXECUTIVE SUMMARY

The conference *Paving the Way Forward for Rural Finance*, held in Washington, DC in June 2003, brought together academics, donors, practitioners, and development professionals to discuss successes and failures from past involvement in rural finance, and to explore creative solutions to the problems that constrain rural financial market development. This conference was meant to encourage a reengagement and a rethinking by donors and practitioners in the field of rural and agricultural finance. This paper represents a synthesis of ideas that emerged from the conference. The ideas here are not intended as a comprehensive list of either the constraints or possible programming options. Instead, this synthesis puts forward a way of thinking about rural finance and proposes concrete programming options that flow from this conceptualization of the rural finance problem. Conclusions and recommendations presented here do not necessarily reflect USAID policy.

The steady withdrawal of USAID and other donors from rural finance over the 1980s was the result of hard-learned lessons about the failures of subsidized credit and the consequent dependency on external sources of funding. Yet the entry of private, unsubsidized institutions has been slow, and rural financial markets remain thin. In this environment, the productivity of the rural economy is dampened by three forces: (i) liquidity constraints, (ii) risk constraints, and (iii) savings constraints. While growth and poverty reduction are sometimes discussed as separate goals and addressed with different policies, relaxation of these constraints holds out the promise of an interlinked approach to both growth and poverty reduction. A deep and broadly-based rural financial system can boost growth by enhancing the productivity of agricultural enterprises, address poverty by improving the financial access of low-wealth households, and relink growth with poverty reduction by assuring that small-scale producers and low-wealth households are positioned to participate in new markets and growth opportunities.

Now is a propitious time for USAID and other donors to rethink rural finance with the goal of enabling the deep and broadly-based rural financial markets needed to achieve these growth and poverty reduction goals. Given the unique challenges of the agricultural economy, and the diversity of rural clients, it is unlikely that any single institution can achieve these goals. For example, microfinance has a role to play in expanding the reach of the financial system to clients with needs for small loans and lacking collateralizable assets. At the same time, there is space and need for financial institutions that can lend on the conventional collateral of agricultural and other rural enterprises. The key is to find a set of policies and programs that will induce the entry, assure the sustainability and facilitate interlinkages along a continuum of rural financial institutions poised to provide credit, savings, insurance and other financial services.

While a number of the specific interventions discussed in this document have been implemented as elements in other development programs, one of the key points raised by many at the conference is the need to utilize effective programming approaches, whether proven or innovative, with the conscious objective of promoting rural financial markets as part of broader financial sector strengthening. Unlike earlier generations of rural finance programming, the approaches here are *indirect*—they do not directly provide financial services. Instead, they create an enabling environment and strengthen institutional capacity in a way that will induce the entry and evolution of competitive providers of rural financial services. The result should be a stable yet dynamic financial sector, capable of operating without subsidy, and freed of the sustainability limitations that plagued earlier rural finance efforts.

The ideas presented here are organized into five strategic programming areas that address the liquidity, risk and savings constraints to economic growth in the agricultural sector and rural areas. Mitigating these constraints could reshape the rural economy, opening the way for vibrant rural financial markets poised to service agricultural enterprises and rural households. The five strategic areas are:

1. Mitigating Risk

Correlated risk and sectoral uncertainty limit the entry of new financial institutions into the rural market. Creating instruments that protect financial institutions from some of this risk can stimulate lending in rural financial markets, especially for agriculture. Such policies will have a multiplied effect as they open the space for the entry of new and more affordably priced financial intermediation services and help liberate rural households from risk constraints that suppress their own entrepreneurial activity.

2. Improving Information Access and Management

Rural financial institutions have a difficult time gathering sufficient information about potential clients and managing that information efficiently. Improving the infrastructure for collecting, processing and sharing information will make smaller rural institutions more efficient and lower lending costs. Improving informational systems will help these institutions move along the path to financial sustainability.

3. Diversifying Products and Services

To help reduce poverty and stimulate economic growth in rural areas, effective rural financial markets would provide a wide range of services and products including lending, savings, leasing, insurance and transfers (e.g., of remittances). While various conference papers touched on a number of these products and services, the need for expansion of savings services was highlighted as an element critical to both building institutional sustainability and meeting client needs. Innovative savings products for rural areas give local families reliable ways of making their savings more productive and help them cope with shocks. Savings instruments can relax aggregate liquidity constraints by capturing and intermediating the substantial inflow of remittances. Achieving these goals will require well sequenced efforts to enhance institutional capacity, extend the reach of effective regulation and supervision, and intermediate remittance flows.

4. Strengthening the Legal Environment

A well-functioning policy and legal framework is key to the development and sustainability of the financial sector. The nature of laws that govern the financial sector, as well as the quality of the institutions that enforce those laws, will also largely determine the shape and depth of the financial sector. Of particular importance are the laws and institutions that either facilitate or inhibit secured lending by influencing the ease with which agricultural and other rural assets can be used as collateral. The legal environment for secured lending can be strengthened through collateral widening measures that codify land rights, promote legal reform for institutions, cooperatives and NGOs, and expand borrowing laws to increase the participation of poor. Improving the systems through which collateral can be provided and collected will open the door to a larger client base, while still protecting the interests of lenders.

5. Enhancing Value-chain Financing

Input suppliers, processing firms, warehouses and other commercial actors in the agricultural and rural sectors provide critical financial services to small and medium rural producers. Enhancing existing, interlinked rural finance activities and facilitating new services by these actors can expand access and ensure competitively-priced financial services.

These five strategic programming areas are intended to open the way to greater entry and sustainability of private financial institutions along the continuum that stretches from microfinance providers to conventional, collateral-based lenders who operate without extensive monitoring and supervision of their clients (so-called "arm's length" lenders). Given the importance of microfinance in assuring a financial system that reaches out to provide services to a broad range of rural residents, it is worth stressing that programming ideas put forward here should provide the foundation for more effective rural microfinance institutions that will serve the needs of low wealth households. Correlated risk and other constraining features of the rural economy make effective microfinance particularly challenging in rural areas. Programming innovations proposed here would relax those constraints, creating the foundations for a rural microfinance revolution.

These programming ideas proposed here should also help link institutions along the rural finance continuum, creating the basis for a financial services ladder. As households advance economically they can climb the ladder and move from microfinance providers to arm's length lenders, who offer larger loans at potentially more favorable rates but who require large amounts of collateral and reputational assets. A return to some principles of microfinance, in combination with the interventions listed above, creates the possibility for rural finance to evolve in a way that includes as wide a range of the population as possible and helps them all move towards a more productive and profitable future. Efforts to further promote microfinance in rural areas, along with an expansion of rural and agricultural finance, should then support the financial sector strengthening needed for broad-based economic growth.

I. Why Rural Finance, Why Now?

In the 1980s, USAID and other donors disengaged from rural finance as the result of hard lessons about the failures of targeted, subsidized credit and the consequent dependency of financial institutions on external sources of funding. Policies that were widely practiced in the 1970s did not prove successful. Government involvement in the management and implementation of rural financial systems was expensive and inefficient. The often political nature of loan programs, coupled with poor record keeping, meant delinquency was often overlooked. The result was a poor repayment culture and financial instability among lending institutions. Subsidized credit programs further undermined the institutional sustainability of financial institutions, distorted financial markets, and discouraged savings mobilization. Government interventions had a tendency to crowd out development in the private sector, and many people, particularly in rural areas, did not have access to adequate financial services.

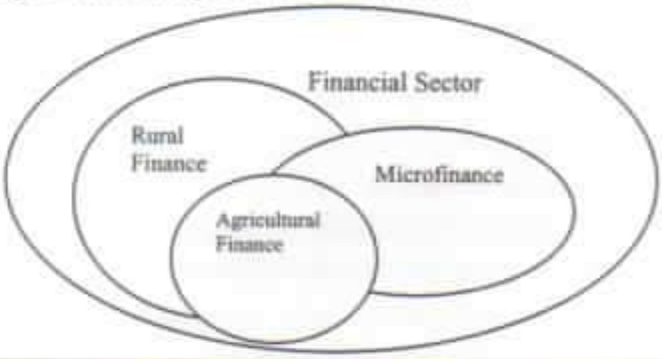
Unfortunately, the withdrawal of ill-advised state programs alone did not spur greater entry into rural financial markets. A number of factors continue to thwart the development of vibrant financial markets in the rural areas of most countries. The higher transaction costs associated with dispersed populations and inadequate infrastructure, along with the particular needs and higher risk factors inherent in agriculture result in an under-provision of financial services in rural areas. Further, where services are available, products are often designed without consideration for the needs and capacities of rural households and agricultural producers.

The inability of households and enterprises to access capital on competitive terms to undertake profitable investments, or take advantage of market opportunities, means that incomes and growth are lower than they need be. Without market instruments to insure against risk, rural households and enterprises may even retreat from profitable projects for which they have adequate liquidity. The absence of competitive savings instruments and other financial services in rural areas leads to less productive forms of savings that cut further into households' scarce liquidity and dampen local growth prospects.

Expansion of rural financial services can create a win-win scenario that will *promote growth* while also helping *reduce poverty*. Given the high proportion of poor populations that live in rural areas, the growing income inequality between urban and rural markets, and concerns for food security and population vulnerability in rural communities, many development agencies are returning their attention to rural financial deepening as part of a strategy to stimulate rural private sector development. Innovative programming, however, must be mindful of past lessons while also attending to the constraints that limit the ability of agricultural enterprises and rural households to take advantage of emerging economic opportunities.

The figure below illustrates some of the specific challenges of rural and agricultural economies that block the easy achievement of these goals. There are key differences between rural and urban areas that affect the characteristics necessary for successful rural financial institutions. The first is the prevalence of agriculture in rural areas. Agriculture is distinct from other sectors because of its seasonality, geographic limitations, price volatility, and dependence on natural conditions. Moreover, households in rural areas are often poor, and have greater difficulty managing risk, coping with shocks, and accessing consistent cash flows. In order to address the nature of borrowers and their industry in rural areas, there is a need for a continuum of financial institutions that can provide products to a wide variety of households and enterprises. Among a wide range of services microfinance institutions can provide, they have an important role to play in expanding the reach of the financial system to clients who need small loans and lack collateralizable assets. At the same time, there is need for financial institutions that can lend on the conventional collateral of agricultural and other rural enterprises. The key is to find a set of policies and programs that will induce the entry, assure the sustainability and facilitate interlinkages along a continuum of rural financial institutions poised to provide credit, savings, insurance and other services.

Rural Finance spans the range of financial services offered and used in rural areas by people of all income levels. **Agricultural Finance** is the sub-set of rural finance dedicated to financing agricultural related activities such as input supply, production, distribution, wholesale, processing and marketing. **Microfinance** provides financial services for poor and low income people by offering smaller loans and flexible savings services where permitted, while accepting a wider variety of assets as collateral. *



*Adapted from CGAP Donor Brief No. 15, October 2003.

The strategies for rural financial market development presented in this document are designed to alleviate some of the principal constraints that limit the expansion of financial services in rural areas. Addressing these constraints should open the way for an increase in the variety of services provided by existing institutions and induce the entry of other providers into the market. A stronger rural financial sector will bolster the productivity of agricultural enterprises. In addition, improving access to liquidity and other services can help households improve their production processes, build assets over time, and deal more effectively with economic shocks. In short, the development of rural financial markets can promote economic growth and help a wider range of households take advantage of that growth.

This document summarizes some of the principal constraints, best practices and new ideas that emerged from the USAID-sponsored conference on rural finance in June 2003. None of the programming options are presented as a silver bullet to solve the problems of rural finance. Instead, the ideas and recommendations included in this synthesis are possible components of an approach to induce the creation of an efficient financial market that services the needs of agricultural enterprises, non-farm rural enterprises and both poor and non-poor rural households.

II. Rethinking Rural Finance: Constraints and Programming Options

The rural finance programming options that emerged from the conference cluster into five strategic areas designed to reshape the rural economy by opening the way for vibrant rural financial markets that are poised to serve the needs of rural households and agricultural enterprises. The next five sections organize these programming areas around the specific objectives each has been designed to achieve. A list of further readings on each of these programming areas is provided at the end of the document.

1. Mitigating Risk

Risk is a major factor limiting the development of enterprises and restricting the livelihood options of rural households. Households and enterprises must routinely make investment decisions based upon their assessment of vulnerability and likelihood of return. Moreover, their investment decisions will be shaped by which risk mitigation mechanisms are available to them. Without alternative risk mitigation mechanisms, households will resort to informal, autarchic savings and low-risk/low-return livelihood strategies. Micro insurance, flexible savings and other financial services to help poorer households smooth consumption and protect themselves against shocks can help minimize potentially devastating asset loss and facilitate shifts toward adoption of livelihood strategies with potentially higher returns.

