Meeting Development Challenges
Renewed Approaches to Rural Finance

Agriculture and Rural Development Department
World Bank
Table of Contents

Acknowledgments v

Acronyms and abbreviations vii

Executive summary ix

1. Introduction 1
   • Objective of the paper 1
   • Why rural finance? 2
   • Bank approach to rural finance 2
   • Special challenges of rural finance 4
   • Special challenges of rural finance within the World Bank 4
   • Focus of the approach paper 5
   • Methodology and organization of the approach paper 6

2. The three pillars of rural financial sector development 7
   • Government policies and the legal, regulatory and supervisory framework 7
   • Financial sector and real sector infrastructure 8

3. Grants and subsidies 13
   • Appropriate subsidies to support rural finance goals 13
   • Grants versus credit—subsidies to the poor for asset acquisition 15

4. Delivery channels and models for rural financial services 17
   • Overview 17
   • Potential areas of intervention for the World Bank 17
   • Success factors for financial institutions in rural areas 18
   • Commercial banks and rural finance 19
   • Models for commercial banks entering rural markets 21
   • Areas for possible Bank interventions 24
   • Donor credit lines to commercial banks 24
   • State-owned Agricultural and Rural Development Banks 25
   • Areas for possible Bank interventions 28
   • Specialized rural microfinance institutions 28
   • Cooperative financial institutions 30
   • Informal village-based models 33
   • Community-driven development and rural finance 35
5. **Special-purpose institutions and products** 37
   - Leasing, a source of investment capital for rural areas 37
   - Guarantee institutions and guarantee funds 39
   - Supply chain financing 39

6. **Cross-cutting issues of risk management, technological innovation and specialized collateral arrangements** 43
   - Technological innovations to reduce transaction costs and to achieve greater outreach for financial institutions 43
   - Risk management instruments for financing for agriculture 45

7. **Pulling it all together: a practical approach to strategy formulation** 49
   - Step 1: Preparation of a country diagnostic matrix 50
   - Step 2: Formulation of core strategic focus 50
   - Step 3: Prioritising the options and coming to a decision 52
   - Conclusion 55

Appendix 1 **Rural finance portfolio analysis at entry 2004 and 2003** 57

Appendix 2 **Diagnostic matrix: Rural financial sector development—An example from a developing country—Uganda** 67

Endnotes 69

Bibliography 73
This paper was prepared by Renate Kloepinger-Todd, Rural Finance Adviser, Agriculture and Rural Development Department, with significant support from Anne Ritchie, Senior Financial Sector Specialist, Financial Sector Department. It builds on rural finance work done in the past within the Bank and international experience worldwide.

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Acronyms and Abbreviations

ALCU Association of Lithuanian Credit Unions
ARB Association of Rural Banks
ARD Agriculture and Rural Development Family of the World Bank
ASCA accumulating savings and credit associations
ATM automatic teller machine
BAAC Bank for Agriculture and Agricultural Cooperatives
BANSEFI Banco del Ahorro Nacional y Servicios Financieros
BRAC Bangladesh Rural Advancement Committee
BRI Bank Rakyat Indonesia
CARD Center for Agriculture and Rural Development
CAS Country Assistance Strategy
CDD community driven development
CECAM Caisse d’Epargne et de Credit Agricole Mutuel
CGAP Consultative Group to Assist the Poorest
CLUSA Cooperative League of USA
CRMG Commodity Risk Management Group
CVECA Caisses Villageoises d’Epargne et de Credit Autogérées
DFCU Development Finance Corporation (Uganda)
EBRD European Bank for Reconstruction and Development
EU European Union
FAO Food and Agriculture Organization of the United Nations
FFI formal financial institution
FI financial institution
FMO Netherlands Development Finance Company (FMO)
FSAP Financial Sector Assessment Papers
GoB Government of Bangladesh
GTZ Gesellschaft fuer Technische Zusammenarbeit
IFAD International Fund for Agricultural Development
IFC International Finance Corporation
IGVGD Income Generation for Vulnerable Groups Development Program
IMF International Monetary Fund
IPC Internationale Projekt Consult
IT information technology
ITC Indian Tobacco Company
KAFC Kyrgyz Agricultural Finance Corporation
KfW Kreditanstalt fuer Wiederaufbau
KPI key performance indicator
<table>
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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>LAAD</td>
<td>Latin America Agribusiness Development Corporation</td>
</tr>
<tr>
<td>LCCU</td>
<td>Lithuanian Central Credit Union</td>
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<tr>
<td>MIS</td>
<td>management information system</td>
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<td>NBFI</td>
<td>nonbank financial institution</td>
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<td>NGO</td>
<td>non-governmental organization</td>
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<td>NLC</td>
<td>Network Leasing Corporation (Pakistan)</td>
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<td>NMB</td>
<td>National Microfinance Bank (Tanzania)</td>
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<tr>
<td>OED</td>
<td>Operations Evaluation Department</td>
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<td>PDA</td>
<td>personal digital assistant</td>
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<td>PEP</td>
<td>Private Enterprise Partnership</td>
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<tr>
<td>PFCCO</td>
<td>Philippine Federation of Credit Cooperatives</td>
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<tr>
<td>PoS</td>
<td>point of sale</td>
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<tr>
<td>PRSP</td>
<td>Poverty Reduction Strategy Papers</td>
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<tr>
<td>RCSS</td>
<td>Rural Savings and Credit Cooperatives</td>
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<td>ROSCA</td>
<td>rotating savings and credit associations</td>
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<tr>
<td>SME</td>
<td>Small and medium sized enterprises</td>
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<tr>
<td>TA</td>
<td>Technical assistance</td>
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<td>UMU</td>
<td>Uganda Microfinance Union</td>
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<td>WBI</td>
<td>World Bank Institute</td>
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The majority of the world’s poor live in rural areas. It is clear that the Bank will not be successful in achieving its overall poverty reduction objective unless it addresses rural poverty and helps to create broad-based economic growth in rural areas.

Rural finance is a necessary ingredient for rural economic growth. It makes a significant contribution to increasing incomes for farmers and other rural entrepreneurs and their employees; it helps create opportunities for self-employment; and it reduces the vulnerability of the poor to economic swings by offering opportunities to save in good times and to borrow in hard times.

The potential of rural finance has never been better

The approach to rural finance developed over the past decade within the international community, including the World Bank, emphasizes the importance of creating sustainable financial institutions providing a range of financial services that are based on client demand. This approach offers the opportunity to make a lasting contribution to the reduction of rural poverty, because people need access to financial services on a permanent basis in order to manage their financial affairs, including the growth of their economic activities. While there are still many unresolved issues, especially with regard to financing for agriculture, diverse institutions in a number of countries are now providing a broad range of people in rural areas with access to appropriately designed financial products. Innovations that increase the efficiency of these institutions, and thus make the provision of financial services to rural people more attractive, are well beyond the pilot stage in many cases.

However, the World Bank, in its rural activities, has not yet fully realized this potential. Reviews of the Bank’s rural finance portfolio over the past three years show that there are very few stand-alone rural finance projects that aim to increase access to financial services on a comprehensive basis. Most rural finance projects are components of larger projects and contribute to the solution of specific, narrowly defined problems, mostly credit for project target groups through the provision of credit lines.

What needs to be done to realize the potential?

There is a need to address the lack of financial services in the rural areas of most countries head-on. The time has passed to just add credit lines and a bit of technical assistance to rural and multi-sector projects and expect that this will result in the sustainable provision of financial services to rural households and enterprises.

This approach paper provides practical guidance to Bank staff that are willing to take on that challenge. It is not only meant to assist staff to knowledgeably choose the appropriate design for rural finance projects but also, maybe even more importantly, to enable them to provide advice and guidance to World Bank country directors and counterparts in Ministries and elsewhere in the partner country. It also provides practical information to Bank staff working on multi-sector projects where access to finance in rural areas can only be a component.

The primary target audience of the approach paper is task team leaders who are nonfinancial sector specialists working on rural development, irrigation and other programs and projects where access to finance is an issue. Financial sector specialists without a comprehensive background and exposure to rural finance might also find it useful.
What are the basic underpinnings of a comprehensive approach to rural finance?

The development of a well-functioning rural finance system rests on three pillars: good policies including an enabling legal, regulatory and supervisory framework; financial sector and real sector infrastructure; and strong financial institutions. Interventions on all three levels, appropriately sequenced, achieve the best results. Nevertheless, there are potentially many activities on the institutional level that can be undertaken to increase access to financial services, even if the enabling environment is not fully supportive. Institution building measures include technical assistance to help financial institutions develop appropriate products, systems and service delivery strategies that will enable them to profitably serve a rural clientele.

Financial services are delivered to rural populations by institutions that exist along a continuum from formal to informal. Formal institutions include public and private commercial banks, state-owned agricultural and rural development banks, cooperative banks, microfinance banks and special purpose financial institutions such as leasing, housing and consumer finance companies. Informal providers of financial services include small groups that rotate internally generated savings as loans to members, money lenders, pawn shops, and businesses that provide financing to their customers. In between stand the semiformal institutions such as NGOs and small financial cooperatives. All these institutions have a role to play in rural finance.

What is the role of government?

There is a significant role for government. However, the role of government should be limited to creating good macroeconomic policies and an appropriate regulatory and legal framework, supporting the creation of appropriate financial and real sector infrastructure, and funding technical assistance that supports the efforts of rural financial institutions to achieve sustainability. Direct government intervention in rural credit markets through interest rate subsidies, caps on interest rates and credit forgiveness measures undermines efforts to achieve sustainable rural finance.

How can the World Bank intervene?

Areas for Bank interventions exist at many points along the continuum, depending on the specific conditions and requirements of a particular country, or region of the country. A focus on policy dialogue with respect to good policies and creation of an enabling environment for rural finance is needed to support interventions at the institutional level. Therefore, close consultation and cooperation between rural staff who are responsible for designing and implementing projects that focus on the specific issues of rural finance and financial sector staff who are working on general financial sector issues in support of such projects is strongly recommended.

Promising areas for World Bank interventions to support rural finance are commercial banks looking for new markets, select state-owned agricultural and rural development banks that can be reformed or restructured, specialized rural microfinance institutions, cooperative financial institutions, and community-based financial organizations. The same basic success factors apply to most types of financial institutions and include good governance and management, appropriate credit technology, efficient internal processing and controls, portfolio diversification, and sound accounting and management information systems. The Bank has knowledge and experience in all these areas, so should be able to provide appropriate technical support. However, the challenges are quite significant, as capacity building often requires a longer time frame than a typical World Bank project. This implies that the way projects in rural areas are measured and evaluated within the Bank should be refocused, so as to set the right incentives for Bank staff.

Special purpose products offer additional opportunities. Leasing provides medium- to long-term funding for agricultural machinery and other productive assets. Guarantee mechanisms, when properly designed, offer the opportunity to reduce specific credit risks for financial institutions that would otherwise not provide services in rural areas.
Appropriate design and a focus on minimizing moral hazard are essential here as in all other interventions. In most developing countries, supply chain financing that provides the largest amount of financing for agriculture is a private sector activity that operates without much support from international institutions. A question that remains to be answered is whether and how the Bank can intervene in this area, in order to increase financing options for smallholder farmers and to encourage processors to provide credit to farmers in regions that are without access to credit.

Risk management instruments for financing for agriculture and technological innovations that enable financial institutions to reduce transaction costs and increase portfolio quality present additional opportunities. Knowledge about these exciting developments (as well as their limitations) needs to be made available to task team leaders and become part of the tool box for design of rural finance projects.

Grants and subsidies are needed in many cases to support rural finance interventions. Bank policy on financial intermediary lending (OP8.30) allows the use of subsidies to create the conditions that make access to financial services to underserved populations possible. Appropriate subsidies include technical assistance to financial intermediaries to improve systems that enhance efficiency; to develop and introduce demand-responsive products on a pilot basis; to develop new or revised service delivery mechanisms to enable larger outreach into rural areas than the financial institution would attempt on their own; and to cover a portion of the cost of establishing new branches in areas that do not have financial intermediaries that serve the rural poor. Subsidies are also relevant for the development of financial and real sector infrastructure, as well as development of the enabling legal and regulatory environment.

Very poor populations who lack access to economic opportunities and are too vulnerable to take risk can in some cases be assisted with matching grants that enable them to acquire income generating assets. These assets can kick-start an activity that will result in future income generation. However, such grants must be carefully targeted to avoid capture by elites, have a match from the beneficiary to ensure real ownership, and be accompanied by other types of support, such as training. In some cases, a portion of an investment can be financed with a grant and the balance by a loan from a financial institution.

