Rural Finance Today: Advances and Challenges

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Rural finance generally refers to the provision of financial services through formal, semiformal and informal institutions to rural farm and nonfarm population at all income levels.

In the past, many rural finance programs failed due to a combination of lack of attention to institution building, faulty design and implementation, and bad macro policies driven by political interests. They were generally unable to close the huge gap between demand and supply. The gaps were created by insufficient and inefficient products and services to manage high transaction costs, weak institutional capacity, seasonality, farming risks, and lack of usable collateral that are inherent to rural areas. As a result, rural finance was almost considered a lost cause in the late 1980s.

RURAL FINANCE TODAY
Currently, however, advances are being made to efficiently expand rural financial services. New and promising developments that may potentially push the rural finance frontier forward are observed. Indeed, many advances are building on new learning from and strengths of microfinance.
The new rural finance paradigm is premised on the fact that rural people are bankable. The major breakthrough for the current form of rural finance occurred with the evolution of the new rural finance paradigm in the late 1980s. The paradigm is premised on the fact that rural people are bankable, and rural clientele are not limited only to farmers and they demand varied types of financial services for which they are willing to pay. It advocates demand-driven design and efficient provision of multiple financial products and services through an inclusive financial sector comprised of sustainable institutions serving many diverse clientele in rural areas.

The new paradigm, learned from past mistakes of supply-driven rural finance, quickly moved to push for innovations to manage risks, information, incentives, and contract enforcement barriers that increase costs of operations in rural areas and hinders sustainable rural outreach. The following discussion highlights several advances that are being made in today’s rural finance sector, and identifies many remaining challenges.

ADVANCES IN INSTITUTIONS

Government-owned agricultural development banks (AgDBs) still dominate in many countries and some have been successfully reformed. While there is no assurance that a reformed or privatized AgDB will strive to expand its agricultural and rural outreach aggressively, many AgDBs have been, nonetheless, reformed and re-engineered. Whereas many are failing, such as in the People’s Republic of China, Egypt, Pakistan, and Ecuador, there are some success stories, such as the Agricultural Bank of Mongolia (now called Khan Bank), the National Microfinance Bank in Tanzania, and BANRURAL in Guatemala, where they are now profitable and privatized. The “technology” of reforming AgDBs is now well understood but reforms tend to take a long time to work and require long-term political and financial commitments and technical assistance. When governments are blocked from using AgDBs as a means to allocate subsidies for economic and political interests, they tend to seek other channels such as microfinance institutions (MFIs), cooperatives, provincial banks, and village or community funds.

Several microfinance institutions are increasing their rural operations and are becoming important suppliers of rural financial services. MFIs such as BASIX in India, and microfinance banks such as Banco Los Andes Procredit (formerly Caja Los Andes) in Bolivia, Banco ProCredit El Salvador (formerly Calpiá) in El Salvador, and K-Rep Bank in Kenya have now developed specific rural products and technology to deliver rural financial services. ACLEDA Bank in Cambodia has expanded its rural financial services significantly in recent years. Many MFIs in Bangladesh are already serving microenterprises in rural areas. In some cases, MFIs may need to cross-subsidize their rural operations with robust, urban operations. As a result, weak and small MFIs that limit coverage only to rural areas may not be suitable to provide sustainable services. In addition, few MFIs have effectively devised products and systems to make large numbers of seasonal agricultural loans.

Member-based/owned informal institutions such as self-help groups (SHGs) and savings and credit cooperatives (SACCOs) are increasing and have the potential to play an important role, especially in remote rural areas. SHGs are growing rapidly in India and are now being replicated in some African countries. Some SHGs are federating to intermediate funds and also access external funds. While SHGs are suitable for rural areas, only those SHGs that are well connected to formal financial institutions tend to effectively provide services without receiving continuous support from external sources for funds and technical assistance. The emerging lessons show that SACCOs appear to be suitable for remote rural areas only if their funds are managed well. In Niger, CARE introduced one of the innovative types of local, self-managed systems of financial intermediation through SACCOs for use in remote rural areas. CARE provides only training and monitoring, while all funds lent come from member savings. No written records are kept to minimize paper work for members in remote areas who are generally illiterate. All information about amounts saved, lent, and due at each meeting must be remembered by the members. The program has experienced steady growth and some groups have formed local networks that are registered to facilitate linkages with other financial institutions.
including credit unions, to access services that cannot be provided locally. Several small SACCOs in rural Kenya now hire private management agencies to assist women to form groups, keep accounts, make monthly contributions called shares, and convert the shares into loans.