At the *Paving the Way Forward for Rural Finance* Conference, the discussion of risk focused on the constraints to the provision of rural financial services in the agricultural sector. The reluctance of many lenders to operate in rural areas can be traced to the greater risk, both real and perceived, that they associate with agriculture. Vagaries of weather and market price make agriculture inherently more risky than many other economic activities. However, lenders are often disinclined to lend in rural areas and to the agricultural sectors simply due to a lack of familiarity with the sector or clients within that sector. If agricultural producers were able to decrease the risk of default in the face of a catastrophe, or if lenders could protect themselves, at least partially, in the case of loan loss, this would increase the likelihood of entry by private sector financial institutions to rural areas and the agricultural sector. To reduce this critical constraint, two broad types of risk must be addressed: correlated risk and sectoral uncertainty.

Constraints

Correlated risk occurs when the economic fortunes of a large segment of the borrowing pool are tied to the outcome of the same random forces. Lenders can generally manage risk within their loan portfolio if their borrowers are not all exposed to the same risk at the same time. However, if the majority of the loans in a lender's portfolio are vulnerable to simultaneous catastrophe, the lender cannot internally manage the risk. In agriculture, correlated risk is almost always a problem because changes in commodity prices, imperfect weather and natural disasters generally impact large groups of borrowers in the same way. Either everyone will be positioned to repay loans in a favorable year of good rains, or no one will be able to repay in the wake of a drought or other occurrence that destroys crops and undermines incomes. Correlated risk can wreak havoc on an agricultural loan portfolio.

The predictable result is the under-provision of loans to the rural sector, especially for agricultural activities, and to lower-wealth rural borrowers who may lack assets or be unwilling to risk them as collateral. In many developed countries, crop insurance protects lenders from impact of correlated risk. However, the large subsidies or direct cost for such coverage make these programs impractical for developing countries.

Compounding this problem of correlated risk is the general lack of knowledge that financial institutions have about the rural sector. This sectoral uncertainty makes lenders reluctant to enter rural markets, where rural borrowers and agricultural enterprises are perceived as high risk. As a result, if they are willing to lend to agricultural enterprises at all, lenders require large amounts of collateral to secure loans, and the loan products offered are often not designed to fit the needs and income flows of these enterprises. Without incentives to cover the perceived risk to lenders and additional training in how to select rural borrowers and make lending to them profitable, it will be very difficult to entice new agricultural lenders into the market.

Programming Options

Both programming interventions discussed below shift some of the risk away from financial institutions, thus minimizing a major disincentive to their lending to rural households and agricultural enterprises. Neither intervention increases rural or agricultural lending directly, yet both can be used to promote the expansion and deepening of financial intermediation in rural areas and to the agricultural sector.

Index-based Insurance

Unlike traditional (multi-peril) crop insurance, index-based insurance pays out only when a designated, observable event takes place. For example, a farmer's crop can be insured against drought using objective measures of rainfall within the farmer's geographic area. If the rainfall drops below the target level, payments are made whether or not the insured farmer actually experiences crop loss. While index-based insurance offers more narrowly focused coverage, it protects against the type of correlated risk that dampens entry by competitive rural lenders. Because payouts are based on events that are observable to all and are beyond the control of the farmer, index-based insurance does not suffer from the so-called moral hazard problems that undermine the viability of standard crop insurance programs.

The World Bank has been one of the leading agents of this type of intervention, often helping create the knowledge base needed to value the risk and price the insurance products within target countries and regions. Where appropriate, USAID and other donors can contribute to the effectiveness of such programs by strengthening the institutional, infrastructural and human capacity to ensure a reliable and objective source of data and will enable developing country policymakers and practitioners to engage with private sector insurance providers. These discrete programming interventions can, in turn, leverage private sector financial resources to supply the needed insurance instruments. The use of index-based insurance programs in developing countries is still in the early stages of development. While it will not be appropriate in all contexts, it is worthy of further examination for application to a range of situations. Mechanisms should be put in place to carefully monitor impacts of any interventions in this area.

Loan Guarantees to Stimulate Private Rural Lending

Banks in developing countries generally prefer to pursue more conservative investments like low-risk government bonds or making loans to established clients. If these banks do make other loans, they will often require collateral of 100-200% of the loan amount. Donor-supported guarantees can encourage private-sector lenders to engage in rural financing activities. While the portion covered by the loan guarantee can vary, the donor organization shares the risk of the loan(s) by agreeing to reimburse a certain percentage of the losses. Portfolio guarantees under USAID's Development Credit Authority cover up to 50% of the loan against loss, ensuring that banks have significant investment in making good loans, but expanding the range of activities and clients to which they lend. By sharing the risk, loan guarantees not only encourage the circulation of available investment capital, but also demonstrate the soundness of lending to sectors that may not otherwise have access to capital. In conjunction with the loan guarantee, technical assistance and training provided to the lending institutions can help improve the quality of the bank's loan portfolio and the financial services and products offered to clients.

• • •

2. Improving Information Access and Management

Reliable client information is a key to successful financial operations, and therefore a critical component of strategies for financial sector development. Currently, a lack of cost-effective information collection, management, and sharing challenges existing rural financial institutions and discourages entry by potential market participants. Improvements in information systems would lower intermediation costs and induce new institutions to enter, creating the possibility for lower cost financial services. Further, improved information systems can enhance the viability of rural financial institutions by improving both the quality of their lending portfolio and the overall efficiency of operations. However, there are large fixed costs associated with establishing information systems and certain components that would require public investment.

A number of papers at the conference addressed the problems associated with financial institutions' access to information. Several pointed to the need for institutional development in the area of information systems and elements of desirable information systems. Others explored mechanisms to facilitate financial sector information sharing.

Constraints

The cost of lending in rural areas is relatively high as a result of low population densities combined with low loan volume. For many larger financial institutions, which often operate through arm's-length contracting, it is not worth the substantial investment required to move into rural areas. For this reason, in many countries, the providers of rural finance are smaller, locally-based institutions. While these enjoy some cost advantages in information collection because of their familiarity with the community they serve, they can still face problems in client assessment and monitoring.

Their first challenge is collecting and managing reliable client information. Geographic dispersion of households and enterprises means that collecting and verifying information about new clients is time consuming and labor intensive. Once institutions have the necessary information, there is the problem of managing it in an efficient manner. Many institutions have only basic information management technology, which decreases the capacity of credit officers and the reliability of records.

These problems are especially significant for the smaller rural institutions that make up a large part of the market. In an effort to make their services more accessible to a larger population, many are willing to forgo or minimize collateral requirements, relying instead on increased monitoring. Information collection and client monitoring come at a high cost, however, and these costs generally result in higher interest rates.

Information problems are perhaps most problematic in the case of tracking borrower histories. If institutions do not have records about prior borrowing and repayment behavior, more costly research is required to determine whether or not clients are creditworthy. Often the financial institution simply forgoes lending to those clients. These problems, which have their roots in the geographical dispersion of rural populations, are exacerbated if confidentiality regulations, other legal limitations, or general mistrust prevent information sharing between lenders.

The end result is an institutionally thin, high-cost rural financial sector. Breaking out of this self-perpetuating state of high costs and few market participants will require proactive programming that improves the collection, management and sharing of information.

Programming Options

Mechanisms that help lenders collect and manage information could help them improve efficiency and reduce costs. The two programming options below address managing information about clients both within an institution and across lenders. While neither approach would be appropriate for all areas, they each offer possible solutions for exploration. Moreover, each of these mechanisms have substantial fixed cost and public good components, making it unlikely that financial institutions by themselves will find it profitable to adopt the needed changes. By helping to cover some of the new fixed costs incurred, donors can help institutions lower their variable costs, improve efficiency and ultimately create incentives for greater entry and density of financial service providers in rural areas.

Information Technology

Effectively managing information about many borrowers is critical to sustainable financial service operations. Many rural lending institutions have small staffs that must keep track of the details of many accounts with only very basic computerized systems. The manual methods they employ to transfer data from the field into the central records significantly increase the cost of lending. If financial institutions had the hardware and software to help them manage their records more efficiently, they could expand the number of loans managed by each loan officer and improve the quality of their loan portfolio through better tracking. Relevant additions would include computer systems for institutions that lack them, or more advanced technologies like handheld PCs, smart cards, and other innovations that can improve information collection by credit officials, and access to accounts by end borrowers.

The upfront costs of investing in new technology are high. Donors could help cover the cost of technology and provide staff training in the usage of new systems. Training is important not only so current staff can adjust to new systems, but also so that understanding can be passed on and the technology used sustainably. Lenders and clients could benefit immediately, since they both would be able to access account information more easily.

Credit Bureaus and Credit Scoring

Credit bureaus provide large historical databases containing the credit repayment history of individuals and firms. These histories are used by lenders to assess loan applications and reduce the possibility of lending to a person who has a history of delinquency or default. By making delinquency or lack of repayment public information, credit bureaus increase the incentive to repay all loans. Some bureaus also allow clients to establish a *good* reputation that can be transferred to new institutions. This mobility can be especially valuable for low-wealth borrowers, whose initial entry point into the loan market is through locally-based microfinance institutions. Credit bureaus could help these clients graduate to lenders that may offer larger loan sizes or lower interest rates than those that they had access to when they first entered the market. The related tool of credit scoring provides a statistical method for analyzing repayment probability for different types of borrowers. It consists of the assessment of which client characteristics affect the likelihood of repayment and the construction and use of a decision-oriented model to predict the future performance of borrowers. The score that is assigned to an individual is based on their financial status and history, and allows them to be more easily compared to other potential clients.

Both of these approaches are still rather new in the developing country context and appropriate intervention and application are still in debate. One debate revolves around the locus of control of credit information—i.e., whether credit reporting bureaus should be public or private. Best practice suggests that credit bureaus need to be independent private entities. Lenders might be shareholders but ideally the bureau is a freestanding entity serving as much of the market as possible.

There are various areas of potential donor support for establishment of credit bureaus or scoring systems. First, these systems require large amounts of data. Where lending has been deeply constrained and data simply doesn't exist, application of these approaches will be limited. In areas where they could be used effectively, the costs of initiating either bureaus or scoring tools are high and lenders themselves generally do not have sufficient resources to cover those costs. Donors can partner with existing lending institutions to help cover the costs of the initial collection and centralization of information about borrowers. Donors could also help establish rules for how information would be submitted into the bureaus and provide training to lenders that want to participate. Standardization of information is an important component of any centralized system. Further, development of guidelines regarding how information will be handled would provide greater assurance to borrowers that their financial information won't be misused. Any system should have privacy measures in place before being allowed to collect or transfer information about individuals.

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3. Diversifying Products and Services

A narrow focus on credit provision has been one of the underlying weaknesses of many financial institutions seeking to operate in rural areas. Narrow geographic range (i.e., just in rural areas), or narrow client base (i.e., targeted lending to poorer populations or to women exclusively) can further undermine the long-term sustainability of financial institutions. While this imbalance can result from policy restrictions, donor programs have sometimes exacerbated this imbalance by setting targets or restrictions on institutional support.

From the client's perspective, effective rural financial markets would provide a wide range of services and products including lending, savings, leasing, insurance and transfers (e.g., of remittances). While various conference papers touched on a number of these products and services, the need for expansion of savings services was highlighted as an element critical to both building institutional sustainability and meeting client needs.

The absence of safe, convenient savings services in many rural areas forces many households to rely on autarchic savings strategies, typically through accumulation of grain stores, livestock and other commodities that often offer low or even negative real rates of return. Such in-kind or commodity-based savings strategies can have negative consequences for both the savers and local economy. Safe and accessible savings instruments would permit rural households to fulfill their precautionary savings goals with fewer funds, allowing the option of increased investment in productive activities. In addition, the intermediation of those savings through financial institutions would permit other households and businesses to tap into household savings as a source of investible funds. This latter effect has become even more important with the growth of remittances into rural areas. Intermediation of the remittances that are in excess of the receiver's immediate consumption needs can have substantial local economic development effects.

Constraints

The paucity of deposit-taking institutions and savings options in rural areas results primarily from two interlinked problems. Many larger commercial banks do not find it profitable to operate in rural areas because of the transactions and informational costs of offering services. While there are some notable exceptions, financial institutions serving rural areas often do not accept savings, and in many countries are restricted from doing so. While these legal restrictions may be prudent, breaking the savings constraints will require a creative approach to (i) ensuring that rural financial institutions can serve as reliable custodians of savings deposits; and, (ii) modifying the legal and regulatory structure to permit them to take deposits and require them to protect deposits. If successful, this approach will not only expand the financial services provided in rural areas but enhance the sustainability of rural financial institutions by lowering their cost of funds.

Programming Options

There are several ways that donor intervention can support the diversification of financial services and products in rural areas with safer savings and improved financial intermediation.

Institutional Strengthening

Many financial institutions are prohibited by law from accepting deposits because of a lack of either regulatory agency capacity to adequately oversee them or of government confidence in their ability to protect their clients' investments. Standard accounting practices and effective documentation by all financial institutions would facilitate oversight mechanisms and better self-regulation through great transparency and efficiency. Institutions could be required to increase their equity or loan loss provisions in order to maintain the security of deposits. Donors can help build financial management capacity within non-regulated financial institutions through training in standardized accounting practices, documentation, and financial disciplines. In addition, assistance/training on product/service design, portfolio management and outreach strategies can further enable institutions to sustainably expand their services.