**Pulling it all together:**
**a practical approach to strategy formulation on the country level**

Rural finance is a complex subject that requires specialist knowledge. In order to help Bank task managers decide on an appropriate set of interventions from among all the options, a three-step approach to strategy formulation has been developed. In the first step, information on the key elements of the policy context, enabling environment, and financial institutions are collected and analysed, along with information on the characteristics and structure of the real sector. The findings from this analysis are then coupled in the second step with an analysis of the demand for financial services in the proposed project area. A typology of countries has been developed that provides a framework that should enable task managers to compare the strategic approach contemplated for the project under design with that of similar countries. Taken together, this analysis should enable the principal strategic focus of the project to be developed. The third step concludes the analysis with the identification and prioritisation of intervention options. This three-step process is obviously a simplification of the project design process; the intent is to provide a structure that will guide task managers and help to ensure that all important elements are considered.

This paper has attempted to create awareness of the complexities of rural finance and its relevance for rural development, and to explain the principal methods and solutions that have been successful. Many of the challenges that have confounded efforts to increase the access of rural populations to sustainable financial services have now been overcome in a number of countries. Over the years, the World Bank has been an integral part of the international effort that has led to the current state of knowledge. It is now time to increase that effort as an indispensable part of the fight against poverty.
This paper is one in a series of sector papers elaborating the implementation of the Bank’s rural development strategy “Reaching the Rural Poor.” It builds on rural finance work done in the past within the Bank and on international experience worldwide. Its starting point is the publication “Rural Financial Services” that outlines the Bank’s strategy for rural finance within the framework of “Reaching the Rural Poor.”

The range of topics related to finance in rural areas is extensive, ranging from the financing of rural development and infrastructure, to financing agricultural growth and private sector development, to the sustainable provision of financial services to rural populations. All of these topics are important with respect to the Bank’s rural development strategy. Moreover, they are all within the mandate of the Bank’s Agriculture and Rural Development Department. However, in order to keep this approach paper to a manageable size that is practical to use, the decision was made to limit the paper to the internationally accepted definition of rural finance. Rural finance for the purposes of this approach paper is defined as the provision of financial services such as savings, credit, payments and insurance to rural populations by organizations that exist along a continuum from formal to informal, ranging from commercial banks to informal village-based savings groups. This includes financing for agriculture, agro-processing and other rural enterprises, from part-time income generating activities to full-time micro-enterprises to small and medium size (SME) enterprises.

Rural finance projects, which are based on the Board-approved rural development strategy, can improve the living situation of the rural poor on a sustainable basis. Access to financial services is an important ingredient to achieve this overall objective, and makes a meaningful contribution if implemented well. The purpose of the rural finance approach paper is, therefore, to provide practical guidance to Bank staff who design and implement rural finance projects. It is meant not only to assist staff to knowledgeably choose the appropriate design for rural finance projects but also, maybe even more importantly, to enable them to provide advice and guidance to their counterparts in partner countries. The primary target audience of the paper is task team leaders who are nonfinancial sector specialists working on rural development, irrigation and other programs and projects where access to finance is an issue. Financial sector specialists without a comprehensive background and exposure to rural finance might also find it useful.

Within the context of this paper, rural finance is the provision of financial services such as savings, credit, payments and insurance to rural populations by organizations that exist along a continuum from formal to informal, ranging from commercial banks to informal village-based savings groups. This includes financing for agriculture, agro-processing and other rural enterprises, from part-time income generating activities to full-time micro-enterprises to small and medium size (SME) enterprises.

Rural finance projects, which are based on the Board-approved rural development strategy, can

# Introduction

The overall objective of the Bank’s rural development strategy “Reaching the Rural Poor” is the
either be comprehensive stand-alone projects, or rural finance components of rural development projects. Credit lines for rural projects, where the end-user receives funds in the form of a loan and is required to pay it back, regardless of the institutional arrangements, are also considered rural finance components for the purposes of this paper. In the past, it has often been the case that rural finance components were developed as an afterthought, once it became obvious that stated project objectives could not be achieved without supporting access to financial services. This paper will provide rural staff with knowledge of the success factors for rural finance, gained from international as well as Bank experience, and a tool to make design decisions based on a systematic and transparent process.

Why rural finance?

From the standpoint of rural development and poverty reduction, as supported by the World Bank, three strategic goals are central, and rural finance, when properly implemented, makes a contribution to all three of these goals:

- **Achievement of economic growth**
  Access to a range of financial services is necessary in order to achieve economic growth, including growth in rural areas. Growth in agriculture as well as other rural economic activities can be substantially enhanced if there is reliable and sufficient financing, and sustainable financial intermediation, in addition to many other factors.

- **Inclusion and participation of all members of the rural population in economic development**
  In many countries, poor rural populations do not have access to financial services even if there is access for wealthy persons, larger farms and larger rural enterprises. The microfinance “revolution” has demonstrated conclusively that financial intermediaries that serve the poor, as well as better-off populations and enterprises, can be successful. Access by the poor to financial services provides them with some of the resources they need to pursue economic opportunities as well as manage their household finances.

- **Reduction of vulnerability to economic, physical and other shocks**
  The poor in general have few resources and are vulnerable to even small swings in income or unexpected expenses due to illness, death of a family member, seasonal liquidity problems related to the agricultural calendar, and a wide variety of other factors. The ability to save even small amounts during good times and keep these sums safely locked away until they are needed is essential. Another financial product that is important to poor rural populations is the ability to receive remittances reliably and at a low cost from migrant workers, especially in rural areas that have poor prospects for economic growth and income generation.

  While there is no conclusive proof that access to financial services has a significant impact on poverty reduction, there is substantial field-based evidence pointing to the importance of rural finance for economic development. Most households with economic activities above the consumption level and most enterprises in rural as well as urban areas need access to financial services in order to grow and generate income, be they agriculture-based or off-farm. Access to finance is also needed for improvements in rural infrastructure such as telecommunications, energy, irrigation and watershed management, all of which have an impact on the improvement of people’s lives.

Bank approach to rural finance

For many years, rural finance was defined as the provision of credit to special target groups, mainly farmers. International donors, including the World Bank, supported this approach through the provision of funds for international and domestic credit lines. By the early 1990s, it became apparent that many such credit lines had low recovery rates, were implemented by unsustainable institutions, and did not achieve the intended purpose of increasing rural livelihoods, except for those few
farmers, often the more wealthy ones, who directly benefited from the limited funding and inefficient distribution structures. Consequently, significant analytical work was done within the Bank and the international community to analyze the issues involved and to develop alternative approaches. Donor agencies began to shift their approach away from a focus on agricultural credit towards a wider view of rural finance, characterized by a broad range of financial services, rather than credit only; provision of financial services to all rural dwellers, not just farmers; use of market interest rates; and the operational efficiency and financial viability of rural financial institutions.

Rural finance for rural development in the current context of the World Bank is based on the following principles:

- **Demand-responsive approach to financial services access**

  Rural populations demand a range of financial services, depending on their current economic development, potential for future development, and ability to take advantage of opportunities within their existing environment. In many cases, credit is not the most appropriate product. In fact, savings and payment services might initially be more relevant for poor rural populations, enabling them to accumulate assets and to smooth uneven income flows. Consequently, the design of programs that support rural financial intermediaries has shifted from a focus on credit only to a better understanding of the demand by rural populations, including the poor, for all financial services, including savings, insurance, payments and remittances, as well as credit.

- **Sustainability of access to financial services**

  Sustainable access to demand-responsive financial services is critical for the economic development of rural areas and contributes to the reduction of vulnerability of poor populations. It is therefore now seen as the primary objective of rural finance. Within this context, helping rural financial institutions—all along the continuum from formal to informal—to achieve long-term institutional sustainability is paramount. Support for the creation of an enabling environment and support for institution-building are thus essential project features, rather than simply support for credit lines. The long-term sustainability of financial institutions requires access to reliable sources of funding for their credit business. Savings, properly safeguarded by means of supervision and possibly deposit insurance arrangements, are a first choice. Therefore, savings should be regarded as not only a product demanded by customers, but also a strategic priority for a financial institution’s sustainability. Access to domestic and possibly international bond markets are another potential source of funding in more developed financial markets and could well be supported. One example is International Finance Corporation’s (IFC) recent partial guarantee of a bond issue for Compartamos, a Mexican rural microfinance institution.

- **Clearly defined role for government**

  There is a significant role for government in rural finance. But this role should be limited to the creation of good macroeconomic policies, an appropriate regulatory and legal framework, and funding for technical assistance to rural finance institutions. Direct interference in rural credit markets through interest rate subsidies, caps on interest rates and credit forgiveness measures undermine efforts to achieve sustainable institutions. State ownership of rural financial institutions has in the past often not resulted in achieving sustainable access to financial services and should therefore not be promoted, except under exceptional circumstances and as outlined in Chapter 4.

- **Holistic approach**

  Efforts to achieve access to financial services need to be complemented by other interventions that support the sustainable development of rural economic activities. Access to financial services is only one of the factors influencing rural economic development. For example, access to quality agricultural inputs, access to agricultural extension services, access to markets and market information, and access to physical and communication infrastructure are all important, and should be investigated as complementary measures in order to achieve best results.
Special challenges of rural finance

The establishment of viable rural financial systems encompasses many specific challenges, in addition to the challenges inherent in the development of countrywide financial systems. Low population density and difficult to reach remote areas in many countries translate into high transaction costs for financial institutions contemplating an entry into these areas. Limited economic opportunities in many rural areas result in small transactions, further increasing overall transaction costs.

The heavy concentration on agriculture and agriculture-related activities in rural areas exposes farmers and their lenders to multiple risks. Some of these risks are idiosyncratic, affecting a single household, whereas others are covariant in nature and affect an entire region or country. Weather risk is probably the single most important risk influencing the outcome of a farmer’s investment. This risk also affects associated economic activities such as agro-processing. Price risk can also be quite substantial, especially for products that are sold in very competitive international markets.

For financial institutions, in addition to the risks inherent in financing agriculture and agriculture-related activities, there are risks associated with the concentration of portfolios on the agricultural activities that are most prevalent in a particular rural area; this makes risk reduction through portfolio diversification in rural areas difficult if not impossible to achieve. On top of this, the risk of political intervention can strongly influence the overall risk from the perspective of the intermediaries, as payment morale can be completely undermined by debt forgiveness granted at the government’s instigation and interest rate caps can eliminate what may already be very slim margins.

All three factors together—high transaction costs, high risks, and the possibility of political interference—constitute a problem structure for rural finance which has to be well understood and taken into account in strategy formulation. This combination of factors can render rural finance an unattractive proposition for many financial institutions, especially those that have well-established and profitable business lines and no mandate to serve the rural sector. This clearly implies that any strategy for rural finance has to provide clear-cut answers on how the proposed actions tackle the problem structure arising from the specific circumstances of the particular country.

Special challenges of rural finance within the World Bank

Bank lending for lines of credit

Credit lines are often part of rural development projects. They fulfill a useful function in those countries where there is a demonstrated lack of liquidity or long-term funding in the financial markets, or where funding is not available for rural lending, and where there are institutions available that have the capacity to implement a credit line. They are also beneficial when financial institutions that do not have access to commercial sources of funding are supported in their early stages. This is especially important in those Bank member countries that are reluctant to borrow for technical assistance to establish new institutions or to strengthen existing financial institutions, but can be convinced to do so if the technical assistance funds are complemented by a line of credit.

Over the past few years, credit lines within the Bank have been subjected to close scrutiny, including development of a Bank policy on credit lines, OP8.30, in 1998, and an Operations Evaluation Department (OED) review of Bank lending for credit lines in 2003/4. This review included rural finance operations. The main findings were that (i) implementation of Bank guidelines for lines of credit has been poor, (ii) outcomes are poor, (iii) cancellation rates have been high, and (iv) better outcomes are associated with stable macroeconomic conditions, stronger financial sectors, use of clear eligibility criteria for the selection of participating financial institutions, and use of private sector financial intermediaries. One lesson learnt is that rural credit lines usually perform better if they are designed as part of a comprehensive rural finance project rather than as a short-term solution to credit needs in a general rural development operation. As a result of the OED review, the Board has made a policy decision to have all proposed credit lines reviewed by financial specialists reporting to the financial sector board regarding their adherence to the principles of OP8.30.
According to this policy, institutions that do not have strong institutional capacity can become eligible for Bank credit lines if they develop and implement an institutional strengthening plan. Funds must be used for the increased production of goods and services, and appraisal must determine if the operation can achieve its desired objective with due regard to the sustainability of the financial sector. On-lending terms must be set within the context of a country’s interest rate structure and must provide financial institutions with adequate margin to cover all their costs, including credit and other risks, and an adequate profit margin. Thus, OP8.30 provides space for rural finance operations in areas with weak financial institutions, provided that they explicitly address the weaknesses of these institutions.