ADVANCES IN PRODUCTS AND SERVICES

Flexible savings products are being developed to service rural areas. Khrisna Bhima Samruddhi (KBS), a local area bank of BASIX, India, offers a flexible daily-deposit scheme in which savings are collected daily at the doorsteps of rural depositors by mobile deposit collectors (called microsavings agents) who typically cover about 150 depositors a day. The model is similar to Safesave’s approach in Bangladesh. As an incentive, the bank offers loans of up to $110 to depositors who have regularly saved for a minimum period of 100 days without an interruption lasting more than 20 days. In addition to MFIs, Post Office Savings Banks are emerging as significant providers of deposit services in rural areas of India, Kenya, Tanzania, and South Africa, especially catering to the poor. Use of lockboxes for clients to deposit their savings and collect the contents of the box at periodic intervals are observed as in the case of the “ganansya box” provided by several Rural Banks in the Philippines. These savings are generally used for consumption smoothing and some level of asset creation. Recently, the Grameen Bank’s new long-term savings program has become a highly accepted product that functions as a pension plan for poor rural women.

Some institutions are now cross-subsidizing their rural operations with urban operations. For example, COOPECS, a cooperative society in West Africa is migrating to urban areas to capture larger volumes of savings to make rural deposit mobilization viable. Some institutions, such as BURO Tangail and ASA in Bangladesh, are increasing savings volume by including clients higher in the poverty strata as associate members who are only eligible to save with the institutions. However, it is not clear if such practices will be permitted by the Central Bank in Bangladesh to continue in future. Piggybacking savings services on to other delivery systems, with savings services offered at a time and place where clients are already transacting other business, are used to reduce the costs of deposit mobilization. Examples include the use of milk cooperatives in Nepal, and lottery and mobile phone kiosks in Haiti and India. Mobile banks in Viet Nam and Kenya, if scaled up, can reduce transaction costs for financial institutions if infrastructure facilities are fair.

Rural leasing, under certain conditions, provides a viable financial option for rural clients. The rural leasing arrangements currently found in Central Asia, Russia, Africa, and Latin America suggest advantages for both lessors and lessees in terms of costs and risks involved. For example, John Deere in Mexico, Uzelmalhosh Leasing in Uzbekistan, and AgroMash Leasing in Kazakhstan operate exclusively in rural areas and provide leasing contracts for agricultural equipment and processing units. The Grameen Bank is the largest provider of leases to rural microenterprises in Bangladesh with a lease portfolio valued at $22 million per year. Grameen and AgroMash reported no repayment problems on their leasing portfolio, while John Deere and Uzelmalhosh reported a portfolio at risk (30 days) of about 4%. The Network Leasing Company in Pakistan offers leasing for agriculture-based enterprises in small towns adjacent to villages. Experiences now indicate that leasing may not be suitable for remote areas because of the high costs of transporting equipment and machinery, and the lack of servicing stations for the leased equipment. Also, the vulnerable poor may seldom require assets that are suitable for leasing for their income-generating activities. Leasing products are, nonetheless, suitable for individual-based transactions but require a significant down payment or collateral for reducing risks for the lessor. Many legal and tax issues must also be resolved before leasing can become an attractive alternative for loan products in rural areas.