Institutional capacity alone, however, is not sufficient where policy restrictions prevent rural financial institutions from accepting savings. Beyond assisting institutions in gaining the capacity for sound financial management, donors can become an advocate for expanding the number and type of institutions that are allowed to accept deposits. As part of this effort, donors could invest in expanded regulatory capacity, support appropriate adjustment of laws and regulations, educate policymakers on the ways in which financial integrity and security can be ensured without direct regulation and government oversight, and illustrate the potential contribution to economic growth that expansion of savings services can bring.

Deposit Insurance

Deposit insurance was one program intervention that was discussed at the conference as an innovative approach to smoothing some of the risk that is often associated with savings. While it won't be feasible in all countries, a workable deposit insurance program could further rural financial institutions' efforts to mobilize savings by increasing the confidence that potential clients have in these institutions. Moral hazard is a potential problem with deposit insurance, making it vital that it be used by strong institutions that follow standardized procedures, and can be effectively monitored and regulated.

Developed countries have well-functioning programs for deposit insurance with different schemes that are adapted for different participating financial institutions. For example, in the United States, deposit insurance mechanisms are modified depending on whether the participating financial institution is a bank or a credit union. While unilateral capitalization of a deposit insurance scheme may not be possible or even desirable, donor programming could support the design and piloting of a deposit insurance scheme that would then leverage public and/or private sector funds for full implementation. Considering the limited regulatory and oversight capacity in many countries, training and assistance on deposit insurance may also be necessary for government officials, regulators and representatives of central banks.

Enhancing Remittance services

Global remittance flows in 2003 are estimated to be over $90 billion. It is further estimated that in many countries, nearly 50% of remittances flow to rural areas (Orozco 2003). Remittances are an important source of income for many households and in many cases exceed their immediate consumption needs. By offering savings services, financial institutions not only provide households a more secure and flexible mechanism to save excess funds but also increase the capital available for investment by other entrepreneurs.

In addition to expansion of savings services, there are a number of other programming interventions that can enhance services to remitters and remittance receivers. A number of donor organizations are partnering with private sector entities to pilot new innovations, such as smart cards, aimed at lowering costs and improving convenience and transparency of transfer mechanisms. Donors can also work with government counterparts to promote beneficial taxation and other policies that facilitate remittance flows rather than driving them toward informal, non-transparent transmission mechanisms.

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4. Strengthening the Legal Environment

A well-functioning policy and legal framework is key to the development and sustainability of the financial sector. Macro-level policies governing such things as interest and exchange rates and repatriation of funds can have significant impact on liquidity within the financial sector and provision of services. The nature of laws that govern the financial sector, as well as the quality of the institutions that enforce those laws, will also largely determine the shape and depth of the financial sector. Of particular importance are the laws and institutions that either facilitate or inhibit secured lending by influencing the ease with which agricultural and other rural assets can be used as collateral. These laws and institutions, together with the limited legal literacy in rural areas, are two issues of particular concern for the development of rural financial markets.

Constraints

Without the ability to turn existing assets into capital, rural households and enterprises cannot borrow to finance productive activities. This lack of collateralizable wealth discourages entry by financial institutions resulting in thin markets. If households and enterprises cannot clearly lay claim to their property, then it is highly unlikely that financial institutions will accept it as collateral for loans. This is frequently the case for land. While land is likely to be a household's most valuable asset, lack of clear title may prevent its use as collateral. Even where titles are granted and publicly registered, additional factors could limit the use of property as collateral. In countries where there are not clear mortgage laws, or land markets do not function well, then even clear title to land may be insufficient for its use as collateral. Lack of knowledge about establishing ownership and registering collateral may further prevent households and enterprises from making better use of their existing assets.

The use of movable assets, such as tractors, standing crops and even television sets, has been suggested as an option in cases where land is not useable as collateral. However, many countries have laws that prevent or severely limit the use of movable property as collateral. In addition, the lack of registries for movable property makes ownership of these assets difficult to prove, thus limiting their use even in the presence of enabling policy. Thus, households and enterprises may have assets of value but are unable to use them to secure a loan.

Where lending is taking place, and where there are multiple lenders, the priority of claims needs to be well defined in order for lenders to value the risk when accepting collateral. If a client has, for example, used the same collateral to secure more than one loan, and if the priority of claims is not well defined by the legal system, then at least one of the lenders will be left out if the client defaults. The legal system should not only establish the rules for prioritizing the claim but set up rules for the enforcement of a claim on collateral, including how assets will be seized and liquidated. If the terms were more clearly defined for both parties, then lenders could feel more secure in their ability to make claims in the case of loss, and borrowers could clearly understand the process of repossession in the case of default.

Programming Options

Enabling Collateralized Lending

While non-collateral lending plays an important function in the deepening of financial services and the development of the "lending ladder," the ability to collateralize loans increases exponentially the borrowing power of enterprises and households. For lenders to be able to accept assets as collateral, they must be able to:

- establish clear ownership of property,
- expand the types of assets that can be used to secure loans,
- define the priority of claims over mortgaged property, and
- rely on the judicial system to enforce contract disputes.

Programming interventions to support the development of mortgage laws, property registries, titling schemes, collateral definitions, and priority of claims could help improve the environment for secured lending. There often are many layers of laws—including pledge, mortgage, and property laws—that figure into secured transactions. No two legal frameworks are exactly alike, so understanding which component is the greatest barrier in a given context will help policy interventions have maximum impact. Recommendations should take into account the available assets in rural areas and make sure that reform will allow these assets to be used as collateral.

Beyond support for legislative reform, support may be needed to strengthen the institutions that manage information such as property ownership and liens against property. Finally, property only has value and use as collateral in an environment where property laws are enforced. Interventions to strengthen the human and institutional capacity to enforce contracts and other laws will often be necessary. With support for legislative and institutional reforms that enable secured lending, rural households and enterprises will be better able to turn existing assets into capital and borrow to finance productive activities.

Legal Literacy and Advocacy

The establishment of an appropriate enabling environment does not guarantee that people will use their assets as collateral or use them wisely. Oftentimes in rural areas, people's understanding of their rights to property is not adequate for them to utilize opportunities that their ownership makes possible. Efforts to educate potential borrowers as to the rights and responsibilities associated with property ownership help them leverage their assets while understanding the risks in doing so. Legal assistance centers can further enable small enterprises and rural households in their attempts to understand legal and commercial processes such as contract enforcement, mediation and foreclosure.

In cases of nascent property rights systems, excessive bureaucracy or other problematic environments, better information on processes for utilizing collateral may also be necessary to induce lenders to enter the market. Clarity in the claims process for different types of collateral in the case of default could further widen the range of assets lenders are willing to accept as collateral.

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5. Enhancing Value-chain Financing

In many places, input suppliers and other non-financial enterprises are an important source of rural finance. Input suppliers, processors and other product traders often provide credit or in-kind inputs to farmers at time of planting, repayable upon harvest. In some cases, the intermediary accepts a portion of the producer's output, often at a price agreed to when the credit is issued. While significant price fluctuation can make these contractual relationships less advantageous to the producer at times, they are still generally preferable in the absence of more conventional financial services. Often these relationships are an important source of information, as well as access to input and output markets. Several papers at the conference explored mechanisms that promote mutually beneficial relationships between non-financial entities and agricultural producers that improve the latter's access to credit. Opportunities to expand these market chain relationships through the engagement of financial institutions were also explored.

Constraints

While trader-supplied credit and contractual arrangements with processors may be the best option a producer has for financing production, traders or processors may enjoy spatial monopoly and the resulting credit contracts may not be competitive or fair. Depending on the region and crop, the terms of the contract may place the producers at a serious disadvantage. At a minimum, price differences for product sold can hide the actual cost of the loan extended by the trader. Many farmers cannot access larger markets where they might receive a better price for their product and therefore are dependent on the price offered by the traders operating in their region. Limited competition among traders and a lack of transparency in formation of contracts can lead to higher credit costs for producers.

Even when supplier/trader credit is functioning with a reasonable degree of transparency and efficiency, the limited liquidity of non-financial agents limits their ability to support economic growth in the agricultural sector through these arrangements. Most input suppliers, processors and other trading intermediaries are not in the business of financial intermediation and have limited liquidity. Without access to additional funds, they often have to limit the number of contractual relationships they form. Moreover, when traders do not have established relationships with producers, they may be more reluctant to provide credit even on a contractual basis. It is often particularly difficult for small producers to gain access to these business networks. The transactions costs associated with a large number of small producers, make working with low-volume producers a less attractive investment for traders than working with larger operations.

Finally, the liquidity problems that producers experience as a result of the seasonality of production can be smoothed by non-financial mechanisms. Prices for most commodities are often lowest at harvest time when the supply is very high, and are higher later in the season. This price fluctuation can be problematic for farmers who often need to sell their product at harvest in order to repay the loans that financed production. Without a means to store their output for sale when prices are more optimal, and to cover loan or working capital expenses until later in the season, many farmers get locked into low-input, low-return production strategies.

Programming Options

Linking non-financial institutions with financial markets is key to expanding economic growth in rural areas, since so many different types of institutions provide financial services to agricultural producers. There are several ways to expand these services to benefit these producers and help them make better use of these markets.

Producer Associations

One of the problems facing small farmers is that, as individuals, they do not have bargaining power relative to the market. By forming producer associations to jointly market their product, they have more influence on output prices and trade relationships. Associations can also help their members to meet higher quality and production standards and thus demand higher prices on the market. There are excellent examples of associations adding value for members through product branding and quality "seals of assurance." Associations can help lower transactions costs for traders as well, since they can deal with a single, larger entity rather than dealing individually with many farmers. Associations may also help farmers make use of warehouse receipt systems (see discussion below), since many storage facilities have quantity minimums that exceed the capacity of individual small producers.

Donors can help in the formation of associations, including both legal formation of the association and the institutional strengthening as they expand operations. In some countries, producers may need to be educated as to the potential benefits of associations. In addition, they could work on educating traders and others to help them understand the potential benefits of working with associations, including higher quality and lower transactions costs. Donors can also help associations link up with larger corporations, including export businesses, to increase the market for their product.

Building Market Linkages with Financial Institution Participation

While non-financial institutions may have access to more information about clients and be better able to provide technical services to clients, they often have limited liquidity with which to finance producers. Financial institutions have greater liquidity and can offer a wider range of services. Linking financial and non-financial institutions in the provision of financial services through supplier/trader credit or contractual arrangements can "harness the respective advantages of both" (Pearce, p.9). The non-financial partner is able to expand activities by tapping into the financial institution's funds while the financial institution benefits from the lower selection and monitoring costs. The producers also benefit since they can access a wider range of products, and potentially larger loan sizes, through the financial institution than they could through non-financial entities.

These linkages can be facilitated through the creation of intermediaries that jointly offer technical assistance and help farmers access finance and trader relationships. Donors can help fund the start up of these institutions, which could operate either as a business or an NGO. These institutions can help farmers access financing sources, requiring that farmers use their technical assistance program in order to improve their productivity and increase chances of repayment. This is similar to the model practiced by Fintrac in Honduras and elsewhere. Building capacity in these linking institutions could help farmers access new services, improve productivity, increase competition among traders, and strengthen market networks in rural areas.

Warehouse Receipt Lending

Warehouse receipt lending enables producers to use stored product as collateral. Thus, producers are able to secure cash at the time of harvest and sell their product at a more favorable price. While fees paid to the storage facility increase the "cost" of obtaining a loan, depending on the crop and context, the difference in price that farmers can get waiting several months after harvest can often exceed this additional cost. Since farmers remain dependent on the future sale of their stored product to repay loans, it is critical that storage facilities ensure the quality and security of stored product.

Donor programs to establish the legal and regulatory frameworks and certification policies for storage facilities can enable the use of this financial access mechanism. Often, legal frameworks in developing countries need to be amended to allow for the use of stored product as collateral. Additionally, training provided to warehouse administrators in proper storage techniques provides greater certainty to both the lender and the producer who has taken the loan secured by stored product.

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III. Foundations for More Effective Rural Microfinance

Reducing risk, improving the informational environment, facilitating the intermediation of savings and enhancing the collateral value of rural assets—these efforts can enhance the entry and sustainability of conventional rural financial service providers. Yet, many poor rural households lack the resources and assets to take advantage of the services offered by these providers who rely heavily on standard, easily marketable collateral assets. For these households, microfinance institutions—which typically employ either collateral substitutes (*e.g.*, peer monitoring and joint liability) accept more flexible collateral or augment clients' limited conventional collateral with intensive screening, management and supervision—have an important role to play.

The microfinance revolution of the 1980s and 1990s significantly expanded poor people's access to financial services. However, while there have been some successful efforts to expand the outreach to rural areas, microfinance has admittedly had more impact in urban areas. Underlying the constraints to rural microfinance is the correlated risk that typifies agriculturally-dependent, less diversified rural economies. Correlated risk undercuts the very logic of joint liability lending, which requires one individual to be able to cover the loan payments of another individual who suffers an economic downturn. The system fails when all individuals simultaneously suffer income losses.