The definition of credit line for the purpose of the OP8.30 review includes any project that channels Bank funds to households or businesses with an obligation to repay, regardless of what entity is intermediating the funds (financial institution, government department, nonfinancial company, etc.) and regardless of what it is called (loan, cost recovery of grants, reimbursable assistance, revolving fund or other terms). Thus, grants made by projects, especially Community Driven Development (CDD) projects, to communities that lend these funds to their members, must be reviewed.

**Status of rural finance within the World Bank’s rural development operations**

The Agriculture and Rural Development Department conducts annual reviews of rural finance projects approved in a given year that are either exclusively focused on rural finance or have components or activities directly related to rural finance. In FY04, there were 20 projects with a volume of $241 million, and in FY03, 17 projects with a volume of $666 million. The difference in volume is explained by one large adjustment project ($506 million) in FY03. The analysis revealed that the designs of most projects are based on good practice for the chosen approach and that several projects have outstanding innovative features. However, the majority of rural finance projects are components of larger projects and tend to focus on support for service provision, where credit is the predominant service being provided (14 projects out of 20 in FY04 and 13 out of 17 in FY03). In both years, only two projects are stand-alone rural finance projects that aim to increase access to financial services in rural areas on a comprehensive basis. In FY04, 10 projects were initiated by the agriculture and rural development sector, four by the financial and private sectors, and two each by infrastructure and social protection.

The annual review of approved rural finance projects, as well as the OED review of credit lines, including credit lines to rural financial institutions, demonstrates clearly that rural finance within the World Bank has not yet taken on the full role it needs to play to support rural development. Rural finance project components contribute to the solution of specific, narrowly defined problems, mostly credit for project target groups. They rarely comprehensively address the issues that constrain access to finance by rural populations, and consequently have only modest impact. The scarcity of such operations, regardless of sector attribution, points to either insufficient resources, lack of knowledge about rural finance and its relevance for rural development, or other priorities within the regional departments and their partner countries. The potential contribution of rural finance to rural development warrants a far more substantial approach.

**Focus of the approach paper**

This paper builds on the three pillars of rural financial sector development; namely, government policies and the enabling regulatory and legal environment, infrastructure for the financial and real sectors, and financial institutions. The major focus of this paper is on the third pillar, the institutional level, for the following reasons:

- Rural finance is a subsector of the country’s financial sector, and many of the issues concerning government financial sector policies and the regulatory framework are better addressed through country-level financial sector work. Interventions on that level are therefore only covered in this paper insofar as they apply to specific rural circumstances.
• Considerable research work on cross-cutting issues, for example, on credit information systems, remittances, and the use of postal systems for improved access, is being done by other parts of the Bank and should not be duplicated. The cross-cutting issues covered in this paper relate directly to rural finance; this includes risk management instruments for financing agriculture and innovations that will enable rural finance institutions to cover their costs.

• The institutional level is the area of greatest demand for advice, as most rural finance projects within the Bank concentrate on this level.

References are provided throughout the text on where to look for further information on topics mentioned in the text.

Methodology and organization of the approach paper

The approach paper has five major thematic blocks. Chapter 2 provides an overview of the main issues restricting the development of rural finance on the three levels of policy, enabling environment and institutional capacity. Chapter 3 discusses the issues of appropriate subsidies and the use of grants versus credit. Chapters 4–6 analyze the delivery channels and models for supporting rural finance, including special purpose institutions and products, and an overview of several cross-cutting issues. Chapter 7 develops a practical approach to the formulation of a country-specific rural finance strategy.
Provision of financial services in rural areas remains a challenge. During the last ten years, the adoption of the financial systems approach—that is, the financing of economic activities in rural areas as part of a comprehensive financial sector development strategy—has led to significant breakthroughs in increasing the outreach of financial services and the performance of financial intermediaries. However, many rural areas worldwide still lack an adequate supply of formal financial services; even the strong expansion of microfinance has not changed this significantly, especially with regard to financing for agriculture. Government policies in many countries hinder rather than support the development of financial markets that provide access to the majority of the population. In the case of rural financial markets, there are often additional issues related to government policies to subsidize farming and farmers.

In the ideal case for agricultural and rural development, rural financial markets are efficient and afford access to all population groups for their financing needs, including agriculture, and offer demand-responsive products and services tailored to the requirements of their diverse customers. Macroeconomic policies are favorable as is the legal and regulatory environment, and there is sufficient financial and real sector infrastructure to support the development of efficient financial institutions. However, this is not the case even in highly developed countries; much less in transition and developing economies where financial markets in general and rural financial markets in particular are often weak, fragmented and cater only to the least-risk and higher-value customers, including the government itself. Government policies can be erratic and opportunistic, responding more to political than economic considerations. Issues that frequently have a major impact on rural finance are highlighted in the sections below.

The three pillars of rural financial sector development are: 1) government policies and the legal, regulatory and supervisory framework, 2) financial sector and real sector infrastructure, and 3) financial institutions.

**Government policies and the legal, regulatory and supervisory framework**

**Policy level issues**

- Crowding out of private sector customers through large government borrowings from the banking sector, as government bonds offer financial institutions less risky and often shorter-term investment opportunities than the financing of small farmers and rural entrepreneurs.
- Monetary policies leading to high uncertainty and the unwillingness of investors to provide mid- and long-term domestic funding.
• Tendencies of governments to please potential voters in the short run by providing inappropriate subsidies to the detriment of longer-term sustainable financial sector development. Caps on interest rates that can be charged by financial institutions also deter financial institutions from entering or staying in those markets where there are higher costs and/or credit risks.

Issues in the legal, regulatory and supervisory framework

• Missing or inappropriate laws on property, especially land, but also other kinds of physical property, and their use as collateral; and lack of efficient bankruptcy laws.

Especially in rural areas, the role of secure property rights, i.e. land rights, are of great importance, both for credit purposes and as an incentive for people to invest in the development of that land.\textsuperscript{16} They need to be administered and enforced by institutions that have both legal backing and social legitimacy and are accessible by and accountable to the holders of property rights. However, not just property rights, but also land transactions such as rentals and sales are important to realize full benefits. Most financial institutions will not provide credit without collateral, meaning in most cases land or the right to use land. However, land as collateral by itself is only valuable if it can be collected, or if the threat of collection contributes to credit discipline. Efforts to support land titling as well as the establishment of property registries can make a significant contribution to access to credit for rural populations\textsuperscript{17} as can efforts to establish efficient markets for land.

• Lack of enforcement capabilities or willingness to take action against offenders, even if there is an appropriate legal framework.

• Issues with the regulation of the financial sector.

These issues range from inadequate regulation to excessive regulation, and disagreements on which institutions should be defined as being part of the financial sector, and therefore subject to supervision. Usually, unsupervised financial institutions are not allowed to collect deposits, so as to provide protection to depositors. These institutions are thus likely to depend on governments or donors for refinancing, or on capital markets in more mature markets, and often have limited growth potential.\textsuperscript{18}

• Shortage of institutional capacity in bank supervision.

Supervising financial institutions is costly and resource-intensive. This is especially true for smaller institutions in rural areas. Solutions such as delegated or auxiliary supervision are being used for cooperative financial institutions in some countries and could be an example for other networks of nonbank financial institutions.\textsuperscript{19}

Financial sector and real sector infrastructure

Financial sector infrastructure

• Lack of training institutes, industry associations, and information agencies, including credit and collateral registries.

Credit registries allow a borrower to establish a credit history, an important factor in a bank’s decision to grant a loan. Collateral registries allow financial institutions to collect on collateral without having to go through often lengthy court processes. Other financial sector infrastructure such as training institutes and industry associations increase the professionalism of financial institutions’ management and staff. Financial institutions that are staffed with educated people that receive ongoing professional training are likely to be better managed and better able to calculate risks, than institutions with less-developed staff.

For a real reduction of critical transaction costs, best results are achieved when all relevant issues are addressed. The establishment of credit information registries, adequate creditor rights in secured transactions, and efficient bankruptcy laws all work together to facilitate access to credit. Information sharing allows creditors to distinguish good clients from bad clients, while legal rights enable claims enforcement in the event of default.

• Lack of agricultural risk management instruments.

Weather and prices both pose great risks for farmers. Instruments to manage such risks have been developed and are available to farmers
in developed countries. New ways are being sought to apply these instruments to developing countries and to smallholders. Chapter 6 takes a closer look at such instruments and their potential.

• Payment systems that need to be modernized.
  In many developing countries, payment systems are woefully inadequate, slow, expensive to access, and with limited outreach to rural areas. Small rural banks might be excluded from check clearing by large urban banks; access to cash might be sporadic, resulting in the rural population being forced to carry much larger amounts of cash for purchases than would be advisable for security reasons. Migrant remittances to rural areas are also expensive. These issues can be addressed by a combination of measures, as demonstrated by the Ghana Rural Financial Services project outlined in Box 1 below.

• Lack of facilities such as deposit insurance that would safeguard and encourage savings.
  In many rural areas, savings are collected through informal or semiformal savings groups where members know each other and savings are safeguarded through the group process. Mobilization of savings on a larger scale might be accompanied by some kind of protection scheme, such as a fund set up by the members of a financial network, for example, cooperative financial institutions. Deposit insurance within the formal financial sector is a complex issue and is not likely to be addressed in a rural finance project.20

Real sector infrastructure

• The impact of inadequate infrastructure on the development of rural enterprises can be massive.
  A lack of paved roads in rural areas, unreliable electricity and an inadequate telecommunications infrastructure all increase costs for businesses and financial intermediaries. Overcoming serious deficiencies will have a very positive impact on the development of a rural financial system. As these statements are simple, commonsense observations, not much literature is available here.

• Lack of market information such as current prices for basic commodities.

• Lack of processing facilities for local value-adding.

• Lack of competent business development services that could assist farmers and other rural enterprises with informed decision-making and the acquisition of management skills and support them in developing business plans that would enable them to better approach financial institutions.

• Stifling bureaucracy in the registration of businesses.

Addressing macro-level monetary policy and financial sector issues is obviously outside the scope of Bank agriculture and rural development activities in a given country. Instead, a close coordination with the International Monetary Fund (IMF) and Bank departments working on such issues at the country level could be beneficial for the development of rural finance over the long run. Supporting the development of a suitable legal and regulatory framework, financial and real sector infrastructure, and an enabling environment for economic activities can, however, be an important part of rural development projects. This should only be considered if the project team contains, or can acquire, the required

BOX 1  Rural Financial Services Project (RFSP), Ghana

RFSP supported the establishment of an apex bank for the network of rural banks in Ghana. The Association of Rural Banks (ARB) Apex Bank is undertaking several measures to increase access to nationwide payment systems. It supports the individual rural banks in their check clearing efforts so that rural bank checks are now accepted across the country. Apex-link was developed; this is a network linking all rural banks to the Apex Bank for fund transfers. The ARB Apex Bank’s regional branches also supply bank notes to the rural banks on short notice and without charge.

technical expertise. Otherwise, the principle of “Do No Harm” should be followed. Task team leaders who are looking for further information on the issues highlighted in this section should refer to the references provided throughout the paper.

Financial institutions

At the core of rural finance are the financial intermediaries that deliver financial services within rural areas. In the end, all other aspects of rural financial sector development are no more and no less than necessary or desirable elements that ultimately support the development of institutions that can deliver financial services in rural areas on a sustainable basis. It is important to stress this point: one key consequence of the financial systems approach which has evolved over the last 10–15 years is that it is not primarily target group outreach which determines the success of a project, but equally important—or even more important—whether or not services can be delivered to the target group on a sustainable basis. Reaching a specific target group once or even a couple of times cannot in the end be considered as any success at all, if the fundamental need for sustainable financial services has not been satisfied or if it comes at the expense of other clients. Almost all businesses and households need an extensive set of financial services that enable them to actively manage their financial resources; these include access to savings, credit, insurance and payments systems, including the ability to send and receive remittances.

