Lawyers can play an essential role in developing countries in effecting positive change in rural economies by ensuring that the financial transactions and contracts used in this sector advance the interests of all the parties involved: the lender/investor, the small-scale farmer, and society as a whole. This technical brief summarizes key finding from a three-year microfinance lawyer training programme implemented by the International Development Law Organization.

Since the rural finance industry aims at building inclusive financial services sectors, it should consider including more legal professionals in its activities. Lawyers have the specific expertise to ensure that the current legal framework adequately meets the needs of the financial service providers and to advocate on behalf of the rural poor.

Rural finance must be recognized as a unique part of the wider financial system; thus, development practitioners should proactively seek and encourage alternative and creative solutions to providing financial services in rural areas, which implies enlarging the elite circle of experts involved in rural finance to include legal professionals.
How does microfinance differ from rural finance?

Microfinance implies the use of a specific financial technology that adapts to the needs of the poorer sectors of the population both in rural and urban areas. Rural finance is a broader category that deals with financial services for all types of clients in rural areas. Therefore, microfinance is only part of the larger spectrum of rural financial products and services. Rural finance not only services small enterprises in rural areas, but also the entire value chain of agricultural production and non-farm needs.

When providing any financial services designed to support agriculture-based livelihoods, complications arise, such as seasonality and constraints of the geographical dispersion of rural areas. Inadequate regulation and supervision of financial intermediaries, limited or non-existent lobbying power among the rural poor, weak governance, corruption and other political factors also limit the provision of rural finance. Thus, microfinance providers may be reluctant to enter the riskier financial market in rural areas.

The provision of financial services, especially in rural financial transactions, requires contracts and agreements of trust between two parties. In the developing world, lawyers can facilitate these contractual agreements and advocate for their clients’ interests, either the financial service provider or the borrower/customer; however, there are often inhibiting factors that make their involvement difficult. These include: the informality of contracts and exchanges in cash-based economies; the lack of proper institutional structures allowing for the enforcement of contracts; socioeconomic conditions that inhibit clients from seeking the assistance of lawyers; and other asymmetries regarding access to information about legal rights.

How interventions by lawyers can address the constraints to financial services

Legal advisers provided with the necessary local knowledge and resources can address specific constraints to providing financial services in rural areas in manner that is most responsive to local needs. Their role could focus on the following aspects:

Addressing risk and vulnerability

The risk of lending is based on the client’s risk. Rural and agriculture-based livelihoods are more susceptible to systemic risks, such as drought and pests, than those who rely on urban-based livelihoods. To reduce these risks, insurance schemes are increasingly being adopted in rural areas, which may range from simple insurance policies that cover debt, to more complex insurance policies to protect client property. Local lawyers are encouraged to keep up-to-date information on the systemic risks in their communities in order to negotiate the best possible insurance contracts for their clients. One way to leverage bargaining power with insurers is by organizing legal entities such as cooperatives and trade associations, where lawyers can play a highly constructive role.

A contractual agreement is often used to reduce market risks. Lawyers can play an important role by facilitating and negotiating equitable risk-sharing clauses that are incorporated into contract farming agreements. Financial institutions also face significant client risks and other barriers, such as the lack of collateral in accessing financial services. Often, much of the property in rural areas is not legally held (or not registered with the appropriate authority) and therefore is not considered legitimate collateral. In rural areas, distances and diverse product needs may not allow for effective group lending. Different securitization options for loans are therefore often used, such as guarantees and covenants. Here, lawyers can play an effective and much needed role by: assisting microfinance institutions (MFIs) to define acceptable and enforceable collateral substitutes; helping to define terms for the extension of lines of credit; and drafting and interpreting loan securitization documents for both the financial service providers and the clients.

Addressing operational constraints

Many operational constraints are due to the lack of assets and investment in remote rural areas, which makes for high inefficiency in servicing the region’s financial needs. Also, there is typically a greater need for diversity in financial products, which poses additional risks since more products add cost and complexity to operations.

Globally, innovative approaches that seek to link the informal and financial systems are becoming more common. They can significantly reduce operational constraints because formal banks can link with informal or non-bank institutions to offer services to hard-to-reach clientele in rural areas. Thus, they can access a wider range of financial products, such as self-help groups to screen and monitor borrowers and bulk loans. To create these linkages, there is often a need for legal counsel to properly structure the formal agreements between the two entities.
Establishment of large numbers of financial institutions, and can act as a deterrent to corruption. Specific rural finance products are particularly affected by the policy environment. Lawyers can assist, for example, in the development of equipment-leasing programmes by defining acceptable terms of lease agreements and advocating for legislation on the availability of this alternative.

Similarly, lawyers can support the development of inventory credit products. Inventory credit is particularly sensitive to political interference. The success or failure of an inventory credit programme ultimately rests on the quality of legislation passed, since most of the major banks will be reluctant to commit themselves to the concept without legislative guidance. Here, lawyers can actively advocate for the benefit of rural development.

Rural finance providers can anticipate political and regulatory risks by working out solutions to legal statutes of government bodies that supervise rural finance organizations in order to reduce political influence in development agendas or ensure the protection of borrowers’ interests.

Addressing capacity constraints
Despite the scarce expertise of most non-profit and community organizations in rural areas in legal and regulatory issues, there is a trend towards changing the legal status of local institutions and NGOs that are providing microfinance services to become formal ‘microfinance banks’. Local lawyers can advise and assist these entities on the context-specific, complex issue concerning what is legally permissible on a local level.

Local lawyers can provide creative solutions to local capacity constraints. They can also advocate for the adoption of legislative solutions that compel or provide incentives for urban banks to service the rural areas.

Rural areas have numerous social and legal constraints to their access to financial and legal services. One possible solution for donors and capacity-building facilitators to obtain legal advice would be to support a voucher system, which could be redeemed by the poor for free legal services. Lawyers as part of local bar associations could also be encouraged to offer sliding-fee scales based on the ability to pay for legal services.

Addressing political and regulatory constraints
Appropriate legislation can establish private, cooperative or community ownership, which could effectively attract private capital for the establishment of large numbers of financial institutions, and can act as a deterrent to corruption.

Recommended readings
Brix, L. and Mckee, K. 2010. Consumer protection regulation in low-access environments: opportunities to promote responsible finance. CGAP focus note No. 60. CGAP, Washington D.C.