The programming options laid out above offer some solutions to some of the issues that have constrained the expansion of rural microfinance. Effective mitigation of correlated risk through index-based insurance should immediately open the door to more sustainable rural programs of joint liability lending and other forms of rural microfinance. Similarly, enhanced savings instruments that provide greater security and flexibility to rural households will stabilize the value of household savings and simultaneously contribute to the sustainability of rural micro-financial institutions. Finally, a stronger informational environment will provide steps up a financial services ladder, in which low wealth households with proven records of credit-worthiness can capitalize on their good reputations and obtain services from institutions that do not rely expensive forms of client supervision that are necessary for microfinance institutions.

Creating a foundation for more effective rural microfinance will address poverty alleviation goals while also relaxing the financial constraints (risk and liquidity) that often block the participation of low-wealth households in the agricultural and rural economic growth process. Besides laying the groundwork for a broadly-based process of agricultural growth, this strategy should also deepen the financial sector itself by linking microfinance to other providers of rural financial services.

IV. Challenges and Learning Opportunities

While all of the possible programming elements above hold promise, designing effective programming and achieving desired results will be challenging. Obviously, programming interventions should be tailored to the specific environment and level of institutional development of the country in which they are being applied. Beyond this, there are four challenges that could undermine programming and inhibit the growth of rural financial sectors. These should be should be kept in mind during program design and implementation.

First, the programming options presented here are designed to more *indirectly* enhance rural financial intermediation. It is not automatic that addressing identified constraints will suffice to induce entry or contribute to institutional development and the effectiveness of this approach deserves monitoring. This will be the case with all types of financial intermediaries. While lessons of the past do support movement away from more direct interventions, the successful outcome of most programming options listed here require actions on the part of private agents — borrowers lenders, and/or others — and there is, therefore, no guarantee that they will have the anticipated outcome.

A second challenge is the complexity of legal reform. Improving the legal and regulatory environment to enable the expansion of rural financial services may necessitate changes to laws or development of new laws. This can be a difficult process, best served when there is strong support for reform within the policymaker community. However, if the benefits of rural finance development are not clear to policymakers, it can be difficult to identify a champion or muster the political will for reform.

A third issue is the willingness of rural populations to take advantage of additional financial services. In many rural areas, people distrust banks and are reluctant to turn over their savings and risk their assets. While many households do take small, uncollateralized loans for productive purposes, fewer of them are willing to risk their assets for longer-term loans that would allow them to invest in production-enhancing technologies. While in some places, the rural population makes good use of the services that are available to them, some populations are hesitant to use savings services, buy insurance or take advantage of other financial services, even when these are available. Therefore, in addition to promoting the development of new rural financial services, it may be necessary to simultaneously educate rural households and businesses as to the benefit of using these new services to improve production, overcome shocks, and improve welfare over time.

Finally, many changes will require the cooperation of financial institutions themselves. Donors alone cannot implement the majority of changes detailed in this document. Innovation should be accompanied by public education, training, and technical assistance. Institutions will have to be able to see the potential benefit to their business before they will be willing to enter in the rural realm and increase their service offerings.

All activities should be preceded by a careful assessment of the needs and limitations of a particular case, and interventions should be tailored accordingly. This will be a learning process for all parties, but initial challenges should not serve as a deterrent to action.

Further Reading

For more information on **Mitigating Risk** *see:*

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For more information on **Enhancing Value-chain Financing** *see:*

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Conference Proceedings

DEEPENING RURAL FINANCIAL MARKETS: MACROECONOMIC, POLICY AND POLITICAL DIMENSIONS

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This paper examines key features of the progression to a macroeconomic environment that is conducive to rural financial deepening. Gonzalez-Vega explores the typical difficulties of the adoption of the required policy framework encountered in the political arena. Experiences throughout history show that efforts were made to promote rural credit programs. Many failed because of macroeconomic instability, financial repression and distorting interventions. Failure led to a consensus that financial policy reform is a necessary but not a sufficient condition for sustainable rural financial deepening. Policy reforms create a more conducive environment, where additional challenges for smooth market operations must be met, including: (1) acceleration of the rate of innovation in financial technologies; (2) improvements in robustness of the organizations that will implement the new technologies; (3) establishment of a facilitating institutional framework and infrastructure.

Gonzalez-Vega goes on to identify the threats and opportunities that emerge from renewed political concerns about rural financial services, and he addresses these issues through two critical changes in perspective about: (1) the role of finance in rural development and (2) the role of the state in the promotion and regulation of financial markets. Financial services are no longer considered policy tools and price controls and administrative allocations are no longer favored. The focus is now on the adoption of promotion policies through the development of the physical and institutional infrastructure to support market operations.

The author continues exploring the challenges that governments and donors face in promoting alternative types of changes in financial production functions. He identifies three gaps (inefficiency gap, insufficiency gap, and feasibility gap), each explaining ways in which the current supply of rural financial services is insufficient, and suggests different types of actions and interventions for their successful closure. The paper acknowledges the urgent need to adopt new policies, develop the necessary physical and institutional infrastructure, improve and disseminate new financial technologies, and design and build new organizations, which would allow a more efficient, sustainable, and broadly-based provision of rural financial services in the developing nations and economies in transition.

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Carolina Trivelli Avila, Peruvian Studies Institute (IEP)
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Full text version of theme and discussant reaction papers, slide presentations and audio MP3 files of question and answer session can be found on the accompanying CD.

LEGAL AND REGULATORY REQUIREMENTS FOR EFFECTIVE RURAL FINANCIAL MARKETS

Authors
Heywood W. Fleisig and Nuria De La Pena (Center for the Economic Analysis of Law)

Rural financial markets rest on foundations of law, customs, and usage. Many rural finance and development projects would perform better if donors and policymakers reformed economically relevant laws in ways conducive to the needs of rural finance. Often, programs fail because they call for behavior that is sometimes unsanctioned by law and sometimes prohibited by law.

Fleisig and de la Peña present examples of legal problems, discuss their consequences for rural finance, and provide best-practice remedies. They also explore the obstacles to success and discuss strategies for legal reform. The paper points out the importance of the legal framework for secured loans, which governs the use of property as collateral for loans.

The authors then turn to other legal and regulatory barriers to rural development including homestead exemptions, scope and coverage of the civil registry, age of majority restrictions on contract signature, and poorly designed laws governing intellectual property rights and the protection of labor and debtors.

The paper concludes with policy guidelines concerning the sequencing of reform, minimum legal requirements, and reform within a budget. The authors also highlight the importance of fixing the legal framework for microfinance, and refocusing land titling projects towards land use rights and using real estate as collateral.

Discussants:

Jolyne Sanjak, United States Agency for International Development (USAID)
Stefan Staschen, Consultant

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RISK MANAGEMENT CHALLENGES IN RURAL FINANCIAL MARKETS: BLENDING RISK MANAGEMENT INNOVATIONS WITH RURAL FINANCE

Author
Jerry R. Skees (University of Kentucky)

This paper concentrates on rural financial markets in emerging and developing economies and the numerous challenges they face. Agriculture and other rural activities are associated with higher risk, which places an even greater importance on the development of innovative risk management mechanisms. If all borrowers are not exposed to the same risk at the same time, lenders can successfully manage (or pool) risk within their loan portfolio; however, correlated risk cannot be pooled because of the large numbers of people who will suffer simultaneously.

Insurance markets are sorely lacking in most developing and emerging economies, and rarely to local insurance markets emerge to address correlated risk problems. There are numerous challenges in developing financial markets to manage risk in developing countries, many of which are reviewed in this paper. However, there is hope, as the paper reviews innovations in global financial markets that provide unique opportunities for rural finance entities to manage correlated risk and expand their ability to help rural households. Two of the most hopeful examples are (1) the use of global futures markets by intermediaries who can offer a form of price insurance, and (2) the use of index insurance contracts to shift natural disaster risk into the global markets.

The paper also includes five case studies of different index insurances specific to the problem areas of each country. These include the use of weather indexes, price futures, and livestock mortality rates to address the correlated risks face by agricultural enterprises around the world. The author concludes the paper with recommendations for the blending of index insurance and rural finance, and a shift of correlated risk out of small countries into the global market.

Discussants:

Tsend Munkh-Orgil, Ministry of Justice and Home Affairs of Mongolia
Hector Ibarra, Agroasemex
Ulrich Hess, World Bank

Full text version of theme and discussant reaction papers, slide presentations and audio MP3 files of question and answer session can be found on the accompanying CD.

MODELS OF RURAL FINANCIAL INSTITUTIONS

Author
Manfred Zeller (University of Gottingen)

Since the1980s, governments and donors have increasingly dismantled support for rural and agricultural finance that followed the path of the old paradigm. A renewed interest has encouraged policymakers, donors and international development organizations to embark upon a new strategy of rural and agricultural finance. This paper describes different models of rural finance institutions, and examines their comparative advantages as well as related challenges to, and strategies for, deepening rural financial institutions. Emphasis is given to rural microfinance institutions, though several models are discussed. The paper explores a focus on building sustainable financial institutions and systems, including the sustainability of microfinance institutions. It looks towards technological and institutional innovations to reduce the costs and risks of financial intermediation, steering away from the false assumptions that were accepted for so long.

The author recommends that public investment in specific rural financial projects be pursued with a financial systems perspective, and that public action and public-private partnerships foster horizontal and vertical integration in a decentralized rural financial system. The paper cautions against over-emphasizing the role of rural and agricultural microfinance in poverty reduction and economic growth. Access to finance in general and to credit in particular may have limited impact in some areas, while in other regions and for other groups it can make an important difference. He points out that there is no single institution that is better or worse for a particular target clientele than another. There is no blueprint for rural finance and each country needs specific attention to their individual needs, making the challenge to expand rural and agricultural finance very large indeed.

Discussants:

Calvin Miller, CARE
Robin Young, Development Alternatives, Inc. (DAI)
Anthon Slangen, Food and Agriculture Organization (FAO)
David Richardson, World Council of Credit Unions (WOCCU)

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INNOVATIVE PRODUCTS AND ADAPTATIONS FOR RURAL FINANCE

Author
Juan Buchenau (Frontier Finance International)

This chapter examines rural financial innovations, characteristics of rural households and agricultural enterprises, and conditions for the sustainable development of financial entities that serve them. Financial services are useful to all rural groups. Independently of the sources and level of income; they can generate value for the clients who use them, allow families and enterprises to improve their liquidity management, diversify or enlarge income sources, and respond to life cycle events and emergencies. Juan Buchenau examines two types of innovations for financial services: 1) new products which match the characteristics of the intended users, and 2) improvements or refinements in the procedures used to deliver the services or to design contracts and achieve their enforcement.

The paper presents new financial products along with innovations that improve their management using examples from various countries. Products designed to finance farmers, such as agricultural investment loans or loans against warehouse receipts, and products geared to serve rural households, including adapted microenterprise loans and savings and remittances are discussed. The author explores innovations in lending procedures (credit bureaus and credit scoring), savings (outsourcing, SafeSave) and processes based on new technologies (the use of handheld computers, ATMs). These innovations are evaluated according to their contribution to rural financial market development by reducing transaction costs, mitigating risk and/or increasing investment capacity.

The author concludes the paper with a discussion of the important issues on how to design and introduce innovations that are relevant to rural areas. He provides a list of suggestions for donors, governments and financial service providers on how to decide which innovations to pursue, and how best to support the adoption of those innovations.

Discussants:

Carlos Cuevas, World Bank
Marguerite Robinson, Harvard Institute for International Development (HIID)

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THE EVOLUTION OF INSTITUTIONAL ISSUES IN RURAL FINANCE OUTREACH, RISK MANAGEMENT AND SUSTAINABILITY

Author
J.D. Von Pischke (Frontier Finance International)

The revival of interest in rural finance should be dedicated to creating more efficient rural financial markets. Efficient markets are most likely to be achieved by institution building based on the objective of commercial sustainability.

Movement toward this objective can be traced chronologically over the last 35 years of donor involvement. "The Past" provides cautionary lessons from inappropriate technical efforts in a hostile political environment that mandated low interest rates, discouraged savings mobilization and distorted credit allocation. "The Continuing" consists of areas of possible weakness that remain and the risks they pose. "The Recent" includes institutional changes that gained momentum in the 1990s that enhanced the role of financial markets, greatly expanding the frontiers of finance in ways that made it possible to assist the poor more effectively. Successful microfinance and rural finance institution building is increasing possible and is increasingly achieved. "The Open" consists of exciting possibilities for innovation.

The opportunities for institutional development created by donors, their critics and state-of-the-art practitioners are captured by a paradigm devised by Manfred Zeller and Richard Meyer: the microfinance triangle of financial sustainability, outreach to the poor and impact. This triangle should be expanded into a microfinance pyramid with transparency as the fourth element, which is also essential for efficient, donor-supported institution building.

Discussants:

Richard Rosenberg, Consultative Group to Assist the Poorest (CGAP)
Richard Meyer, Ohio State University

Full text version of theme and discussant reaction papers, slide presentations and audio MP3 files of question and answer session can be found on the accompanying CD.