The financial systems approach has necessarily shifted the focus from target groups to suppliers of financial services, since only well-managed financial intermediaries can guarantee the provision of financial services to rural customers over the long term. This has huge implications for project design, as not only are the availability of funds and the capacity to reach rural customers, including farmers and the rural poor, important, but also the sustainability of the financial intermediaries that serve these customers. Therefore, complex issues of ownership, governance, management, systems, and service delivery structures have to be analyzed so as to ensure that partner institutions are financially sound and have a business strategy which allows them to extend financial services in rural areas on a sustainable basis.

In many countries, one of the biggest problems in rural finance is that there are not a sufficient number of financial institutions operating in rural areas, or there are not enough institutions serving low-income customers and farmers. Many World Bank projects have used various kinds of incentives, especially credit lines, to stimulate the entry of financial intermediaries that can help to close these gaps, as well as to provide longer-term funding to rural businesses. The recent OED review of the performance of Bank credit lines has revealed a substandard performance across the portfolio including rural credit lines; this has resulted in closer oversight at entry and a focus on better reporting of performance. The real issue, however, is not only the performance of credit lines but also the usefulness of providing such funding at all, especially to financial institutions that in many cases do not have the institutional capacity and strategic motivation to serve the new clientele after the project has ended. The lack of access to financial services other than credit is not addressed by this instrument either.

In many of the Bank’s partner countries, lack of financing in rural areas and specifically financing for agriculture is not due to a general lack of liquidity in the country, but rather to lack of suitable financial institutions and the high risks, perceived and real, in entering such markets. Therefore, providing liquidity in the form of a credit line does not solve the problem in most cases; it provides only temporary funds to borrowers and may not meet their needs for other financial services. An exception is those situations where there is no long-term lending available in a country, even in the face of high short-term market liquidity. In those situations, a Bank credit line directed towards longer-term investment lending could well complement institution-building measures.

Institution-building measures would include technical assistance to help financial institutions develop appropriate products, systems, and service delivery strategies that would enable them to profitably serve a rural clientele. Although this approach can be easily formulated, the challenges are quite significant, as capacity building often requires a long time frame. Significant outreach results should not be expected quickly, as it takes time to build strong structures and systems. This implies that the
way projects in rural areas are measured and evaluated within the Bank should be refocused, so as to set the right incentives for Bank staff.

The lack of financial institutions in rural areas is often the reason that projects channel credit lines through a variety of other institutional arrangements, including community groups, project implementation units and government departments. Unless these arrangements are designed from the beginning to link clients to existing financial intermediaries or to develop these structures into viable financial intermediaries, with the appropriate assistance for institution-building, sustainability cannot be achieved and rural populations will be left once again without financial services after the project ends.
Grants and subsidies are an important topic in rural development; while strictly speaking, this topic is outside the narrow focus of rural finance, the use of grants and subsidies strongly influences the outcome of rural finance activities, so the topic needs to be addressed in this paper. Project teams sometimes provide subsidies and grants, rather than addressing the issue of lack of access to financial services, especially if there are few suitable institutions that could be qualified partners right from the start. This approach can lead to the well-demonstrated effects of capture by elites, lack of access to necessary financial services after the project ends, and market distortions that undermine the efforts of others, who are working on promoting more sustainable arrangements.

Therefore, it needs to be clearly stated that the World Bank adheres to and promotes the financial systems approach to finance, including rural finance. The ultimate goal of this approach is the development of financial institutions operating profitably on a commercial basis and offering products and services demanded by a wide range of clients including the poor. This means that the financing of agriculture and rural development needs to be structured in such a way that it doesn’t distort or inhibit the growth of financial markets, but instead contributes to their development.

Interest rate subsidies and caps, directed credit, forgiveness of farmers’ debts following bad harvests, and government-subsidized crop insurance are always hot topics for Ministries of Agriculture and especially prior to elections. These and similar measures, however, prevent the development of sustainable rural financial markets by crowding out or preventing the entry of private financial institutions, introducing moral hazard and contributing to a bad credit culture. Therefore, they should not be supported. There are, however, many types of subsidies that can contribute to the goals of rural development and poverty reduction without distorting the development of sustainable rural finance. This could include helping financial institutions to become more cost-effective and by fostering competition, thus motivating them to lower interest rates.

### Appropriate subsidies to support rural finance goals

These subsidies can be divided into three categories: subsidies for (i) financial intermediaries, (ii) financial infrastructure, and (iii) economic and social infrastructure. Each of these categories is covered briefly in the sections below. The general rule is that subsidies should be time-bound, limited in nature, and decreasing over time.

#### Subsidies for financial intermediaries

Bank policy on financial intermediaries (OP8.30) allows the use of subsidies to create the conditions that make access to financial services to
underserved populations possible. Subsidies to financial intermediaries must be:

- transparent, targeted, and capped;
- funded explicitly through the government budget or other sources subject to effective control and regular review;
- fiscally sustainable;
- fair, not giving an unfair advantage to some intermediaries vis-à-vis other qualified and directly competing institutions; and
- economically justified.

Subsidies for financial intermediaries that cannot comply with standard eligibility criteria, such as profitability, must be accompanied by an institutional development plan. Monitoring should include sectoral, financial and institutional variables. Key performance indicators (KPIs) should include the quality of earnings and assets.

Appropriate subsidies could:

- provide technical assistance to financial intermediaries to improve systems that enhance efficiency, such as management information systems;
- develop and introduce demand-responsive products on a pilot basis;
- help develop or improve service delivery mechanisms that enable greater outreach into rural areas; and
- cover a portion of the cost of establishing new branches in areas that do not have financial intermediaries that serve the poor.

Subsidies for financial infrastructure

Appropriate financial sector infrastructure is a necessary prerequisite for the development of sustainable financial institutions, not only in rural areas (see Box 2). Significant leverage can be achieved from the investment of relatively small amounts that would benefit a range of institutions. Time-bound subsidies may be appropriate to:

- create capacity within regulatory and supervisory bodies;
- support the creation of industry associations; and
- develop training institutes and credit information agencies.

Subsidies for economic and social infrastructure

Appropriate investments in economic and social infrastructure can raise the productive potential of the community. They do not in themselves generate income, but rather facilitate the carrying out of income-generating activities. Examples of economic infrastructure that directly raise income earning potential include small-scale irrigation, market facilities, a harbour or cold storage for fishing, and even a building and safe for a community-based savings and credit association. Income-earning potential is also increased indirectly by investments in social infrastructure that raise the productivity of labor, such as clean water, education and health facilities. Subsidies can also be used to help develop local organizations that can facilitate input supply, storage, and marketing, either directly or in partnership with other private firms. In all cases, subsidies should:

- decline over time, as the local organizations build up capacity to cover costs through user fees; and
- include a match from the beneficiaries, preferably in cash but also in kind, depending upon the beneficiaries’ economic circumstances.

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<th>BOX 2 Example: Subsidies for the Creation of Microfinance Banks in Eastern Europe, the Caucasus and Africa.</th>
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<td>IFC, in cooperation with other investors such as European Bank for Reconstruction and Development (EBRD), Kreditanstalt fuer Wiederaufbau (KfW), a Netherlands Development Finance Company (FMO) and private investors, has provided investment funds for the creation of microfinance banks. The European Union (EU) and other donors provided technical assistance funds for management contracts, as well as funds to cover start-up costs for the initial two years of operation, decreasing to zero after some additional years. Source: E. Wallace, EBRD, 2003, Personal Communication, S. A. Ahmed, IFC, 2003, Personal Communication.</td>
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Grants versus credit—subsidies to the poor for asset acquisition

During the early stages of the “microfinance revolution” in the 1980s, the provision of credit to poor population groups was indeed a revolution. The strong repayment of loans by both the urban and rural poor who had previously been considered “unbankable,” the ability of clients of microfinance organizations to save, and the development of methodologies that enabled these organizations to cover their costs demonstrated clearly that the provision of financial services can be done on a sustainable basis. At that time, credit programs were targeted primarily to the economically active poor, who were expected to use the funds to develop their livelihoods and earn an income that would support their families.

Subsequent efforts to deepen the outreach of microfinance to ever poorer populations have had mixed results, however. Potential borrowers need to achieve a certain level of economic capacity before they are able to effectively utilize loans for income generation. Those who are extremely poor, living in a post-conflict or emergency situation, or ill with life-threatening diseases, may not be able to profitably manage an economic activity. Hence, the provision of credit for such people may not result in the improvement of their economic situation and a reduction in vulnerability; on the contrary, it may leave them indebted and without the means to repay the loan.

In these cases, the use of grants can be considered. However, since grants cannot be considered a source of sustainable financing, their use should be limited in time and amount. They may be useful to kick-start an economic activity by providing the very poor with an income-generating asset, but must be followed by measures that help people graduate to sustainable sources of financing. Furthermore, extremely poor and vulnerable people may need a package of assistance, including training, if they are to earn income from an economic activity on a sustainable basis. An example of an integrated approach is BRAC Bangladesh’s IGVGD program shown in Box 3.

Some general guidelines for grants for economic activities include the following:

- Grants for economic activities should be limited to (i) very poor people who are too vulnerable to take on the risk of a loan, (ii) poor people living in communities that are beyond the reach of financial institutions that are willing and able to extend services to the poor, and (iii) poor people that have some assets and earning capacity but could not earn enough from the activity to pay off the investment cost within a reasonable time frame.
- Grants must be carefully targeted with strong eligibility criteria to avoid capture of benefits by elites.
- Grants should be made on a matching basis; beneficiaries’ contributions should be in cash if possible. In-kind contributions would only be appropriate in situations such as emergency or...
post-conflict, where the majority of participants could not be expected to have been able to save for the cash contribution.

- So as to ensure that beneficiaries value and care for the assets financed by the grant, they should contribute as high a percentage as is reasonable, given their overall economic circumstances. This should be at least 10% of total cost, and in many cases, a much greater percentage.

- Developing a cost recovery mechanism can help ensure that only people with serious intentions receive grants. One possibility would be to establish local savings and credit associations that would capture recoveries and hold beneficiary savings. The recoveries would help capitalize the entities for future lending within the groups.

- Grants are sometimes made to groups to finance expensive assets that can’t be provided by grants to individuals. However, project teams should be aware that conflicts can arise from group ownership of an asset. If group ownership does not have clear advantages that significantly outweigh these potential conflicts, it might be preferable to provide grants to carefully targeted individuals.

- For poor people who have some assets and income earning capacity, financing a portion of the investment with a grant and the remainder with savings and a loan from a financial institution should be considered. There should be a strict separation between the financial intermediary that is issuing the loan and the body that is issuing the grants, even if the funding is held in the same financial institution. This way, it can be made clear to the beneficiary that the loan coming from a financial institution or other body is indeed a loan and needs to be paid back. If both sources of funding appear to come from the same organization, confusion among beneficiaries is likely to result in poor repayment and damage to the local credit culture. The example in Box 3 outlines how such a separation can be implemented.

- Grants for income-generating activities should in many cases be combined with training in economic activity selection, planning and management. World Bank Institute (WBI) has an established Grassroots Management Training program, which includes household management, business skills, and financial skills. These improve the ability of targeted groups (especially rural women) to manage their income-earning activities and finances, often obviating the need to seek credit and making them more successful when they do. Such programs are sometimes linked with literacy and health programs.
Overview

This chapter provides an overview of delivery channels and models for rural financial services, explores their suitability under different circumstances, and identifies key success factors.

Financial services are delivered to rural populations by organizations that exist along a continuum from formal to informal. The boundaries between these categories are often blurred, but in general formal financial institutions (FFIs) are licensed banks or nonbank financial institutions that are regulated and supervised by a central authority or authorities. They include public and private commercial banks, state-owned agricultural and rural development banks, cooperative banks, microfinance banks and special purpose financial institutions such as leasing, housing and consumer finance companies and providers of payment services. Informal providers of financial services include small groups that rotate internally generated savings as loans to members and that are not licensed, regulated or supervised in most countries. They also include money lenders, pawn shops and businesses that provide financing to their customers. In between stand the semiformal institutions such as non-governmental organizations (NGOs) and small financial cooperatives. These entities have a legal structure and are licensed, but have not typically been subject to banking regulation and supervision.