Index-based insurance is developed to minimize insurance risks in some rural areas. A local area bank of BASIX, India, KBS collaborates with ICICI Lombard General Insurance Company to provide weather-based crop insurance to small farmers based on rainfall data in the region over the past 30 years. Payouts are based on the deviation of actual rain-
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Remittance services are increasing for rural clients through strategic partnerships between remittance providers and MFIs. In India, the ICICI Bank extends remittance services to rural areas using alliances with computer kiosks that are equipped with low-cost automated teller machines (ATMs). The International Remittance Network (IRnet), in partnership with the World Council of Credit Unions, provides remittance services in more than 40 countries including the rural Philippines. It uses an electronic funds transfer service and charges a flat fee of $10 to send up to $1,500. While senders are required to be credit union members, recipients are not. It is found to benefit credit unions by attracting new clients who tend to open savings accounts and thereby accumulate financial assets. The Microfinance International Corporation, a private remittance company that provides remittance services to the poor immigrants in the United States (US) from El Salvador by linking with MFIs with rural reach in El Salvador. It uses an electronic settlement system over the Internet, called the Cooperative Open Banking Information System (COBIS) to make instant transfer of remittances. The remittance service providers, however, are now required to comply by the new anti-money laundering regulations that may potentially raise some costs.

Products that comply with Islamic laws are emerging. Insurance products that conform to Islamic sharia laws, called takaful, have been developed in some Islamic countries, including Malaysia and Sudan. Takaful is a slight variation of mutual insurance and is based on cooperation, shared responsibility, and joint indemnity. Losses are divided and liabilities are spread according to a community pooling system. The Agricultural Mutual Fund was established in Lebanon in 1997 to provide takaful health insurance for the rural poor. Each insured family is required to pay $10 each month but communities cover the cost for the poorest who cannot afford to pay. In Afghanistan, group-based Murabaha loans that follow Islamic principles are currently being pilot tested for rural women. The MFI buys the asset and sells it to the client with a markup.

ADVANCES IN PROCESSES

A better understanding of financing through value chains is developing. In most cases, traders are considered important links in the value chains. The Oriental Bank and State Bank of India in Maharashtra, India are extending loans to small poultry farmers in rural areas who are under buyback contracts with large poultry integrators. The contractual relations with integrators act as a kind of guarantee for the loan. The AGENT project of CARE in Zimbabwe initially provided a temporary guarantee to wholesalers/distributors that provide inputs as inventory credit to traders in rural areas. Since 1995, a total of 580 traders were linked to the private wholesalers, and 60% were fully absorbed into the private-sector distribution network. Farmers have benefited from the increased product range offered through the program, such as a wider variety of seed and fertilizer, basic processing and irrigation equipment, and general construction materials. In Peru, a large trader, Critecnia, sells inputs, buys, and markets cotton for contract farmers, and also brokers loans on their behalf. The farmers provide some loan guarantees in the form of land. This arrangement has led many banks to finance cotton farmers who were previously rejected for lack of guarantees. Trading centers in India and Nepal, such as in wholesale markets, warehouses, and grading
and packaging facilities, appear to encourage traders to link up with small farmers to source products. These linkages in turn are reported to increase access to finance for farmers with assured markets. There is now some experimentation with use of reverse factoring mechanisms in Moldova and Macedonia to provide bank loans to new and risky small and medium (SMEs) processing and manufacturing enterprises in rural areas. Here, the SMEs are assessed based on the accounts receivables from large and reputable buyers. The large buyers guarantee the banks of the accounts receivables. For trade credit to flourish, however, an enabling environment is required in which private-sector growth is not discouraged.