REMITTANCES, THE RURAL SECTOR, AND POLICY OPTIONS IN LATIN AMERICA

Author
Manual Orozco (Inter-American Dialogue)

Within the last three decades, considerable changes in the global market have stimulated migration flows and influenced thought on economic growth and development. The relationship between development and migration and the resulting effects on economic ties between diasporas and home country economies are becoming progressively more applicable to development policy. This affects many levels of the industry, including donors, investment, trade and unilateral transfers. This paper examines the linkage between migration and remittances on a global and regional scale, and looks at rural Latin America as it relates to poverty and inequality. This case study looks at remittances and associated policy opportunities in rural areas where migration has occurred. Policy opportunities are explored through examining the connection between remittances and the rural sector in the developing world, specifically in Mexico, El Salvador, and Nicaragua.

The effect of the movement of people is steadily being thought of as a key factor in making economic growth possible; labor and migration are seen as indicators of economic development. The share of local labor working in the global economy of nontraditional exports and other agricultural and industrial exports and the sharing of technology are significant in a country's economic growth. The paper identifies several policy options, including reducing costs of remittances, promoting financial democracy, linking remittances with micro lending, developing hometown associations, and enabling regulatory environments. Policy intervention will help maximize the positive effects that remittances can have on rural recipient communities.

BUYER AND SUPPLIER CREDIT TO FARMERS: DO DONORS HAVE A ROLE TO PLAY?

Author
Douglas Pearce (CGAP)

Traders, processors, input suppliers and exporters are the primary source (alongside moneylenders) of credit to poor, agriculture-dependent households. These buyers and suppliers provide credit to farmers as part of input supply and product purchase transactions. They overcome high operating costs, lack of client information, and risk by linking credit to the provision of other services such as input supply and technical advice. In many cases, credit is also tied to the sale of produce. Even in areas where financial markets are shallow, product-market credit may be widespread.

Credit is essential for small farmers to access the inputs that support production, and in many cases is part of the technical services and inputs package offered to farmers by agribusiness buyers. Financial institutions are better-placed to offer credit and other financial services, but see agricultural lending as risky. By linking to buyers and suppliers, they can reduce the risks of lending to farmers. Farmers can also access a wider range of credit and other financial services from financial institutions as compared to agribusiness buyers and suppliers. The main challenge facing donors' attempts to improve small farmer access to product-market credit is avoiding market distortion. Long-term support focused on enhancing the service environment for financial service provision can avoid such distortion and have systematic and far-reaching impacts.

Full text version of case studies, slide presentations and audio MP3 files of question and answer sessions can be found on the accompanying CD.

Breakout Session Proceedings

"USAID Azeri Rural Credit Project (ARC): Capitalization, Governance, Ownership, Control"

Author
Al Harding (ACDI/VOCA)

Summary and Key Findings
This case study examines the start-up of CredAgro, a non-bank financial institution in Azerbaijan. The focus is on issues related to sustainability—specifically governance, ownership and control. The proposed change from project staff ownership and control to local staff ownership and control provides an opportunity to test the viability and success of this type of institution. Identification, recruitment, development and retention of good people seems to be a key to organizational achievement, particularly for a financial institution that deals primarily with the high-risk sector of agriculture in a young nation experiencing a rapid transition and reform of its economy.

"Supervision and Regulation of Microfinance Industry in Ecuador—USAID/SALTO Project"

Authors
Rodrigo Espinosa, Alexander Shapleigh, Fernando Fernandez, Marina Mutchler and Jorge Daly (D.A.I.)

Summary and Key Findings
The Strengthening Access to Microfinance and Liberalization Task Order (SALTO) project, financed by USAID/Ecuador, is designed to support microfinance services and macroeconomic reforms that contribute to sustainable economic growth for poorer segments of the Ecuadorian population. The case study reviews the motivations and implementation procedures of the project and discusses institutional and policy impediments. Private investment in credit bureaus will facilitate the development of a healthy market-oriented microfinance industry in Ecuador, which will be able to serve both urban and rural clients. The case study urges that the cooperative sector not be abandoned by donors, because it has social and economic importance in rural areas.

Full text versions of case studies, slide presentations and notes of question and answer sessions for all breakout sessions can be found on the accompanying CD.

"Serving Small Rural Depositors: Proximity, Innovations and Trade-offs"

Author

Madeline Hirschland (Independent Consultant)

Summary and Key Findings

This case study looks at several institutions and their delivery services to small rural depositors. After assessing the strengths and challenges of delivery options, the paper highlights the trade-offs inherent in making deposit services convenient for small rural depositors. Rural savers often have to travel a great distance to make transactions, which is not always practical. Reaching these depositors requires low-cost delivery systems that bring services closer to places they frequent. The case study gives illustrations of microfinance institutions that have discovered a variety of such systems, such as mobile collection, lockboxes, self-managed groups of depositors, and integrating savings delivery into other delivery systems that clients use.

"Business Transactions for Kenyan Smallholder Farmers and Entrepreneurs via DRUMNET"

Author

Jonathan Campaigne (PRIDE-Africa)

Summary and Key Findings

This case study examines PRIDE Africa's introduction of a group solidarity model in eastern and southern Africa. DRUMNET combines the use of internet and web-technology with knowledge of local markets, co-operatives societies, microfinance organizations and the private sector in Africa. The goal is to become an online agricultural marketplace in Africa. Key constraints encountered by the program are low teledensity and collapsing infrastructure. Also, prohibitive dial-up internet costs have conspired to make affordability, cost recovery and e-business quite challenging.

"DEMOS—A Savings and Loan Cooperative in Croatia"

Author

Caroline Tsilikounas (DEMOS)

Summary and Key Findings

DEMOS is a nationally registered Savings and Loan Cooperative, whose mission is to provide economic opportunities to those without access to formal financial services. Although DEMOS is successful in the delivery of credit, it lacks the skills and expertise to implement successful business development services. While DEMOS has done well in establishing systems, controlling delinquency, and becoming relatively efficient, it must also seek alternative market channels. The key to sustainability for DEMOS lies in differentiating its services in rural areas. In this way, DEMOS is becoming a sustainable, market-oriented provider of micro-credit, while staying true to its original mandate of assisting the working poor in the rural war-affected areas. The future lies in combining financial and non-financial services. Enhanced sharing between these two industries should be encouraged and a priority of donors and policymakers.

"The Use of Price and Weather Risk Management Instruments with Examples from Tanzania and Morocco"

Authors

Erin Bryla, Julie Dana, Ulrich Hess, Panos Varangis (all-World Bank)

Summary and Key Findings

This paper looks at innovative ways to deal with both price and yield risk in order to give small land holders greater access to finance. It includes case studies from Tanzania and Morocco. Innovations such as market-based price risk management and index-based yield insurance can be used to improve the ability of financial institutions to offer their services to agricultural producers.

"Agricultural Insurance in Latin America: Where Are We?"

Authors

Mark Wenner and Diego Arias (all-Inter American Development Bank)

Summary and Key Findings

This paper reviews the weaknesses of traditional crop insurance programs and highlights new developments in Latin America that hold promise of making agricultural insurance more accessible, efficient, and sustainable. In the last 12-15 years, new insurance products have emerged, such as area yield and weather index insurance products. These appear to be more cost effective and to eliminate moral hazard issues. The principal lesson learned from the experience of developed countries is to not replicate expensive programs of the past but to use available knowledge and expertise to design and implement insurance programs that avoid the classic obstacles to an efficient delivery of agricultural insurance.

"USAID's Development Credit Authority: Guarantees for Rural Financing"

Authors

John Wasielewski and Stavely Lord (all-USAID/DCA)

Summary and Key Findings

The paper provides an overview of USAID's Development Credit Authority (DCA), a guarantee mechanism intended to mobilize local capital in rural areas. Under the program, development credit can be applied to a specific project or set of projects through four different credit guarantees: loan guarantees, loan portfolio guarantees, portable loan guarantees and bond guarantees. The DCA enables banks to overcome traditional reliance on excessively collateralized loans and other market imperfections that impede lending into creditworthy sectors. For every dollar a Mission devotes to a DCA guarantee, financial institutions can offer an average of $35 in private-sector loans. Program challenges include limited knowledge and understanding of the program, the need for more coordination and participation from Missions and banks during the development stages of the guarantee, and the need for improved monitoring, information collection and ongoing communication at Mission and local bank levels.

"Kyrgyz Agricultural Finance Corporation (KAFC)"

Author

Baktygul Jeenbaeva (KAFC)

Summary and Key Findings

This case study examines the Kyrgyz Agricultural Finance Corporation (KAFC), a project designed to assist in the recovery of the rural and agriculture financial market after the failed economic reform programs in the wake of the disintegration of the Soviet Union. The necessary tools for a successful MFI include a well-developed strategy business plan, regulated legislative environment, trained staff, and branch locations convenient to farmers. The Kyrgyz experience exemplifies that development of sustainable financial institutions is feasible, provided the local authorities and donors cooperate.

"Moldovan Savings and Credit Associations' Experience"

Author

Victor Chiriac (BIZPRO)

Summary and Key Findings

Local commercial banks in Moldova do not have enough capacity to grant loans to private farmers. One proposed solution was to create a network called the Cooperative Savings and Credit Associations of Citizens (SCAs) in order to increase private farmers and rural entrepreneurs' access to financial resources. The case study identifies the conditions for the development and successful implementation of microfinance systems in countries that are transitioning to a market economy. It also examines how well SCAs provide the resources needed by private farmers and newly emerging rural enterprises in Moldova. Barriers to success are weak donor coordination, boundary restrictions to the extension of SCA activity, local commercial banks not willing to acquire knowledge and technologies to lend small amounts to clients, and state agencies attempting to interfere with an MFI's daily activity.

"El Comercio Finance Company in Paraguay"

Author

Carlos Heisecke Rivarola (Financiera El Comercio SAECA)

Summary and Key Findings

El Comercio Finance Company has been providing rural and agricultural micro credit since 1990. To overcome barriers and challenges in Paraguay, it is necessary that successful producers be identified and then connected to producers who have not yet reached the same production level, allowing the latter to grow. All officers in a successful financial firm will be sufficiently and constantly trained, from familiarizing them with tools such as computers, to teaching them about farming periods, production costs, farm suppliers, and better roads to market produce. Project development managers need to be aware of market developments and the evolution of agricultural products in international markets. This will help them offer sound advice to clients on investment matters.

Breakout 5: **Rural Finance Expansion: Experience in Commercialization**

"Expanding Commercial Microfinance in Rural Areas: Constraints and Opportunities"

Authors

Stephanie Charitonenko and Anita Campion (all-Chemonics)

Summary and Key Findings

This paper looks at past lessons in rural lending, elaborates the challenges of sustainably increasing rural finance, discusses practical approaches to successful expansion of MFIs to rural areas, and comments on the role for governments and donors in expanding commercial microfinance to rural areas. General rural finance should include innovations with respect to branch size and design, location and staff allocation. To reach different segments of rural financial markets, financial services such as crop insurance, deposits, commodity-collateralized finance, hedging instruments and microleasing should be introduced and developed. It also identifies several effective approaches to reduce risk and strengthen repayment potential associated with rural lending.

"Reverting the Tendency in Developing Finance: The Case of BANRURAL S.A. in Guatemala"

Author

Luis Noel Alfaro Gramajo (INCAE)

Summary and Key Findings

This paper presents the principal achievements of Guatemala's *Banco de Desarrollo Rural* S.A. (BANRURAL) in terms of profitability, self-sustainability, and outreach. Scholars and practitioners often criticize restructuring/modernization of public banks because the capital structure of the financial institution does not change, and the state continues to be the sole owner. In the case of BANRURAL, private groups and civil society groups were allowed to participate in the process of transforming a traditional agricultural public development bank into a profitable rural bank. The success of BANRURAL depended on multiple factors, including the leadership of the administrative board and the participation of the private sector in the capital structure.

"Selected South African Micro Finance Case Studies in Rural Financing"

Author

Kachesa Ed Bbenkele (Microenterprise Alliance)

Summary and Key Findings

Lack of interest by commercial banks to provide financial services to the poor is due to both risk and high transactions costs in servicing small rural accounts. This paper highlights problems faced by South African rural retail finance institutions and the difficulties micro finance institutions face in attaining profitability. Retail rural financial institutions' experiences with poor collection performance are attributed to ineffective management control systems and unacceptable levels of bad debt. The paper examines ways to counter challenges to sustainability, which include shortening loan maturity periods (though this tends to increase a client's burden of repayment), tightening lending and field operations criteria, dealing with poor performing agents through training or layoffs, improving recruitment and training, and introducing post office banking.

"Sudan's Farmers' Commercial Bank"

Author
Ahmed Gaber (Farmer's Commercial Bank)

Summary and Key Findings

This case study provides an in-depth examination of Islamic lending and deposit products offered by the Farmer's Commercial Bank in Sudan. Financing of agriculture is very risky in Sudan, particularly in the absence of modern means of production to help combat frequent droughts and annual rainfall fluctuations. Recommendations to address risks associated with credit, capital and operations include educational and training programs for rural clients in financial management, assessment of repayment failures so as to be able to avoid past mistakes, and provision of targeted credit to the agricultural sector.