In many countries, informal providers of financial services can be found in rural areas where there are no formal providers of financial services. They offer a range of services, from safeguarding of savings to short-term loans to domestic and even international transfer services for remittances. These entities are often not considered to be part of the financial sector by financial sector specialists and are thus often not included in discussions about financial sector development, even in rural areas. However, they are included in this approach paper, given their importance to poor people in rural areas, especially those areas not served by formal or semiformal institutions.

Potential areas of intervention for the World Bank

There are several areas of intervention that apply to most delivery channels. Establishing and maintaining a policy dialogue about rural finance and its implications for government policy could well be the first step in the development of a rural finance project. The range of issues that might apply in a particular country is outlined in Chapter 2. Establishment of financial sector infrastructure such as credit information agencies, industry associations, training institutions and activities related to land registration and land titling are also relevant no matter which approach is finally chosen. Areas of intervention related to a specific delivery channel will be outlined in the relevant sections of this
chapter as well as Chapter 5. The matrices in Chapter 7 provide a road map for decision-making.

**Success factors for financial institutions in rural areas**

The following *success factors* suggest ways that financial institutions can orient their operations to work profitably in rural areas.

**Portfolio diversification**

A financial institution is able to significantly reduce its portfolio risk through geographic diversification, customer diversification and product/service diversification. However, for this to work successfully, economies of scale in sub-markets need to be achieved. Otherwise, there is the risk that the institution is spreading itself too thin. Diversification only works if the institution invests in understanding the needs of its new clientele, develops products that respond to those needs, and installs systems for efficient processing and monitoring. If this is not done, higher rather than lower risk could be the result.

**Development and marketing of demand-responsive products**

The experience of successful microfinance institutions demonstrates that even poor rural clients are able and willing to pay for financial products that meet their requirements in terms of convenient access and quick turnaround as well as the features of the products themselves. Deposit services are especially valued if there is fast and inexpensive access in case of emergency cash needs. Undertaking marketing campaigns to inform potential clients about the products and services that the institution offers is an important activity that is often overlooked.

**Good governance and management**

Good governance and management are major requisites for any financial institution that intends to stay in business for the long haul. Transparent decision-making procedures based on pre-agreed rules, enforcement of these rules, and committed management from the top down are key.

**Appropriate management structure and staff incentives in order to attract and retain competent management and staff**

Performance-related compensation that is based on fair and measurable indicators, transparent promotion procedures, intensive training, and efforts to create a “corporate we” have been shown to increase staff motivation and loyalty.

**Appropriate credit technology for different lines of business**

Different lines of business require different methodologies, know-how and staffing. Financial institutions are therefore well advised to acquire or develop the right employee skill mix and to install workable and efficient systems (see Box 4). For example, in lending for agriculture, loan officers need to be knowledgeable about agricultural products and markets and understand how to structure disbursements and repayments within the agricultural timetable. Typical corporate banking does not require this particular skill set. Lending to small and micro businesses again requires a different approach. The microfinance experience has shown that high repayment can be achieved on loans, when methodologies include alternatives to land collateral, and repayments are based on household cash flows, rather than cash flows from the economic activity alone.21 Group-based lending in rural areas can decrease the transaction costs and risks of providing very small loans to poor clients, if coupled with the promise of repeat loans for customers that pay on time. Individual loans secured by guarantors and household assets might be suitable for customers with larger credit needs.

**Installation of efficient internal processing, control and management information systems**

A reliable management information system (MIS) providing timely information for decision-making, and knowledge of its uses and limitations, is critical for the success of any financial institution. Up-to-date information on clients’ repayments and on developments in the markets for the principal agricultural products financed by the bank is especially
Credit technologies vary according to a financial institution’s client group, the business sector, and the possibilities of obtaining and enforcing loan securities. 

**Group lending technologies** were pioneered by the Grameen Bank in Bangladesh, and are now being used by numerous microfinance institutions all over the world. Group lending technologies replace the need for collateral from individual borrowers with peer pressure of the group by making the entire group liable for the repayment of individual loans. The credit program is usually supported by mandatory education and training programs for members, as well as by obligatory savings, and is suitable for very poor borrowers who cannot offer collateral.

International Projekt Consult (IPC), a private consulting firm, has developed **credit technologies for individual loans** that emphasize the importance of the clients’ ability to repay from income received from a variety of sources over the ability to offer collateral. Loan officers develop a strong business relationship with the client and are responsible for the same client over the lifetime of the loan. Salaries are performance based, ensuring a loan officer’s vital interest in each client’s repayment performance. This technology has been successfully implemented by IPC in many different regions.

Latin America Agribusiness Development Corporation SA (LAAD) provides loans to medium sized agribusiness and agricultural enterprises in several Latin American countries. The specialization has enabled LAAD to build up considerable expertise in agricultural lending and knowledge of its inherent risks. The corporation follows a client-centered approach, building long-term client relationships with contract terms adjusted to the client’s cash flow requirements, backed up by enforceable collateral. LAAD takes a long-term view of agricultural finance and is willing to restructure loans based on risk assessments. LAAD’s loan portfolio is well diversified in terms of sectors and countries, and thus allows the corporation to fill a market niche hardly serviced by commercial banks in Latin America.

**Sources:** Grameen profile at www.grameen-info.org, IPC profile at www.ipcgmbh.com; LAAD 2004 and 2005.

**Access to appropriate risk management products for agricultural lending**

Lending for agricultural or livestock production entails nonfinancial risks that often prevent lenders from entering this market. The major risks are unpredictable weather and strong price swings for commodities traded in international markets. Pilot efforts are underway to assess the feasibility of risk management instruments to reduce some of these risks. However, it is too early to predict if these can become commercially viable (see Chapter 6).

**Commercial banks and rural finance**

In most countries, commercial banks represent the largest part of the financial sector and offer a diversified set of services that are unparalleled by any other institutional form. They are more suitable for the provision of financial services to small and medium enterprises (SMEs), including farm enterprises, than to the very poor, who might operate part-time seasonal activities and can be more effectively served in many cases by semiformal and informal institutions.

In order to evaluate and best work with commercial banks within the framework of development goals in rural finance, a closer look at the objectives, purposes and motivation of such institutions is in order. In general, commercial banks, in contrast to state-owned development banks, have the one overriding objective of achieving profits for their shareholders. Social development objectives, such as deeper outreach into poorer population groups and
remote geographical areas that are underlying the World Bank’s rural development strategy, are not, for the most part, on their radar screens, and will be embraced if, and only if, there are other benefits that outweigh the financial disadvantages. These benefits include access to new markets with profit potential, or access to government subsidies. There is, in general, a significant conflict of objectives between commercial banks seeking to maximize profits and donor institutions such as the World Bank that support social as well as economic goals. In order to be successful, interventions need to start with an alignment of interests and provide the tools to achieve such alignment. Far too often, funds for refinancing are provided to commercial banks who are eager to accept them and use them once or twice to make loans to underserved groups, but who do not develop a credit technology that will enable them to lend profitably to these groups over the long term. Farsighted international commercial banks, such as those adhering to the Equator principles, realize that adhering to a double or triple bottom line provides for low-cost public relations and other benefits, like increased customer or shareholder loyalty or gaining a new clientele. In nearly all World Bank partner countries, international banks have established a strong presence over the past decade, competing with domestic banks for their best corporate customers. Local banks are losing some of these clients, so are increasingly being forced to examine their competitive position and to look for other, untapped markets, where they are better able to compete. These untapped markets include the rural areas of most countries and low-income people who have been unable to access formal financial services. Governments and donors can achieve sustainable results by aligning their development interests with the self-interest of commercial banks, i.e., helping commercial banks to achieve their objectives. This means, for example, assisting them to improve the profitability of existing rural financial services or supporting their expansion into rural markets with technical assistance and know-how. In general, it is recommended that World Bank programs and projects select those rural financial institutions for partners, where there is a strong alignment of interest in serving those segments of the rural population that are currently underserved, especially farmers and low-income populations, and where services can be provided on a sustainable basis.

**BOX 5 Using Palm Pilots to Speed Transaction in Ecuador**

*Banco Solidario in Ecuador* has introduced Palm Pilots to enable loan officers to process transactions immediately in the field and transfer data to the center. The software used integrates field based and central data collection and processing into a comprehensive management information system (MIS). This technology has supported the introduction of credit scoring systems for client selection, segmentation and payment collection in the urban sector. Scoring uses past performance to predict future behavior and consequently, helps loan officers structure loans. The technology enabled the bank to improve its efficiency by shifting time from administrative work to client follow-up, responding more quickly to loan applicants, and realizing substantial savings on office supplies. Banco Solidario plans to introduce credit scoring to the rural sector once sufficient historical data has been collected. The Palm Pilot software and credit scoring system were developed by ACCION International. Other MFIs in Latin America, for example Mibanco in Peru, are now introducing mobile phones for similar purposes.

Concerns of financial institutions about the profitability of moving into rural areas and especially into agricultural loans are valid and need to be addressed. These include high transaction costs due to small loan sizes and large geographic spread, systemic risk regarding financing for agriculture and agriculture-related ventures, little knowledge of rural customers and their business dynamics and high costs to obtain such knowledge, low equity base and frequent lack of collateral of the clients to be financed making them rather risky business prospects, insufficient credit know-how of banks in those countries where investments in government securities are or were in the past the investment of choice, lack of efficient management information and portfolio management systems, unclear property rights and lack of collateral enforcement rights, government and donor-influenced culture of non-performing loans, unfavorable government policies such as overly large government borrowing that crowds out smaller borrowers, interest rate caps, and interest rate subsidies. These weaknesses are often exacerbated by low institutional capacity, weak or corrupt management, and poor organization of the institutions.

As outlined in Chapter 2, these concerns can be addressed on three levels: the policy level, including the development of a favorable macro-economic, legal, and regulatory environment; the enabling environment, which includes the creation and/or improvement of credit information systems, industry associations, and training institutes that offer business development services to improve borrowers’ ability to manage their businesses; and the institutional level, including instruments to mitigate risk, reduce transaction costs and increase the portfolio quality of financial institutions. Lasting results can be achieved best if deficiencies are addressed on all three levels rather than working on one level only.

Models for commercial banks entering rural markets

There are a number of models that a bank can choose when contemplating entry into rural markets. The choice depends on the importance of this market within a bank’s overall strategic plan, the available business opportunities, the resources it is willing to invest and its appetite for risk. Some initiatives undertaken by commercial banks over the past decade are outlined below.

Integrating rural finance and financing for agriculture into a commercial bank’s mainstream business

This approach is usually chosen by a financial institution that realizes that its traditional mainstay business is getting increasingly competitive, and consequently has made the strategic decision to focus on new markets in order to survive or to increase profitability. This business reorientation can take place in farsighted institutions, without donor support as outlined in Box 6 below.

In other cases, however, support from donors is instrumental. Traditionally donors and governments

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<th>BOX 6 Banco del Pichincha</th>
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<td>Banco del Pichincha in Ecuador has developed a strong rural finance program framed in that bank’s overall strategy of becoming the country’s leading retail banking institution. To achieve this goal, Banco del Pichincha has established a network of over 220 branches serving even remote villages. In 2001, Pichincha was providing almost 20,000 small loans to peasants and rural dwellers with an arrears rate of only 5%. The bank’s relation to the farmers has been the result of its engagement with agro-processing industries, to which the bank provides cash management services. One of these services is the handling of payments to the small farmers supplying inputs to the industry by depositing such payments into savings or checking accounts. The bank has been able to learn through the management of these accounts about the small farmers’ income level and cash flow pattern and has tailored specific loan products for them, which allow a better utilization of the bank’s costly rural infrastructure.</td>
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<td>Source: Buchenau, J. et al., 2003.</td>
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support interested banks through special-purpose credit lines and technical assistance. In many cases, however, it has been the experience that banks continue to focus on the supported markets after project end only if the owners and top management of the financial institution are highly supportive and consider it to be in their own interest. The example in Box 7 below demonstrates how significant donor involvement and an innovative three-party approach resulted in increased lending for agricultural equipment.

**Establishing a separate unit within a bank to serve non-priority markets with lending products**

Many commercial banks are quite interested in entering new markets such as agri-business and SME lending, while staying focused on their existing core business. In this case, setting up a separate unit as a profit center and allowing it to develop a distinct culture and business model can be a good solution. This model has been used successfully by the EBRD to introduce SME lending to commercial banks in Kazakhstan (Box 8). Another example is Kingdom Bank in Zimbabwe, which has established a separate microfinance division with the assistance of ACCION International.