Partnerships between commercial banks and informal systems are expanding rural outreach to new clients. For example, the SHG-commercial bank linkages in India have resulted in reaching over a million SHGs with a total of 15 million members, 90% of whom are rural poor women. The SHG-bank linkages are reported to have made a significant impact on participating members, have reduced the costs of providing banking services to rural areas and the poor, and have reported high repayment rates.5

Strategic alliances among various types of institutions are growing as a way to offer new financial products in rural areas. In India, a nonbank financial institution such as the local area bank of BASIX, KBS, buys bulk insurance from ICICI Lombard Insurance and markets them to peanut, castor, and soy farmers through partnerships with local commission agents, PRADHAN which is a local NGO, and to some paddy farmers through an agribusiness company. A few MFIs in India, Uganda, Bangladesh, and Zimbabwe now provide life and health insurance products through partnerships with local hospitals and specialized insurers. MFIs engaged in remittances to and from rural areas such as National Microfinance Bank of Tanzania, Uganda Microfinance Union, Equity Building Society in Kenya, and Centenary Rural Development Bank in Uganda partner with Western Union and Money Gram as subagents. The MFI Banco ProCredit El Salvador entered into an agreement with the largest remitting agent to El Salvador from the US to ensure safe, quick, and cost-effective transfers. Alliances between the MFI, Beehive Financial Services, and Teba Commercial Bank in South Africa allow provision of debit cards for rural self-employed, borrower clients of the MFI to lower income rural populations. The partnership agreement in Bolivia between two MFIs—FIE and Pro Mujer—permits FIE to operate teller windows within Pro Mujer to provide deposit services in rural areas.

Use of electronic technology is revolutionizing the provision of rural financial services, especially in countries where the information technology sector is less regulated than the financial sector. In technologically advanced developing countries, the use of electronic banking technologies such as hand-held personal digital assistants, smart cards, point of service devices, ATMs, and phone and internet banking are found to be effective in reaching rural areas and reducing transaction costs. The ICICI Bank in India and the MFI PRODEM in Bolivia are installing ATMs in fairly developed rural areas. Some MFIs in India and South Africa are introducing electronic smart cards that function like debit cards. The use of mobile phones to effect payments and loan disbursals (m-payments and m-banking) is being done in the Philippines, South Africa, and Kenya. The mobile banks of Equity Building Society in Kenya use Global System for Mobile Communications technology to process transaction data on-line and provide rural clients with a greater range of services. Solar units, rechargeable batteries, and inverters provide uninterrupted power to laptops. An initiative started by the Hewlett-Packard Company in Uganda is now testing a Remote Transaction System that enables cash deposits and withdrawals by rural MFI clients through a network of loan officers, rural branches, and/or agents.

Electronic banking helps drive down the costs of handling many small transactions in areas where high-tech alternatives are feasible. Large countries that have recently become technologically advanced—such as Brazil, People’s Republic of China, India, and South Africa—can possibly leapfrog other MFIs in rural finance by utilizing their technological edge to counterbalance some constraints due to their size. But electronic banking may not suit all clients, especially the vulnerable poor. It may provide convenience and secu-

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rity for slightly larger depositors and may lower the costs for financial institutions, but it may not be relevant for many smaller depositors in rural areas.

**REMAINING CHALLENGES**

**The possible reintroduction of interest rate ceilings.** A growing concern in countries with competing rural finance institutions is the potential for overburdening clients with multiple debts. The public clamor raised by heavily indebted borrowers in such diverse places as Bolivia, India, and Sri Lanka has led to political calls for loan write-offs and subsidized interest rates. Such controls were one of the biggest factors that contributed to the failure of most small farmer credit programs in the past. If these proposals are adopted, they will affect the sustainability of rural financial institutions and may even lead to their closure or at least constrain their expansion. This would leave the clients with few choices for financial services. For example, the recent government imposed interest rate ceiling and targeted credit for formal financial institutions serving rural areas in India which are hampering viability. It also tends to create unfair competition to those institutions that follow market-based principles. A more positive development is the expansion of credit bureaus so the institutions can better monitor client indebtedness and loan repayment.

**Reducing costs and risks of e-banking in rural areas.** For electronic banking to be cost-effective, scale is necessary. Also, it is important to bundle financial services into the existing physical infrastructure and to widen the client base through strategic partnerships with service providers. These involve initiatives that build public-private partnerships. It is also challenging to deal with security issues, identity thefts, breakdown in communications leading to loss of information and compliance with anti-money laundering laws.