"Islamic Banking and Its Potential Impact"

Author
Thomas A. Timberg (Nathan & Associates, Inc.)

Summary and Key Findings

This study addresses questions about the impacts of Islamic banking in rural areas, with examples from Indonesia. Islamic finance provides services and products similar to other financial institutions. However, issues related to risk sharing and the absence of fixed interest transactions, in which risk is entirely assigned to the borrower, makes Islamic finance a potentially more attractive lending policy. Donors should ensure that their assistance to financial system development includes Islamic financial institutions. This will help include otherwise excluded groups and avoid regulatory loopholes.

"Case Study of Bank Indonesia"

Author
Maulana Ibrahim (Bank Indonesia)

Summary and Key Findings

This case study examines the development of Islamic banking in Indonesia through the experience of Bank Indonesia. Islamic finance prohibits drawing interest in economic transactions, gambling, and investing in (morally) non-legitimated investments. Bank Indonesia's strategies to develop the Islamic banking system include improving the legal and regulatory framework to parallel the commercial banking system and to further develop the dual banking system, providing greater outreach of products and services though a network of Islamic financial institutions, and marketing and promoting the Islamic banking concept to the public.

"HIV/AIDS and Rural Microfinance—A Matter of Survival"

Author
John Magill (Development Alternatives, Inc.)

Summary and Key Findings
This paper examines the impact of the worldwide HIV/AIDS epidemic on microfinance institutions, with an emphasis on rural finance. It reviews the options and strategies MFIs can employ to protect their safety and soundness, which depends on the quality of its loan portfolio and its funding base (capital or deposits). These are strongly affected by client behavior, which in turn is strongly affected by the HIV/AIDS epidemic. Traditional MFI mechanisms for ensuring safety and soundness may be inadequate to deal with the magnitude of risk presented by HIV/AIDS. Most of these coping strategies are designed for relatively low-risk situations, whereas the HIV/AIDS epidemic represents a large-scale threat to the institutions. Recognizing the magnitude of the problem and adopting appropriate strategies to meet that threat are key to an MFI's survival. This paper examines specific strategies for ensuring the survival of an MFI.

"Response Required: Mitigating Risk in African Credit Unions Serving HIV/AIDS-affected Communities"

Author
Anna Cora Evans (World Council of Credit Unions)

Summary and Key Findings
This paper examines credit unions or savings and credit cooperatives serving HIV/AIDS-affected communities in East and Southern Africa. It outlines the challenges facing credit unions and their members stemming from the financial impact of HIV/AIDS and offers policy recommendations for donors to support technical assistance to enable credit unions to mitigate risk by: (a) diversifying credit union membership beyond the workplace and creating the corresponding loan loss provisions, improving credit administration and strengthening existing insurance products, (b) introducing new demand-driven products such as programmed savings for health emergencies, and (c) facilitating linkages between credit unions and health service providers.

"Best Practices by Women's Bank of Sri Lanka"

Authors

Justin D. Keppetiyagama and Nandasiri Gamage (all-Women's Bank)

Summary and Key Findings

This cases study explores gender targeting in rural finance through the practices of the Women's Bank of Sri Lanka. The mission of the Women's Bank is based on the principle of self-help and mutual help, and to not rely on government and external support. It aims to use the resources, ideas and support of its members to raise the members' socio-economic and cultural status. Currently, services are provided to 20,000 of the 80,000 needy families in Sri Lanka. Replication and/or expansion of the Women's Bank of Sri Lanka will require externally-funded activities.

"Case Study of FINCA Uganda"

Author

Fabian Kasi (FINCA Uganda)

Summary and Key Findings

FINCA Uganda (FU) has provided micro-finance services utilizing a group-based lending methodology to economically active poor women for more than a decade. The mission is to provide empowering micro-finance services within Uganda's poorer communities. FU has served more than 100,000 poor women since its inception, over 37,000 of whom are still active clients. Types of activities and products supported include commercial, manufacturing, and service delivery. Clients' businesses include an array of privately-owned shops and food, craft and brewery production. Gender targeted micro-finance services can be very effective in fighting poverty because the target group owns the program and feels that they belong to the institution, while at the same time the institution gets to better understand and serve the needs of the clients. Donors and other agencies should endeavor to foster such issues as sustainability, capacity building, productivity and cost control, on top of encouraging an enabling legal environment for micro-finance operations.

"A Comparative Study of Fertilizer Credit in Bangladesh"

Authors

Robert Weiland (Main Street Economics), Curtis Slover (WOCCU) and M.A. Baqui Khalily

Summary and Key Findings

This paper provides a snap-shot of credit delivery in a market for fertilizer that is undergoing liberalization. The findings indicate that the availability of bank credit significantly increases the availability of trade credit. The paper recommends the following steps to improve credit delivery for the fertilizer sector: introduce variable lending interest rates that account for the risk characteristics of borrowers, design loans to counter loan diversion incentives, increase the use of security pledging in order to create more value at less risk in fertilizer loan portfolios, and take a harder line of the practice of renewing loans without full adjustment of the outstanding balance.

"Case Study of DFCU Leasing Company – Uganda"

Author

Juma Kisaame (DFCU Ltd.)

Summary and Key Findings

This paper provides an overview of Uganda Leasing Company Limited's (DFCU) leasing activities and donor programs, the challenges DFCU faces in the market, and the innovative solutions crafted to provide lease transactions. Challenges to be overcome include tax laws that are not conducive to leasing, inefficient and expensive dispute resolution/court systems, lack of knowledge regarding leasing as an option, absence of local leasing expertise, and limited access to funding. The paper provides specific recommendations to overcome these challenges.

"The Evolution of Commercial Finance in Russian Agriculture"

Authors

Glenn Pederson (University of Minnesota) and Vera Matusevich (World Bank, Moscow)

Summary and Key Findings

This paper explores how past state intervention, agrarian policies, and weak institutions have contributed to fragmented markets in Russia, and how those problems have effectively constrained the development of commercial financing for agriculture. The paper looks specifically at two types of channels for farms and agribusinesses in Russia today. One channel operates with the use of State funds (commodity credit and leasing) and the other is a commercial channel (supplier and vendor credit/indirect lending) that operates without State funds.

"Improving Access to Rural Finance through Regulated Warehouse Receipt Systems in Africa"

Author

Gideon Onumah (Natural Resource Institute)

Summary and Key Findings

Taking the view that access to rural finance can be improved by focusing on risk reduction, this paper argues that the perception of rural borrowers as high risk can be changed, over the long term, by providing them with opportunities such as the warehouse receipt system developed in Zambia. The most significant challenge in establishing these systems in Africa remains the disabling elements in the policy environment, particularly ad hoc interventions occasioned by short-term reactions to symptoms of market inefficiency.

"CECAM: A Cooperative Agricultural Financial Institution Providing Credit Adapted to Farmers' Demand in Madagascar"

Author
Jean-Herve Fraslin, International Association for Agricultural and Rural Credit (ICAR)

Summary and Key Findings
This paper provides an overview of the CECAM network, which has approximately 47,000 individual members, more than 400 farmer associations/agricultural cooperatives, and over 5,000 member households. There are three unique features of the CECAM network that contribute to its success: credit that is adapted to the needs of farmers, a cooperative design that is based on shared capital and collateral, and a strong management role for farmers aimed at building the institution and strengthening the financial structure of the network.

"CLUSA Zambia Rural Group Business Program"

Author
Susan Parker, Cooperative League of the United States of America (CLUSA)

Summary and Key Findings
CLUSA has been managing the rural group business program in Zambia since 1996. The main objective of the program is to increase rural farm income through promotion of sustainable farming technologies. To assist small-scale farmers' access inputs and credit, CLUSA established village-based groups called regional group businesses. To overcome problems associated with non-payment of debt, CLUSA introduced the distributor model which gives distributors responsibility for repayment of credit. The paper provides an overview of these and other CLUSA activities.

"Financing Term Investments in Agriculture: A Review of International Experiences"

Author
Frank Hollinger (FAO)

Summary and Key Findings
This paper discusses the main findings of research conducted by FAO on term finance for agriculture. It summarizes the main lessons from a number of case studies of providers of term loans, leasing and equity finance for small- and medium-scale farm related investments. The paper highlights the main challenges and hot spots for providing agricultural term finance. It also illustrates the financial technologies used by the case study institutions to manage risks and transactions costs. Finally, it points out the crucial role of donors in supporting rural financial institutions and their clients to expand the financial frontier for term finance in rural areas. Case studies were conducted in Bolivia, Ghana, India, Indonesia, Madagascar, the Philippines, South Africa and Thailand.

"Agrocapital & Bai Tushum: Lessons from Two Rural Financial Service Foundations in Bolivia and Kyrgyzstan"

Author
Robert Fries (ACDI/VOCA)

Summary and Key Findings
This paper looks at Bolivia and Kyrgyzstan and how ACDI/VOCA identified a foundation for launching rural finance services. Along with dependable donor capital support, both foundations benefited from concentrated technical support. In both cases, the governance structure was strengthened through technical assistance and international cooperation. Product design stresses convenience and price flexibility.

"PT Ukabima Case Study in Indonesia"

Author
Maria C. Stephens (Catholic Relief Services)

Summary and Key Findings
This case study looks at micro finance in Indonesia and how PT Ukabima was formed. Ukabima promotes the careful selection, monitoring, and training of BPR (people's village banks) clients. Ukabima deals with intrinsic risks in agricultural lending by promoting strong BPRs and eliminating weaker ones, offering unique packages of financial services and training, working with partners who are sensitive to cultural needs, and establishing farmers' information networks to distribute information that helps to minimize risk.

"The Case Study of ACLEDA Bank in Cambodia"

Author
In Channy (ACLEDA Bank)

Summary and Key Findings
This case study examines the transformation of the ACLEDA in Cambodia from a national NGO for micro and small enterprises development and credit to a fully licensed bank. With a mission to market nationwide delivery of high-quality bank products and services, ACLEDA was established in 1993 as an NGO and became a licensed bank in 2000. Market research shows that customers favor ACLEDA Bank because of the service provided, appropriate products, convenience of the network, speed of delivery, good returns, confidence in its management, and good governance practice.

"The Agricultural Bank of Mongolia: From Insolvent State Bank to Thriving Private Bank"

Authors

Debra Boyer and Jay Dyer (all-D.A.I.)

Summary and Key Findings

The Agricultural Bank of Mongolia is the main provider of financial services in rural areas. The case study explores how management, operations and loan and deposit strategies were transformed. Successful turnaround of a large state-owned bank depended on a confluence of political and financial circumstances. Reasons for the successful turnaround include government commitment to privatization and keeping the bank protected from political influence while it diversified away from government reliance. Strong donor support and keeping operating costs low while cutting unnecessary expenses were also important factors.

"Credit Union Empowerment and Strengthening (CUES) Philippines"

Author

Luis Sasuman (WOCCU)

Summary and Key Findings

This case study describes the CUES Philippines project, a combination of two methodologies: Model Credit Union Building, and Savings and Credit With Education. The project's success in strengthening and empowering credit cooperatives shows that the two methodologies, when provided together, can increase member income and savings, improve health/nutrition knowledge and practice, empower women, and improve household food security and children's nutritional status. CUES helped transform cooperatives into financially strong and stable institutions. The combination of positive impact and financial sustainability makes "Credit with Education" a strategy with potential for widespread and sustainable impact.

"Rediscovering Rural Finance by Retooling the Existing Institutions"

Author

Pillarisetti Satish (NABARD-India)

Summary and Key Findings

This case study examines the reform process using a development action plan to shift institutional design from top-down to bottom up. Two successful reforms of institutions are described. Further issues of reform and change relate to the legal and regulatory environment and state control of cooperative banks, human resource training and development, information technologies, and privatization and ownership.

"Los Andes F.F.P. in Bolivia"

Author

Pablo Gonzalez (Los Andes)

Summary and Key Findings

This case study describes the rural credit technology employed by Los Andes and the role of human capital development in this technology. Most of the credit officers are native to the region where they work or have lived there a long time. This complements their academic knowledge as they are already familiar with the agricultural practices of the region, the products, the existence or lack of water, the impact of climate on the potential results of the different activities, and the role that different members of a household might play in regard to an investment project.

"Market-Based Credit Policies for Increased Access to Rural Finance in the Philippines"

Author

Ma. Piedad S. Geron, Credit Policy Improvement Project (CPIP)

Summary and Key Findings

This case study discusses the processes of implementing and evaluating market-based credit policies in the Philippines as a substitute to subsidized credit. Critical credit policy measures adopted by the government, along with key provisions, are aimed at developing viable and sustainable rural and micro finance markets. Recommendations include the need for collaboration among different donors and government institutions on policy directions, technical studies to assess the rural credit policy environment, transparency with financial monitoring and evaluation, and regulatory services adapted to the rural financial operational environment.