**BOX 7 Lending for Agricultural Equipment, The German Romanian Fund in Romania**

In Romania, farmers often lack financial resources to buy equipment, while commercial banks lack secure financial products and procedures to reach these rural clients. Guaranteeing equipment loans is the main issue because banks do not want to take pledges on equipment they would have to sell in case of client default, and farmers do not have collateral. The German Romanian Fund, a program implemented by Horus Development Finance in Romania, offers a solution to both farmers and commercial banks: an innovative product consisting of a bank equipment loan with a buy-back clause from the equipment supplier. The commercial bank and the equipment supplier sign a framework cooperation contract, and then, for each loan, a credit contract guaranteed by a buy-back clause is signed by the three parties (bank, client and supplier). All three parties benefit: i) the banks, who reach a new clientele and do not have to deal with the equipment in case of default; ii) the equipment suppliers, who can sell more equipment and who are very interested, if necessary, in buying back the equipment at a price lower than the market price; and iii) the rural clients, who have access to financial resources to buy new as well as second hand equipment.


**Establishing and spinning off a separate unit to serve rural markets and low-income populations**

This approach goes one step further than the establishment of a separate unit; there is the goal of spinning off the unit once it has demonstrated its profitability. Financial Bank is using this model in West Africa, with the goal of establishing a network of small special purpose banks (Box 9).

**BOX 8 EBRD SME Lending Program in Kazakhstan**

The major commercial banks in Kazakhstan that qualified under the EBRD guidelines were provided with significant technical assistance to set up a separate department with separate staff, credit procedures and management, often located in a separate building. In the early stages of the project, the SME financing units were managed and tightly controlled by international consultants who installed all the systems and procedures and provided training to bank staff. Based on the success of the Kazakhstan project, EBRD expanded the program to other Central Asian countries, in cooperation with IFC.

Establishing a separate unit managed by a service company

Service companies are nonfinancial companies that originate and service loans on behalf of a bank, for a fee (see Box 10). Loans are booked on the bank’s balance sheet but all staff are employees of the service company. The service company identifies customers and initiates transactions, while taking advantage of the bank’s funds, as well as its back-office processing and administrative structures. This model has numerous advantages: it does not require a financial institution license, initial capitalization is very small as it does not need loan funds, and it uses many parts of the bank’s existing infrastructure, thus reducing costs. ACCION International has worked with banks in Haiti (Sogebank), Ecuador (CrediFe) and Brazil (Banco Real) to establish service companies.

BOX 9 Financial Bank of Benin and Chad

Financial Bank (Benin, Chad) is an example of a bank forming a microfinance unit within the bank with the objective of spinning it off once it has achieved outreach, sustainability and profitability. The spun-off units, called Finadev, are private commercial microfinance institutions, with a banking group as the main sponsor and shareholder, international financial institutions as shareholders and partners, and a technical partner (Horus) directly involved through equity capital and technical assistance.

Finadev Benin and Finadev Chad are freestanding microfinance units focusing on low-income customers. They currently target three customers segments, presently all urban: (i) women micro-entrepreneurs, especially active in trade, (ii) SMEs; and (iii) employees in the formal sector, with loans used mainly to fund housing improvement work or an informal business.

Finadev Chad already has a branch in Moundou, the second city of the country, which is located in the main agricultural area of Chad. Many of the women micro-entrepreneur clients of Finadev have, in addition to their business, a cereal storage activity. A study is presently being conducted to develop a small agricultural equipment-financing product. Collaboration with an agricultural development program would certainly help Finadev to develop appropriate products.

Finadev Chad intends to be, within a few years, strong enough to serve other types of customers in rural southern Chad. Important economic reforms are underway to strengthen the private sector in this region, and these reforms require that new intermediation mechanisms be available to finance agricultural production and rural activities. This will only be possible if a sustainable and professional financial institution exists.


BOX 10 Sogebank, Haiti

Sogebank, Haiti’s largest locally owned commercial bank, launched its microcredit program in 2000, after a change in legislation made such operations possible. Sogebank established Sogesol (Societe Generale Haitienne de Solidarite), an independent non-bank microlending company, as its service company. Sogesol provides loan origination and administration services to Sogebank, which issues the loans. ACCION International is a shareholder of Sogesol, has provided technical assistance and has taken over the management contract of the company in 2004. As of June 2004, Sogesol has established nine branches in the capital and secondary cities in Haiti, serving over 6400 clients with an average loan size of approx. US$900.00. Its portfolio quality remains a challenge due to political unrest and hurricane damages that affect the repayment capacities of its clients.

Source: www.accion.org/about_where_we_work_program.asp_Q_T_E_17.
Linkages and agency arrangements with third parties

Linkages or agency arrangements with microfinance institutions, NGOs or village organizations are another way for commercial banks to penetrate remote rural areas. This model enables the bank to avoid high start-up costs for infrastructure, and takes advantage of the expertise of existing organizations. Banco Solidario of Ecuador is utilizing existing rural credit cooperatives as agents to serve rural areas that are outside of its established market. Rural post offices can also serve as agents to provide financial services, especially for the collection of savings. India is a case in point, where significant savings are collected by the post in rural areas.

Establishing mobile branches to extend rural outreach

Mobile banking allows commercial banks to reduce the transaction costs of servicing rural areas. Although initial capital investment in mobile offices is substantial, these costs need to be seen in relation to those of establishing and maintaining a fixed delivery mechanism. The partner bank for the World Bank’s Rural Finance Project in Vietnam has been effective in reaching over 315,000 people in remote areas through mobile units, and these units have proved to be much more profitable than established branches. The case of Kenya’s Equity Bank, outlined in Box 11, demonstrates important success factors such as use of secure vehicles and access to strong communication lines.

Areas for possible Bank interventions

Support to commercial banks entering rural areas can take many forms, apart from activities related to good policies and the enabling legal and regulatory environment that were outlined earlier in this chapter. The boxes in this section on commercial banks provide examples of interventions ranging from technical assistance to the financing of outside management contracts to the provision of technologies, including installation or improvement of communication and computer systems. Support for the training of bank management and staff, as well as access to firsthand information about successful operations through exposure visits, staff exchanges and on-site demonstrations is often invaluable. The provision of credit lines is another intervention that is outlined below.

Donor credit lines to commercial banks

The recent OED review of Bank credit lines from 1993–2002 reveals that many projects did not achieve the stated project objectives with regard to the project credit lines or were not in a position to measure the results. Specifically, it noted that receiving banks were in many cases not sufficiently strong, there was insufficient supervision, and lack of meaningful information on performance. The recommendations reiterate that projects must comply with the Bank’s policy on financial intermediary lending (OP8.30); key provisions of this

<table>
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<th>BOX 11  EBS of Kenya</th>
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<td>Equity Bank, originally Equity Building Society (EBS) of Kenya, a mortgage lender, decided to re-focus its business on low- and moderate-income borrowers and customers in rural areas. While some new branches were opened in more populous rural areas, creating permanent branches in remote areas was not a financially viable solution. EBS purchased mobile branch vehicles with special features, including all-terrain driving ability, constant voice and data communication, power back up and high security. The convenience of access to the mobile branches resulted in many new customers and also helped reduce branch congestion by attracting existing customers to the units. By the end of 2002, EBS was successfully operating 10 branches in the largely rural Central Province and reaching 21 isolated communities via mobile banking units.</td>
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policy are that interest rates to the end-customers should not be subsidized, and that the project must establish eligibility criteria for banks that include commercially oriented governance, adequate profitability and portfolio quality, and appropriate staff capacity for sub-loan appraisal and monitoring. Banks that do not meet these criteria may be supported, provided that they agree to an institutional development plan that includes a set of time-bound performance indicators. In order to implement such an action plan, many banks would need technical and/or management assistance. Significant funding in the form of matching grants and a multi-year time horizon are likely to be necessary for such interventions to be successful.

A specific issue that needs to be addressed is the provision of credit lines denominated in hard currencies, such as the dollar or the euro. Governments often pass the foreign exchange risk on to the participating bank, with a number of potentially undesirable effects. Foreign currency refinancing of local currency loans often results in highly risky foreign exchange exposures. To avoid this risk, the local bank pushes it on to the end-clients, who are usually the weakest link in the chain and the least able to carry such a risk. Their foreign currency loans will have to be repaid from their local currency earnings. If there is significant currency depreciation and clients do not have foreign currency earnings to repay the principal and interest, loan defaults are often the result, with rather unpleasant consequences for both the clients and the banks, which have to cover the losses from their own funds. It is therefore recommended that foreign currency funding only be provided if thorough analysis indicates that local banks and their customers can easily carry the exchange rate risk. Hard currency credit lines could be appropriate if the economy is mostly hard currency based, the majority of the envisioned end-clients have hard currency earnings that enable them to avoid exchange rate losses, or hedging instruments are available.

State-owned agricultural and rural development banks

State-owned agricultural and rural development banks have the dual objectives of operating profitably—or at least recovering their costs—and supporting the government in achieving social development goals (double bottom line\(^3\)). In the 1970s and 1980s, state banks were established in many countries, often with donor support, with high hopes of establishing permanent access to credit in underserved areas, especially for agriculture. Subsequently, in many cases, these institutions neglected, or were forced by governments to neglect, the first objective. This translated many times into decision-making by and for special interest groups, high transaction costs, high loan losses, and corruption. As a result, many of these institutions were closed or privatized in the late 1980s and early 1990s, with the expectation that the private sector would pick up the pieces.

However, in many cases, rural branch networks contracted following privatization, the private sector did not step in, and in some cases, financial institutions completely disappeared in rural areas when state banks closed.\(^3\) Consequently, new thoughts have begun to emerge about the potential of such institutions for rural finance. While the shortcomings of state-owned banks are well known and have been extensively documented,\(^3\) the disadvantages of their disappearance have also now been recognized. As a result, quite a few Bank client countries are looking anew at setting up such institutions and are asking the Bank for guidance and support.

By virtue of their often significant equity base, existing infrastructure in rural areas, and banking experience, state banks focusing on the financial needs of rural populations offer the potential to extend a whole array of financial services into rural areas, to an extent and scale that most commercial banks and other financial service providers are not able to match. This alone would not justify a special focus by the Bank on such institutions, especially given the extensive negative experiences. However, there are now a number of state-owned banks that have been able to provide financial services in rural areas on a sustainable basis and at a significant scale. There are three distinct ways that this has been done: (i) reformation or turn-around of existing development banks, (ii) start-up of new bank or nonbank financial institutions, and (iii) specialized micro or rural finance units within existing state-owned banks.
Reformation or turn-around of existing development banks

Restructuring a poorly managed state bank requires significant resources and political will from all stakeholders, and close cooperation and alignment of objectives. In several countries, mostly in Asia, the existing large state banks were neither privatized nor closed down, but rather reformed to better meet their stated objectives. A case of a reformed institution is BAAC Thailand, which has huge outreach, providing insurance, savings and credit services to nine out of ten farming households. Reformation of BAAC has been strongly supported by the government and donors, who have provided technical assistance in a variety of areas, including new product development and implementation. Another case is the National Microfinance Bank (NMB) of Tanzania that is in the process of being privatized after a management-led turnaround that also benefited from donor support. NMB has a strong network of rural branches and is focusing on the savings business, with lending being introduced on a very cautious basis. The case of the Agricultural Bank of Mongolia is highlighted in Box 12 above. It is interesting to note that these quite large institutions with significant rural outreach report a higher demand for savings than for credit. A net transfer of funds from rural into urban areas at a ratio of one to two is taking place.

Start-up of a new agricultural bank or nonbank financial institution

Creating a new institution might be the approach of choice in those countries where there are no financial institutions in rural areas that could be turned around, or the existing institutions are beyond turn-around aspirations. This has been the case in most countries of the former Soviet Union where, with few exceptions, the former state-owned agricultural banks were liquidated, leaving a void that has not been filled by private sector institutions as anticipated. The World Bank has been instrumental in establishing two agricultural finance institutions in this region, the Agricultural Development Bank of Latvia, which has been successfully privatized, and the still to be privatized Kyrgyz Agricultural Finance Corporation (KAFC), which is profiled in Box 13 on page 27.