**Developing an enabling policy environment.** A macro policy environment that can integrate rural finance into the broader financial sector to access capital funds for the institutions, and recognition of movable property and land user rights as collateral for opening access for long-term financing for rural populations are important. But it is challenging in many developing countries due to weak political will to shift to market-based systems.

**CONCLUSION**

A single formula does not exist for successfully developing institutions, products, services, and processes for rural finance. The varying conditions found in rural areas call for flexibility and a diverse set of approaches. Experimentation is required with products, services, and delivery mechanisms that use electronic technology to reduce information and delivery costs, and modifications of existing financial technologies that recognize globalization and value chains.

There is also a need to realize that some rural clientele may require other services in addition to finance. For example, the highly under-serviced smallholder plantation crop subsector and the vulnerable ultra poor may require other services in addition to rural finance. These require development of human capacity that can boldly experiment, learn, and provide multiple services in an effective, sustainable, and efficient way. To that end, exploring strategic alliances and collaborative linkages among various suppliers of services in rural areas, including private sector participants, is important. These involve longer time periods to realize results that may not be very transparent unless clear results-based monitoring is in place from the beginning. Patience and readiness to face some failures are essential virtues.

Although many countries are adopting the new paradigm, problems emerge resulting in movement back and forth along the continuum between the new and old paradigms rather than a clear-cut shift to the new paradigm. The possibility exists that policy makers will slide back to the old paradigm such as noticed in recent introduction of ceilings on interest rates in some Asian countries and elsewhere. A strong commitment from the governments is necessary but hard to find in many developing countries. Nonetheless, it appears that the recent positive developments result in "some new wine in the old bottle of rural finance."
ENDNOTES

1 This paper is primarily drawn from a longer research document titled “Rural Finance: Recent Advances and Emerging Lessons, Debates, and Opportunities” (www.ruralfinance.org). The authors acknowledge the Ford Foundation for the funding and insightful comments, and generosity of several people who shared valuable information and documents to conduct the research. Valuable feedback from Nimal Fernando at the Asian Development Bank helped shape this note. However, the views expressed in the paper are our own and do not represent those of the Ford Foundation, or its employees.


3 Savings with a minimum of $0.22 to a maximum of $5 per day per depositor are collected. On average, clients deposit about $0.45 per day for a period ranging from 60 to 90 days. Depositors are allowed to withdraw after 6 months of initial savings or any time before that with 5 days’ notice. Interest is about 3% per annum calculated on daily average outstanding balances. Only those depositors who save regularly without a break lasting more than 20 days are paid interest on the deposits.

4 The concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin are clearly stated at the time of the sale agreement. The microfinance institution (MFI) is compensated for the time value of its money in the form of the profit margin and not in addition interest on late payments. This is a fixed-income loan for the purchase of a real asset with a fixed rate of interest determined by the profit margin. The asset remains in the ownership of the MFI until the loan is paid in full.

5 Seibel and Karduck (2004), based on a study of SHGs in Karnataka, India, showed that annual transaction costs of the linked SHGs amounted to $27 per group or 1.22% of loans outstanding to members.

SELECTED PUBLICATIONS ON MICROFINANCE

BOOKS


JOURNAL ARTICLES


SELECTED PUBLICATIONS ON MICROFINANCE

OTHER PUBLICATIONS


Schreiner, Mark. 2006. Simple Poverty Progress Indices for Bangladesh, Haiti, India, Mexico, Pakistan and the Philippines. Washington, DC: Grameen Foundation USA.


New Publication from ADB

Rural Finance in the Lao People’s Democratic Republic: Demand, Supply, and Sustainability

Based on a 2004 national survey of nearly 1,200 rural households, commercial banks, and known microfinance initiatives in the Lao People’s Democratic Republic (Lao PDR), this book provides a comprehensive overview of rural finance in Lao PDR. The study finds that the formal sector (banks) and semiformal sector (microfinance initiatives) are not meeting the demand for financial services of the vast majority of rural households. However, the study notes that the Government’s new market-oriented policy has the potential to have a significant positive impact on sector development.