"Rural Lending in Sierra Norte-Ecuador"

Author

Susana Barton (ACCION)

Summary and Key Findings

This case study examines the design, development and implementation of a rural lending project geared to allow the Banco Solidario in Ecuador to increase the scope, depth and coverage of its loan portfolio to the microenterprise sector. Also described is the work of Fundacion Alternative with the lower income segment of the market. Challenges to rural lending programs include lack of experience in agricultural loan management, misaligned incentives program, operational concerns with loan disbursement in the field, and ignorance of cultural differences between urban and rural clients.

"How M-CRIL Supports the Provision of Financial Services to Low Income Clients in Asia"

Authors

Tanmay Chetan, Sanjay Sinha, and Arshed Khan (all from M-CRIL)

Summary and Key Findings

M-CRIL's mission is to enable flow of loan funds to MFIs and banking institutions, working primarily with low income clients in Asia. Their organization and methodology is compared to formal sector ratings from an institutional, client, and urban-rural basis. Suggested systems and processes required for outreach to low income families include reduction in market distortions caused by donor intervention, and effective dissemination of industry information, standards for disclosure and accountability and internal quality control.

"Adapting to the Challenges of Changing Financial Paradigms: WOCCU's Savings Mobilization Programs in Latin America"

Author

Janette Klaehn (WOCCU)

Summary and Key Findings

This paper discusses WOCCU's model credit union methodology, an integrated savings-based development plan that can minimize dependence on external sources of financing and create a financially self-sufficient, sustainable institution. Financial resources, in the form of subsidies from donors and/or governments, could be better used to support institutional strengthening programs, second-tier entities and supervisory agencies so that credit unions can adapt to the future challenges of changing financial paradigms.

"ASA Experience in Bangladesh"

Author

Mostaq Ahmmed (ASA)

Summary and Key Findings

ASA has introduced flexible, affordable and convenient savings products, such as voluntary savings accounts, which, to the extent possible, has enabled ASA to mobilize savings and generate funds for micro finance activities. However, as local savings mobilization capacity is limited, most MFIs in Bangladesh, including ASA, still depend on donor organizations for capital to operate micro credit programs. ASA faces several challenges in the marketplace, including the lack of a legal regulatory framework, the need for staff training, and the lack of awareness of the benefits of saving.

"Centenary Rural Development Bank (CRDB) in Uganda"

Author

Richard Nalela (CRDB)

Summary and Key Findings

This paper provides an overview of the CRDB, including its five-year business plan, financial projections and budget. In order to improve bank performance, the bank is attempting to place more emphasis on the growth of the micro loan portfolio while trying to increase borrower outreach in rural areas. Challenges the bank faces include political instability in some rural areas, cultural practices that do not encourage savings, challenges/costs associated with expanding the existing branch network, various natural hazards, and a traditional belief in investing savings in cows and other fixed assets.

"The Bolivian Experience of the PRODEM Private Financial Fund"

Author

Eduardo Bazoberry (PRODEM)

Summary and Key Findings

Based on market research that shows rural clients with savings accounts place more importance on the security and ease of access of their deposits than on the interest rate offered, PRODEM designed and implemented savings accounts that incorporated fingerprint identification and a "smart card." PRODEM still faces many challenges in the Bolivian market, including the need for need for outreach, training, education and enhanced management capacity.

Appendices

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8:30

9:15

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2:15

4:15

Conference Agenda

DAY 1: Monday, June 2, 2003

8:30 a.m. - 9:10 a.m.

General Session: Welcome, Opening Remarks, Q&A

Welcome: •Emmy Simmons (Assistant Administrator, Office of Economic Growth and Trade - USAID)

Keynote Speaker: •Andrew Natsios (Administrator - USAID)

9:15 a.m. - 10:45 a.m.

General Session: Macro Economic Policy & Reality

Moderator: •Michael Carter (BASIS CRSP, UW-Madison)

Presenter: •Claudio Gonzalez-Vega (Rural Finance Program of the Ohio State U.)
Deepening Rural Financial Markets: Macroeconomic Policy and Political Dimensions

Discussants: •Carolina Trivelli Avila (Peruvian Studies Institute)
•Nimal Sanderatne (Sri Lanka P.G. Institute of Agricultural Economics)

11:15 a.m. - 12:45 p.m.

General Session: Legal Policy & Ramifications for Rural Finance

Moderator: •Martin Hanratty (USAID)

Presenter: •Heywood Fleisig and Nuria de la Peña (Center for the Economic Analysis of Law)
Legal and Regulatory Requirements for Effective Rural Financial Markets

Discussants: •Jolyne Sanjak, (USAID)
•Stefan Staschen (Consultant)

12:45 p.m. - 2:15 p.m.

Luncheon: Experience with Risk Management: What Worked, What was a Challenge

Introduction: •Arthur Arnold (President and CEO - WOCCU)

Keynote Speaker: •Carole Brookins (U.S. Executive Director -World Bank)

2:15 p.m. - 3:45 p.m.

General Session: Risk Management

Moderator: •Lena Heron (USAID)

Presenter: •Jerry Skees (GlobalAgRisk, Inc. & U. of Kentucky),
Risk Management Challenges in Rural Financial Markets: Blending Risk Management Innovations with Rural Finance

Discussants: •Tsend Munkh-Orgil (Ministry of Justice and Home Affairs of Mongolia)
•Hector Ibarra (Agroasemex)
•Ulrich Hess (World Bank)

4:15 p.m. - 5:45 p .m.

Breakout Sessions (7 concurrent sessions)

Breakout #1: Regulation for Expanding Rural Financial Services
Robert Vogel (IMCC), Moderator
Al Harding (ACDI/VOCA), Case Study Presenter
Rodrigo Espinosa (Superintendency of Banks), Case Study Presenter

Breakout #2: Surveys of Delivery Systems in Rural Finance
Martin Hanratty (USAID), Moderator
Madeline Hirschland (Independent Consultant), Case Study Presenter
Jonathon Campaigne (PRIDE), Case Study Presenter
Caroline Tsilikounas (DEMOS), Case Study Presenter
Charles Gore (Agrilink), Case study presenter

Breakout #3: Risk Management: Pricing, Insurance, Guarantees
Lawrence Johnson, Moderator
Erin Bryla (World Bank), Case Study Presenter
Mark Wenner (IDB), Case Study Presenter
John Wasielewski (USAID), Case Study Presenter

Breakout #4: Agricultural Lending Practices: Non-financial Services with Financial Products
Renate Kloeppinger-Todd (IFC), Moderator
- Baktygul Jeenbaeva (KAFC), Case Study Presenter
- Victor Chiriac (BIZPRO), Case Study Presenter
- Carlos Heisecke Rivarola (Financiera El Comercio), Case Study Presenter

Breakout #5: Rural Finance Expansion: Experience in Commercialization
Stephen Smith (G.W.U.– Dept. of Economics), Moderator
- Stephanie Charitonenko and Anita Campion (Chemonics), Case Study Presenters
- Luis Noel Alfaro-Gramajo (INCAE), Case Study Presenter
- Kachesa Ed Bbenkele (MEA), Case Study Presenter

Breakout #6: Risk Management: Islamic Financial Policies
Ghiath Shabsigh (IMF), Moderator
- Ahmed Gaber (Farmer's Commercial Bank), Case Study Presenter
- Thomas A. Timberg (Nathan & Associates), Case Study Presenter
- Maulana Ibrahim (Bank of Indonesia), Case Study Presenter

Breakout #7: Rural Finance in the Age of HIV/AIDS
Joan Parker (DAI), Moderator
- Anna Cora Evans (WOCCU), Case Study Presenter
- John H. Magill (DAI), Case Study Presenter
- Ethel Matenge-Sebesho (HomeLoan Guarantee Co.), Presenter

6:00 p.m. - 7:30 p.m. *Evening Reception*

Introduction: •Michael Carter (BASIS CRSP, UW-Madison)
Remarks: •Tom Hobgood (Director of EGAT-USAID)
•Kate McKee (Director of OMD-USAID)
•David Stanton (Enterprise Dev. Advisor -DFID)

DAY 2: Tuesday, June 3, 2003

8:30 a.m. - 8:45 a.m.

General Session: Opening Remarks

Speaker: •Michael Carter (BASIS CRSP, UW-Madison)

8:45 a.m. - 10:30 a.m.

General Session: Rural Finance Institutions & Systems

Moderator: •Barry Lennon (USAID)

Presenter: •Manfred Zeller (Inst. Rural Development -University of Gottingen), *Models of Rural Financial Institutions*

Discussants: •Calvin Miller (CARE)
•Robin Young (DAI)
•Anthon Slangen (FAO)
•David Richardson (WOCCU)

11:00 a.m. - 12:30 p.m.

General Session: Innovations in Rural Finance

Moderator: •Beth Rhyne (ACCION)

Presenter: •Juan Buchenau (Frontier Finance), *Innovative Products and Adaptations for Rural Finance*

Discussants: •Carlos Cuevas (World Bank)
•Marguerite Robinson (Institute Fellow Emeritus – HIID)

2:00 p.m. - 3:30 p.m.

Breakout Sessions (7 concurrent sessions)

Breakout #8: Gender Targeting of Rural Financial Services: Is This Appropriate?
Diana Fletschner (UW-Seattle), Moderator
Justin D. Keppetiyagama (Women's Bank), Case Study Presenter
Fabian Kasi (FINCA Uganda), Case Study Presenter

Breakout #9: Agribusiness: Vendor Financing in Input Markets
Bob Barnes (USAID-Philippines), Moderator
Robert Wieland (Main Street Economics), Case Study Presenter
Glenn Pederson (University of Minnesota), Case Study Presenter
Juma Kisaame (DCFU Leasing Co.), Case Study Presenter
Gideon E. Onumah (NRI), Case Study Presenter

Breakout #10: Agricultural Lending Practices: Methodologies and Programs
Henri Dommel (IFAD), Moderator
Susan Parker (CLUSA Zambia), Case Study Presenter
Jean-Hervé Fraslin, (ICAR), Case Study Presenter
Frank Hollinger (FAO), Case Study Presenter

Breakout #11: Rural Financial Institutions: Start-ups
Chris Barltrop (USAID), Moderator
Robert Fries (ACDI/VOCA), Case Study Presenter
Maria C. Stephens (Catholic Relief Services), Case Study Presenter
In Channy (ACLEDA), Case Study Presenter

Breakout #12: Rural Financial Institutions: Restructuring and Post-Restructure Results
Curtis Slover (WOCCU), Moderator
James Boomgard (DAI), Case Study Presenter
Luis Sasuman (WOCCU Philippines), Case Study Presenter
Pillarisetti Satish (NABARD), Case Study Presenter
Pablo Gonzalez (Caja Los Andes), Case Study Presenter

Breakout #13: Risk Management: Information Technology
John Caan (DAI), Moderator
Ma. Piedad S. Geron (CPIP), Case Study Presenter

Susana Barton (ACCION), Case Study Presenter
Tanmay Chetan (M-CRIL), Case Study Presenter

Breakout #14: <u>Rural Financial Institutions: Savings Mobilization</u>
Mohamed Nazirwan (BRI), Moderator
Mostaq Ahmmed (ASA), Case Study Presenter
Janette Klaehn (WOCCU), Case Study Presenter
Richard Nalela (CRB, Ltd.), Case Study Presenter
Eduardo Bazoberry (PRODEM), Case Study Presenter

4:00 p.m. - 5:15p.m. *General Session: Rural Finance Innovation Case Study*

Moderator: •Juan Buchenau (Frontier Finance)
Presenter: •Manuel Orozco (Inter-American Dialogue)
Remittances, the Rural Sector, and Policy Options in Latin America
•Douglas Pearce (CGAP)
Buyer and Supplier Credit for Farmers: Do Donors have a Role to Play?

DAY 3: Wednesday June 4, 2003

8:30 a.m. - 8:45 a.m. — *Opening Remarks*

Introduction: •Lucy Ito (WOCCU)
Speaker: •Kate McKee (USAID)

8:45 a.m. - 10:15 a.m. — *General Session: Rural Finance Outreach & Sustainability*

Moderator: •Lucy Ito (WOCCU)
Presenter: •J.D. Von Pischke (Frontier Finance)
The Evolution of Institutional Issues in Rural Finance Outreach, Risk Management and Sustainability
Discussants: •Richard Rosenberg (CGAP)
•Richard Meyer (Professor Emeritus, Ohio State University)

10:45 a.m. - 12:30 p.m. — *General Session: Framework for Rural Finance Development*

Moderator: •Michael Carter (BASIS CRSP, UW-Madison)
Speaker: •Emmy Simmons (Assistant Administrator-USAID)
The Value and Challenges of Donor Programming Principles
Presenter: •Brian Branch (WOCCU)
Rural Finance Programming Principles

2:00 p.m. - 3:15 p.m. — *General Session: Donor Perspectives on Rural Finance Programming*

Moderator: •Michael Carter (BASIS CRSP, UW-Madison)
Panel Members: •David Stanton (DFID)
•Mark Wenner (IDB)
•Thorsten Giehler (GTZ)
•Henri Dommel (IFAD)
•Kevin Cleaver (World Bank)
•Jock Conly (USAID)
•Brigit Helms (CGAP)

3:15 p.m. - 3:30 p.m. — *Closing Remarks*

•Emmy Simmons (Assistant Administrator, Office of Economic Growth and Trade, -USAID)

RURAL FINANCE PROGRAMMING PRINCIPLES

Draft for Donor Discussion

The objective of this paper is to solicit views from donors with the objective of improving donor collaboration and consistency in donor rural finance programming principles that will expand the outreach of financial services in rural areas and strengthen the sustainability of the institutions providing those services. Today's **financial systems approach** enhances the efficiency and depth of savings, financing and insurance services available to rural communities. This approach supports rural employment and economic growth and, therefore, income generation and wealth accumulation in rural areas.