Specialized micro or rural finance units within an existing state-owned bank

A specialized department focusing on rural clients, that can be isolated from political pressures and has the organizational independence to follow best practices, might be the preferred solution in those countries where there is an existing state-owned institution that is focusing on a different market
and doesn’t need a turn-around. Indonesia’s state-owned Bank Rakyat (BRI) is a case in point.\textsuperscript{41} Its local micro and rural finance units were established to operate completely independently of the parent institution and to provide financial services to the rural population on a sustainable basis. The strength of this system was demonstrated during and in the aftermath of the Asian financial crisis. The case of CrediAmigo in Brazil is highlighted in Box 14 above.

In addition to the success factors for financial institutions outlined earlier in this chapter, the state-owned banks cited above consistently made use of the following success factors:

\begin{itemize}
  \item \textit{Clear separation of banking operations and decision-making from government influence}, and strong political will from all parties for an independent institution, including sanctions against political actors who attempt to use their influence to interfere;
  \item \textit{Appropriate governance structure} including a majority of private sector representation on the board, political independence of the board and managing director, overlapping terms of appointed officials with the electoral cycle, and a non-removal clause for the managing director except for proven malfeasance, corruption and incompetence;
\end{itemize}

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**BOX 13 KAFC of Kyrgyzstan**

The Kyrgyz Agricultural Finance Corporation (KAFC) was established in 1997 under the Bank-financed Rural Finance Project as a nonbank financial institution serving farmers and rural entrepreneurs. KAFC was designed to operate on a commercial basis—extending credit based on rigorous financial appraisal, taking full collateral, and fully covering its costs through its on-lending rates. The bank’s loan recovery rate reached approximately 98% in 2004. KAFC offers individual collateralized loans and social collateral-based group loans on a short- and medium term basis. KAFC supplies 90% of all agricultural and livestock lending in Kyrgyzstan, serving mainly small clients with an average loan size of US$1,400. KAFC has also started to lend to micro-credit organizations, and had financed nine such organizations by 2003. KAFC has applied for a banking license in order to extend services to include deposit and payment facilities. The Bank assisted in establishing an enabling environment, providing funds for on-lending, obtaining donor support for technical assistance and early stage operating expenses, and ring-fencing the new institution from political influence.


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**BOX 14 CrediAmigo**

CrediAmigo is a micro lending initiative of Banco do Nordeste, a regional state-owned development bank dedicated to stimulating economic development in Brazil’s poorest region. In 1997, Banco do Nordeste approached ACCION for help in designing a microcredit program. The program, called CrediAmigo, began in five pilot branches and quickly expanded to 51 branches in 1998. While CrediAmigo is managed by Banco do Nordeste, it has separate staff and offices adjacent to the bank’s branches. This pre-existing infrastructure has facilitated CrediAmigo’s expansion at a low cost. In 2003, it served 118,000 active borrowers through a network of 165 branch offices with an average loan size of US$211, and just under 50% women borrowers. CrediAMIGO entered into a cooperation program with the Mexican MFI Compartamos in order to improve its outreach in rural areas. A key success factor has been strong and patient support from the World Bank and highly professional technical assistance from an international microfinance network. While in the past CrediAmigo focused on nonagricultural loans in densely populated areas, it plans to enter more remote rural areas, again supported by technical assistance.

• Consistent government policies concerning the development of a sustainable rural financial sector; e.g., no debt-forgiveness, interest rate subsidies or interest rate caps;
• Sufficient, no-strings-attached funding by government and/or donors for expert international technical assistance to build the institution’s systems and products;
• Ability of the institution to charge full cost-recovery interest rates (net of time-bound subsidies for technical assistance (TA) and initial operating expenses);
• Access to local currency funding through deposit mobilization or credit lines;
• Long-term approach that recognizes that progress might be slow and initially not spectacular.

Areas for possible Bank interventions

The areas for possible interventions to support commercial banks equally apply to state-owned banks. An additional area of intervention at the policy level is dialogue on the strict separation of banking decisions from government influence. Supporting the start-up of specialized rural financial institutions, such as KAFC, through a range of activities on all three levels (policy, enabling regulatory and legal framework, and institutional development) is also a possibility that could be explored if there are no other suitable existing institutions that could be supported.

Specialized rural microfinance institutions

Specialized rural microfinance institutions can take the form of NGOs, commercial finance companies or specialized financial institutions operating under the supervision of the banking authorities.

NGOs and microfinance

NGOs have played a leading role in the development of the microfinance industry over the past 25 years. NGOs have an ownership structure totally different from companies or cooperatives; in fact, they do not have real owners. They are usually established under a country’s laws as a non-profit society or trust with charitable objectives. The NGO’s capital comes mainly from donors, because they are unable to raise capital through issuing shares or mobilizing deposits. Many microfinance NGOs began life as organizations with the mission of alleviating poverty through multifaceted enterprise development (Box 15). Over time, many began to realize that their clients particularly valued easy, flexible and continuous access to financial services, and that the interest from loans could cover the NGOs’ costs, provided that the organizations had sufficient scale and efficient methodologies. Consequently, starting in the late 1980s and early 1990s, many of these organizations began to shift from a social approach to a business approach, focusing on the sustainability of the organization as well as the sustainability of clients’ businesses. The borrower gained recognition as a valued client (rather than a “beneficiary”) with diverse and continuous needs for financial services—not just loans.

With their new orientation as sustainable financial businesses serving a low-income clientele, microfinance NGOs needed to grow the liabilities and capital side of their balance sheets, so they would have the scale to become financially viable and have sufficient funds to serve new clients as well as old ones. However, their status as NGOs made this difficult. They couldn’t raise capital because they weren’t shareholding entities. They couldn’t raise deposits, except in some cases small savings from their members that served to partially guarantee a loan. These savings could not be intermediated because the NGOs were not licensed as financial institutions and had no shareholders who could recapitalize the institution in the case of loss. They also had great difficulty accessing commercial bank loans because of their lack of owners and perceived status as charitable non-profit organizations. In many cases, this status also created difficulties with the tax authorities.

Despite the constraints noted above, NGOs play a valuable role in the provision of financial services to poor populations, providing outreach that otherwise would not be possible. However, unless the NGO focuses on provision of financial services, or strictly separates its financial and nonfinancial activities, there can be significant problems, including client confusion between cost-covering financial services and subsidized social services.
Specialized financial institutions and commercial finance companies

In order to overcome the constraints outlined above, some microfinance NGOs have undertaken an ownership transformation from NGO to company with share capital. This change has enabled them to attract shareholders, access capital markets, become licensed as banks or nonbank financial institutions, and offer new products to their clientele, including deposit products. However, experience has shown that transformation is a difficult and lengthy process, involving not only major changes in ownership and governance, but also acquisition of a whole new set of skills, such as the management of deposits and the production of timely and consistent information for regulatory bodies. An alternative from transformation is for these organizations to become agents of mainstream financial institutions; the NGO benefits from bank funding and the bank benefits from the NGO’s capacity to reach a poor clientele.

As a result of the accumulated lessons and constraints, many institutions specializing in micro and rural finance that have recently been created by innovators like International Projekt Consult (IPC) and ACCION began life not as NGOs, but as licensed and regulated financial companies.

Microfinance networks

Over the past decade, many national and regional networks have been established by the financial entities that are focused on providing financial services to the poor. While most of the financial institutions in these networks are urban-based, there is a growing interest in expansion into rural areas. Other networks have been set up by international organizations that have provided technical support to microfinance institutions in a large number of countries. Examples include Women’s World Banking, Opportunity International, ACCION International (see Box 16) and IPC. Most of the networks receive donor funding for various purposes and can potentially be valuable partners for the Bank in rural finance. The institutions participating in these networks have a wide variety of institutional types: NGOs, nonbank financial institutions, banks, and cooperatives.

Areas for possible Bank interventions in rural microfinance

The Bank can support the development of efficient microfinance institutions in rural areas in a variety of ways, ranging from provision of advice on legal and regulatory issues, to support for transformation from an NGO to a shareholding company structure, to funding for capacity building. Technical assistance for the development of products and services, creation of transparent accounting and management information systems, and acquisition of technologies that will create efficiencies are all possible interventions. In addition, partial funding of microfinance ratings or assessments can help well-performing organizations to obtain commercial funding. For those institutions that receive a low rating, the advice given in the assessment can provide useful guidance that...
will help move these institutions closer to eligibility for commercial funding. Credit lines can be justified when institutions are performing well, but cannot yet obtain commercial funding. Credit lines should be priced at the market rate, so that they do not distort incentives for seeking commercial funding. They should be accompanied by capacity-building assistance to help the institutions overcome their deficiencies, so that the credit line can be replaced with domestic funding when it becomes due.

**Cooperative financial institutions**

Cooperative financial institutions range from formal cooperative banks to semiformal financial cooperatives and credit unions to informal village-based savings and loan associations. The main characteristics include ownership of the entity by members (or member cooperatives in the case of a federation or a bank), the provision of financial services to members, and governance by elected representatives of the owners/members. Members are usually people with a common bond, either geographic or occupational. Membership can in some cases be purchased for a token amount while in other cases significant involvement of the member is required, as well as a savings history, before he or she becomes eligible for loans.

Small primary cooperatives may be managed by members on a volunteer part-time basis, with low operating costs and close contact with their customers. Once an institution grows above a certain number of members, the social cohesion found in small cooperatives is not sufficient and needs to be reinforced through the installation of more professional management. While even small volunteer-managed cooperatives need to have a transparent structure, good accounting and sound criteria for decision-making, this is even more important when the cooperative grows and paid management takes on the functions previously performed by members. Many financial cooperatives become organized into federations so as to obtain services such as external audit and training that enhance accountability and professionalism (see Box 17).

Credit unions are a type of financial cooperative. They are based on a common bond, often occupational, and often serve a primarily urban and middle-class clientele. Examples are teachers, government workers, farmers and corporation-based credit unions including the Bank's own Bank-Fund staff credit union. Credit unions can be small village-based entities or larger, more professional organizations that are federated (Box 18).

**Cooperative banking networks** consists of primary financial cooperatives, often in the form of community banks, with an apex institution owned by the member cooperatives and providing services to them. There may also be parallel independent apex institutions responsible for supervision and auditing of the member institutions. This model had its origins in central Europe in the early 1800s, with the idea of encouraging poor people and small groups to pool their financial resources for mutual benefit. Membership was open to everyone, with special emphasis on lower-income groups. Over the years, these European cooperatives have grown into major participants in the financial markets of their respective countries as well as internationally. Rabobank, DZ Bank, Credit Agricole, Raiffeisenbank and Desjardins are all full service banks.
owned by their member community banks. This model is also found in countries like Argentina, Uruguay, Chile, Brazil and West Africa.

In developing countries, cooperative financial institutions have had a mixed history in terms of financial performance, governance and sustainability. Problems have occurred at all levels. One of the major reasons that rural financial cooperatives have failed so often over the last three decades has been the involvement of governments and donors, who have used cooperatives to channel cheap credit, and undermined the savings-based character of these organizations. In addition, lack of transparency in decision-making, poor financial management and the inability of board members to provide effective oversight have been extremely damaging. Those cooperatives that succeed in overcoming these issues face the problem that all small financial institutions face; namely, the difficulty of providing a full range of banking services and obtaining reliable refinancing facilities. Belonging to a federation can help to alleviate these difficulties.

Success factors

Despite their often dismal history, financial cooperatives represent an important area of intervention in rural finance, due to their comparatively low costs and huge potential for massive outreach to the rural poor. However, there is also considerable risk of failure, especially if donors’ and governments’ objectives are not aligned with the institutions’ objectives. Success factors include attention to all the following areas:

- **Policy and enabling environment.** Political will is required at the policy level to develop an enabling legal, regulatory and supervisory framework.
- **Governance.** Transparent structures and transparent decision-making processes on all levels of the institution from board and management to loan officers are critical for the cooperatives’ sustainability. Strong governance is also the first line of defense against those who try to use financial cooperatives for political influence and

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**BOX 17 Setting Up Financial Cooperatives in Russia**

In Russia, the first Rural Savings and Credit Cooperatives (RSCCs) were established in 1996, in the midst of the Russian banking crisis that led to the closure of many rural banks and branches. The sector operates as a three-tier structure with local credit cooperatives, regional and federal level federations, and apex institutions such as training institutes. The Central Bank is responsible for supervision. The RSCCs are the main source of credit for the rural population, farming families and rural small businesses. Repayment rates are impressive with over 99%. International technical assistance is directed at all three levels, with emphasis on the development of an enabling regulatory framework and sector development at local and regional levels.