The structure of this paper and the USAID-sponsored *Paving the Way Forward for Rural Finance: An International Conference on Best Practices* has been built around but is not limited to a conceptual framework wherein rural financial systems development is implemented through (1) establishing an enabling economic policy environment, (2) establishing an enabling legal framework (3) supporting mechanisms to reduce risk in rural financial intermediation, (4) building or restructuring sustainable financial institutions, (5) developing appropriate/innovative products for rural finance, and (6) supporting agribusiness linkages that deepen rural financial services.*

(1) Establishing an enabling economic policy environment.

The role of Government economic policy is to support and stimulate market operation, not to administer market operations. Donors can provide incentives to eliminate Government biases in sectoral economic policies, such as agricultural price control and tax regimes, that reduce the profitability of rural production. The Government should not engage in price controls, interest rate controls, portfolio quotas, directed credit, operational subsidies or direct provision of financial services. The role of the Government in undertaking complementary investment in non-financial rural infrastructure to improve the return on rural finance investments. Donors may support Government development of rural education, health care, agricultural research and extension and public investment in physical infrastructure upon which financial services returns are indirectly dependent. This infrastructure is characterized by public goods—benefits available to the wider population and not adequately provided by the private sector.

Goal: Establish conducive economic policies that stimulate financial systems to expand rural financial services access in a sustainable manner.

Donor Programming Do's	*Donor Programming Don'ts*
• Assist in the establishment of information infrastructure such as credit bureaus and property registries that reduce the risks for intermediaries. • Require clear prudential norms, transparent reporting and effective supervision consistent with international standards for donor supported deposit-taking institutions. • Support product innovation not by having the Government implement innovation itself, but by motivating the Government to establish a framework that allows innovators to experiment and benefit financially from desired innovations.	• Do not support interest rate controls. • Do not provide credit or grants for subsidized interest rate lending, directed credit, or credit programs with political rather than commercial management. • Do not support direct provision of financial services by the Government.

Slide presentations, MP3 audio files of the question and answer session and other commentaries can be found on the accompanying CD.

(2) Establishing an enabling legal framework.

An adequate legal framework defines the manners in which a borrower and a lender may undertake secured transactions and how that contract will be enforced. The legal system needs to establish the mechanisms and rules by which (a) the lender takes collateral upon a specific property, (b) the claims on collateral are prioritized, (c) the claims are registered and (d) the collateral arrangement is enforced and liquidated. One of the critical issues is the clear definition of legal rights to land and the right of landowners to pledge land as collateral. Another constraint includes the ability of rural producers to pledge their crops as collateral.

Goal: Establish a legal framework that offers property for collateral in a transparent manner to reduce risk in lending and allow financial institutions to offer rural finance in larger amounts, at lower interest rates, and for longer terms.

Donor Programming Do's	*Donor Programming Don'ts*
• Create incentives for establishing a single or umbrella legal framework that defines the priority of claims upon borrower collateral. • Support programs that strengthen institutions that title and register security interest. • Improve the security of land tenure legal frameworks by (i) strengthening title process and registries, (ii) defining transfer and pledging rights, and (iii) removing legal restrictions on mortgaging rural property (iv) removing restrictions on sales, rentals and other forms of transfer of rights. • Provide support for improved court and legal system, enforcement of contracts and bankruptcy law. • Encourage the use of collateral alternatives such as producer crops and joint liability groups. • Support the regulation and supervision of deposit taking institutions under the same or consistent and capable formal finance sector supervisor. • Encourage governments to simplify the regulatory structure thus reducing opportunities for rent-seeking behavior	• Do not encourage unnecessary bureaucratic procedures that would provide opportunities for rent seeking.

(3) Supporting mechanisms to reduce risk in rural financial intermediation.

Risk can be pooled and managed for the mutual benefit of the individual producer and financial institution through insurance programs. Such programs will then increase the access of producers to agricultural credit. Index-based insurance programs provide financial institutions with greater incentives for investment in rural markets while maintaining the incentives for producers to produce effectively and avoid risks.

Goal: Reduce high degrees of price and production risk in agriculture finance.

Donor Programming Do's	*Donor Programming Don'ts*
• Create incentives for establishing or strengthening market information mechanisms such as price information services, distribution information and associations to reduce risk to producers and rural financial institutions. • Require accurate actuarial and statistical information modeling for donor supported insurance programs. • Support crop insurance programs which are profitable and are attractive to private sector ownership and management. • Provide incentives and support programs that determine insurance premiums and payments based upon indices such as rainfall, crop production histories, and natural events which are beyond the control of producers so that producers are still motivated to manage and maximize their production. • Require that donor supported deposit guarantee insurance have in place prior financial monitoring and supervision systems to reduce the risk of morale hazard.	• Do not support the establishment of multiple peril insurance programs which decrease the incentive for producers to well manage their production. • Do not support insurance programs that lack adequate limits on what can be insured, have high monitoring costs, and/or face generally high losses. • Do not support crop insurance in markets characterized by decreasing productivity trends, unfavorable terms of trade, geographic concentration and small market size.

(4) Building or restructuring sustainable financial institutions.

Various financial institutions possess distinct comparative advantages which makes their co-existence and fierce competitiveness possible. Institutional diversity breeds competition and competition is healthy in that it breeds institutional innovation and sustainability. Institution-building is a function of information and incentives. Information begins with transparency and full disclosure of reporting by financial institutions. To be sustainable, rural financial institutions need to cover their full costs including financial costs, operating costs, provisions, and capital accumulation to meet capital adequacy requirements. Institutions must be able to pay full market costs (meaning non-subsidized costs) for their loanable funds. As part of this commitment, donors, as key investors in financial institutions, should consider taking an active role in the formulation of institutional policy and oversight. Active participation on the institution's board of directors either as a voting or nonvoting member should be seriously considered. The creation or restructuring of sustainable institutions requires a long-term commitment to put systems and trained personnel in place.

Goal: Establish a diversified range of rural financial, bank and non-bank, institutions which provide efficient financial services in rural areas and which are sustainable.

Donor Programming Do's	*Donor Programming Don'ts*
• Require rural financial institution partners to meet standardized international reporting and auditing requirements for the measurement and monitoring of sustainability and financial health. • Limit investment grants or operating subsidies for start up or restructuring to specific costs with clear objectives, timelines, and performance criteria for reaching sustainability. • Require that partner financial institutions target, plan, and price to achieve full cost recovery and financial sustainability with operating revenues; create incentives for actually reaching full cost recovery and financial sustainability. • Insist that governance of rural financial institutions be strengthened with (i) a clear definition of the roles and responsibilities of board members and managers, (ii) criteria for board candidates, (iii) internal controls, and (iv) conflict of interest controls. • Provide credit lines only on a non-subsidized basis and only when local financial markets do not provide long term financing. • Assure that, in donor supported rural finance programs, external credit is priced at commercial wholesale rates to financial institutions and at retail market rates to client-borrowers. • Require that rural finance partners hire and dismiss management on commercial criteria and performance standards in response to market forces and not on political objectives. • Donors should structure long-term partnerships with institutions they supporting by ensuring their participation on the institution's board of directors.	• Do not support rural finance programs that lend at interest rates which fail to cover the lender's full costs. • Do not rely solely on Government-owned financial intermediaries to provide rural financial services. • Do not rely on Government-owned non-financial institutions or non-financial ministries (likely to pursue political ends) to implement rural finance projects.

(5) Developing appropriate/innovative products for rural finance.

Innovations may help reduce the costs of rural finance operations for financial institutions, lower transaction costs for client and institution, or reduce the risks to the institution and the client. The worth of innovation is in the increased profitability of the financial institution and in the increased income or wealth through access to financial services at the client level. Innovations may be the creation of new products, changes in the characteristics or application of old products, or simply the transfer of products and technologies from one country or one sector to another.

> **Goal**: Introduce product innovations which expand rural finance services by reducing the costs of services, reducing the risks of providing services, or expanding the range of financial service characteristics tailored to the disbursement, term, and repayment characteristics of the economic activity of the clients.

Donor Programming Do's	*Donor Programming Don'ts*
• Provide incentives for strengthening rural financial institution lending capacity to include household multi-activity repayment analysis for farm and non-farm activity lending. • Develop long term funding vehicles and methodologies at market interest rates to finance longer term agricultural investment. • Restrict innovations which require large financial investment to larger and financially sound institutions. • Ensure commitment of the financial institution introducing the proposed innovation; require co-funding of institution where innovation is introduced. • Emphasize savings services among regulated financial institutions and credit for purposes beyond agricultural production. • Establish standards for warehousing and strengthen boards which monitor the quality of warehousing receipts.	• Do not limit partner financial institution services to just agricultural credit. • Do not support uniform supervision policies which place barriers to providing rural lending services via nontraditional collateral arrangements.

(6) Supporting agribusiness linkages that deepen rural financial services.

Non-financial institutions provide interlinked credit arrangements such as contract farming, supplier trade credit and output distributor advances. Rural traders who advance agricultural inputs or purchase harvest are important providers of credit in rural areas. Large supply or processing companies often use the traders as middle men to interface with producers. Where traders are absent, the processors often work directly with the producers. Traders apply their patronage history knowledge of clients to screen credit recipients who usually tend to be small and medium producers. Trader credit operations therefore tend to be limited to a small number and geographic area but are replicated on a major scale.

Goal: Expand financial services through interlinked markets and coordinating with commercial non-financial entities.

Donor Programming Do's	*Donor Programming Don'ts*
• Support trader or processor business relationships linked to credit without distortion or crowding out of private sector activities. • Support the development of liquidity management systems for traders and traders' supplying companies. • Ensure that the resource allocation distortions caused by donor intervention are transparent and outweighed by the public benefits of the intervention.	• Do not support or promote programs in which supplier, processor or trader relationships with producers are "predatory", i.e., locking producers into production/debt peonage through credit terms.

[*] The text of this paper draws from but is not limited to the papers commissioned for this conference, including Deepening Rural Financial Markets: Macroeconomic Policy and Political Dimensions by Claudio Gonzalez-Vega, Legal and Regulatory Requirements for Effective Rural Financial Markets by Heywood Fleisig and Nuria de la Pena, Risk Management Challenges in Rural Financial Markets: Blending Risk Management Innovations with Rural Finance by Jerry Skees, Models of Rural Financial Institutions by Manfred Zeller, Innovative Products and Adaptations for Rural Finance by Juan Buchenau and The Evolution of Institutional Issues in Rural Finance Outreach, Risk Management and Sustainability by J.D. Von Pischke.

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Additional Information about the Enclosed Compact Disk

To start the CD manually

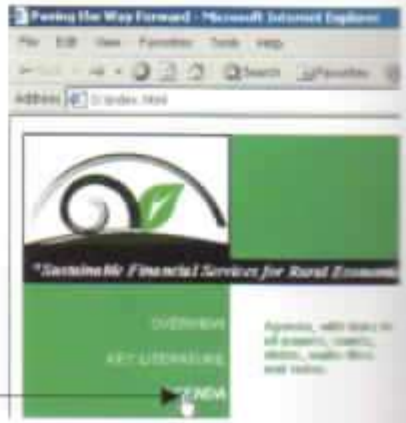
1. Select the CD drive from the Windows Explorer program (or compatible program if not using Windows operating systems)

2. Click on the index.html file that looks like: index
The opening page will look like:

To find papers, presentations, audio recordings and other conference literature

KEY LITERATURE
Use this link to access all theme papers, case studies, slide presentations, donor reviews, and literature review resources

AGENDA
Use this link to access all theme papers, case studies, slide presentations and audio MP3 files



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B A S I S

Broadening Access and Strengthening Input Market Systems

May 2004

Dear Conference Participants,

Please find enclosed *Paving the Way Forward for Rural Finance*, the final and complete packet of materials from the USAID rural finance conference that took place in Washington, DC last summer. These materials have been developed to give the reader a comprehensive body of work on the issues and solutions that comprise rural financial sector development.

This packet is comprised of three complementary components:

- The synthesis document- An analysis of the major findings of the conference based on constraints in rural finance and programming solutions to those constraints.
- The conference proceedings- A reference guide including short summaries of the papers and case studies available on the CD (below).
- The conference CD- Full copies of all papers, case studies and power point presentations as well as select audio files of presentations.

We hope you find this packet of information useful and that you share it with your colleagues and collaborators. For additional copies, please contact Eliza Waters, eswaters@wisc.edu.

Thank you,

Michael R Carter

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Director
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