**BOX 18 Credit Unions in Lithuania**

The first credit union in Lithuania was founded in 1995, after a new law on credit unions was passed in the midst of the 1994–1996 banking crisis. In 1997, 11 credit unions formed the Association of Lithuanian Credit Unions (ALCU). ALCU provides training, technical assistance, lobbying and financial services to its members. In order to separate financial from technical functions, an apex bank, the Lithuanian Central Credit Union (LCCU), was established in 2002. LCCU provides financial services to credit unions, including the administration of a stabilization fund, a liquidity fund, and credit and deposit facilities. While the Central Bank retains supervision authority, LCCU provides supplementary supervision services to its members. The sector has shown impressive growth since its establishment. Growth accelerated after a modification of the law in 2000 and the closing of rural branches of commercial banks.

Source: Lietvos Centrine Kredito Unija (undated).
personal gain. A strong governance structure could include political independence of the board and management, overlapping terms with the electoral cycle and others.

- **Professional management and staff.**
- **Recognizing the important role of member savings.** Savings, as well as equity participation, provide members with a strong sense of ownership of the cooperative, which should motivate them to demand transparency and accountability from the governing body as well as management. External funding, whether it is from governments or donors, can diminish the incentives for good governance and management unless the savings focus can be maintained. This being said, for larger financial cooperatives, the issue of sufficient capitalization is a major one and cannot be solved through member savings and equity holdings alone.
- **Strong systems.** This includes products, service delivery structure, accounting and financial management systems.
- **Affiliation with a federation of financial cooperatives.** This is critical for a primary cooperative that aims to provide a range of financial services to its members. The degree of federation can strongly influence the capacity to provide a wide range of services to members, which in turn can strongly influence the achievement of profitability.
- **Defining the role of the federation.** A clear distinction between financial functions such as funding, supervisory functions and support functions such as promotion and training is needed in order to avoid conflicts of interest.
- **Developing more effective regulatory and supervisory structures.** In many countries, financial cooperatives are regulated and supervised by institutions such as Cooperative Ministries or Departments that typically lack specialized technical expertise to supervise financial institutions. Direct supervision through the Central Bank is often not possible, except in the case of cooperative banking networks, due to the costs of supervising a large number of small institutions that are geographically dispersed. Other methods of supervision such as auxiliary supervision and delegated supervision are now being tried in some places. For a further discussion on the features, advantages, and disadvantages of the various models see Arzbach 2004.
- **Independent auditing of primary cooperatives and their federations.**

**BOX 19 Cooperative Reforms**

Since 2001, *Mexico* has restructured its “popular” savings and credit sector, comprising financial institutions providing rural, SME and microfinance. At the macro-level, a new sector law defines and regulates the institutions within a three-tier structure of retail institutions, their federations and confederations. The law defines regulatory standards (including accounting and prudential standards), and identifies the supervision authority and mechanisms. At the meso-level, the Mexican government provides temporary infrastructure support and technical assistance to the sector through the newly established state-owned development Bank, BANSEFI, and through newly established second-tier federations of financial institutions. At the institutional level, the reform package provides technical assistance for a transition process, which requires relicensing of all financial institutions of the popular savings and credit sector. Financial assistance is available for restructuring, and for temporary liquidity problems.

In the **Philippines**, the 30-year-old credit union movement has had weak structures, with many inactive unions, and others that are financially unstable with high default rates. The credit unions have also been used as a conduit for cheap credit. The credit union federation, PFCCO, has been underfunded and not been able to provide technical services to its members. At the end of the 1990s, the government initiated a reform program with international technical assistance, with the objective of establishing model cooperatives, turning them around from loss-making entities into independent profit oriented unions, adhering to strict prudential standards and emphasizing savings mobilization. Results for the first batch of model credit unions have been impressive, with default rates declining from 63% to 7% in 2002. New business plans and marketing strategies have quadrupled the membership.

• **Eliminating the use of cooperatives to promote political goals or to benefit powerful local individuals or companies.** Governments need to establish enforceable policies and procedures to prevent interference and influence peddling.

The examples in Box 19 on page 32 describe two successful programs for cooperative reforms in different parts of the world.

### Areas for possible Bank interventions

Strengthening financial cooperatives requires a dramatic shift in the priorities of governments and donors. In particular, they should not provide credit lines to cooperatives unless there is a strong institutional structure, including effective governance, a substantial savings base, and strong financial management including loan losses of less than 5%. Experience in a wide range of countries has shown that external financing damages these institutions by changing them from savings-driven institutions to borrower-driven institutions.

Many of the success factors listed above represent areas of possible interventions for the World Bank. Successful interventions usually address issues at all three levels of intervention in a carefully planned sequence, starting with policy dialogue, advice on an enabling legal and regulatory framework, technical assistance and possibly refinancing on the institutional level.

### Informal village-based models

In many countries today, neither banks nor specialized microfinance institutions (MFIs) nor cooperative networks have reached the majority of villages in the rural areas. Even those MFIs that have developed methodologies that enable them to reach the poor are seldom able to reach clients in rural villages beyond secondary towns. This is particularly true in countries with dispersed rural populations, due to high transaction costs coupled with small transaction size. However, financial service providers do exist in villages, including the ubiquitous moneylenders and a variety of informal groups.

Informal and semiformal village-based models, including those using a CDD approach, hold the most promise at the present time in most countries for provision of financial services to people in remote rural areas. Traditional informal savings and credit groups exist virtually everywhere, and have proved to be remarkably resilient over time, with features that have made them indispensable to the financial management activities of the rural poor. Their resilience offers a contrast to the failures of many other models. Many microfinance best practices have evolved from the lessons learned from traditional group mechanisms. Hence, it is important to understand this dimension of rural finance. Informal financial groups can be broadly divided into two categories:

- **Rotating savings and credit associations (ROSCAs)** are unregistered, time-bound groups whose members deposit a fixed amount of money each period. One member receives all the funds collected during that period. The group stays in existence until each member has received a payout. ROSCAs enable their members to receive usefully large sums of money and are simple and easy to manage. However, they are inflexible: members can’t deposit and withdraw funds as needed, so they are not suitable for emergencies or for occasions such as festivals when all members need money at the same time. Amounts saved are usually quite small so they are not generally adequate for the financing of small economic activities.

- **Accumulating savings and credit associations (ASCAs)** are unregistered, time-bound groups whose members deposit a fixed sum each period. Rather than disbursing the funds in rotation, ASCAs loan money to members with interest. At the end of the predetermined cycle, members receive a return on their investment. ASCAs are more flexible than ROSCAs but require greater management skills. As amounts saved are usually small, funds available for lending are also small.

**Success factors** that have contributed to the widespread development of ROSCAs and ASCAs by communities in many parts of the world include:

- a common bond that creates pressure for members to honor their commitments, whether that be to continue saving until all members have received an equal share (ROSCAs) or to repay loans within the agreed time period (ASCAs).
- Members save and, in the case of ASCAs, lend their own money so they have a vested interest in protecting their savings and recovering loans.
• Because the organizational structure is impermanent, and the amounts of money generally small, these groups do not need sophisticated accounting and management skills. Periodic paybacks of capital and earnings that reset the balance sheet to zero has proven to be one effective way for non-literate or semi-literate groups to manage their finances by themselves.

Some countries and organizations have developed models that are essentially revised versions of the basic ASCA. For example, CARE International has implemented a Village Savings and Loan model\textsuperscript{10} in several African countries that retains many of the features of ASCAs, but seeks to improve the prospects for long-term sustainability through training of groups in organizational development topics such as ownership structure, governance, internal rules and financial management. Technical assistance and training is provided through local facilitators, keeping expenses to a manageable level. In India, informal and unregistered self-help groups (SHGs) have been linked to banks, dramatically increasing the number of poor villagers who have been able to access services from the formal financial system.

Factors for success of these semiformal models include the common bond and peer pressure so important for informal ROSCAs and ASCAs. In addition, strong governance structures that limit the ability of any subgroup to dominate, clearly defined policies and procedures, strong internal controls and financial management are paramount. In particular, the members’ strong sense of ownership and commitment are critical to the long-term sustainability of these organizations.

The creation and/or strengthening of second-tier federations of small village-based organizations can help these entities receive important institution-building services that they cannot avail on their own and link them with the formal financial sector (see Box 20). Federations can help their members to set performance standards and monitor performance against the standards. Once standards have been defined and monitored, creating links to banks for refinancing facilities becomes easier. Federations can also provide a link to national and international sources of best practice training and networking.

**Areas for possible Bank interventions**

Informal village-based models are best supported by providing funding for technical assistance institutions that can demonstrate a proven track record of successful work with such models. In particular, the model must be shown to be very low-cost; otherwise, the costs will outweigh the benefits in terms of number of people served. Funding for the development of training materials for non-literate or semi-literate people is important, as is the training and equipping of local people who can become para-professionals, thus continuing the dissemination of the model after an initial phase. Efforts to link such groups to commercial banks may start with the opening of accounts for the safekeeping of savings. Further information can be found on the website of the Rural Finance Learning Center, a joint undertaking of Food and

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**BOX 20 CVECAs of Mali**

The Self-Managed Village Savings and Credit Banks (Caisses Villageoises d’Epargne et de Credit Auto-gérees, CVECAs) have been established in Mali since the 1980s as small, locally-managed savings and credit associations. The CVECAs have formed regional federations with technical functions such as self-regulation through peer monitoring, and they act as financial intermediaries between the National Agricultural Development Bank (BNDA) and the village units. The profits from these operations are used to contract technical services for member units, including auditing services and management training. Unlike traditional cooperative second-tier organizations, the CVECA federations have no office structure and do not provide technical services directly, but through outsourcing. The federations are district-based, ensuring local solidarity. The model has been replicated in several regions within Mali, as well as in other African countries such as Burkina Faso, Gambia, Madagascar and Benin.

Source: Chao-Beroff, R., 1999.
Community-driven development and rural finance

Village-based models are relevant for Bank community-driven development (CDD) projects, especially if they focus on member savings and bank linkage rather than external grants. CDD is an approach that treats poor people and their institutions as partners in the development process. CDD projects strive to devolve control of decisions and resources to community groups, which work in partnership with government and support institutions such as NGOs. Many CDD projects have an “open menu” which enables communities to decide how to spend project resources. Typical investments include community infrastructure such as schools, health clinics and improved roads. However, many communities decide that income-generating activities are a key priority for villagers. If they cannot access funding from banks or MFIs, they sometimes use project resources to set up community-managed revolving loan funds. A recent OED review of microfinance credit lines including revolving funds showed that such funds within World Bank projects have generally not performed well. It is an open question whether or not this trend can be reversed. However, learning from the experience of informal models, it can be hypothesized that success factors include:

- Development of a strong local institution owned by *community members* rather than “the community.” The ownership structure could be either a cooperative or company model in which members buy shares. These members then have a vested interest in the success of the institution. They should be in control of policies and processes, including rules on membership, focus on collective versus individual production, risk management strategies, and setting interest rates.
- Provision of grants for revolving loan funds only after members have saved their own money over a substantial time period and demonstrated an ability to rotate these savings in the form of credit to members.
- Strong technical assistance to build transparent and accountable governance, management and financial systems.

Box 21 provides an example of a CDD project that has made use of these lessons.

**BOX 21 Using the CDD approach in Andhra Pradesh, India**

_The World Bank’s Rural Poverty Reduction Project (RPRP) and District Poverty Reduction Initiative Project (DPIP) in Andhra Pradesh, India_ illustrate the potential for institutional strengthening, scaling up and linkage of informal institutions to the formal financial sector within a project using a CDD approach and having grant funds. Andhra Pradesh (AP) has a well-developed microfinance industry with a variety of institutional models: licensed nonbank microfinance institutions such as Basics, Share and SKS, financial cooperatives and self-help groups (SHGs). SHGs are small groups of 15–20 members coming together to save and lend among themselves; they are significantly different from groups using the Grameen model, in that SHGs are not just solidarity groups receiving financial services but are financial intermediaries themselves. Well-managed SHGs are often able to access loans from local banks, sometimes with funding from NABARD, the National Bank for Agriculture and Rural Development. RPRP and DPIP support the development of SHGs and their federations, Village Organizations (VOs) and Mandal Samakiyas (MSs). VOs are federations of SHGs in a village or cluster of villages, whereas MSs are federations of VOs in a Mandal, the sub-district administrative unit in AP. The success of the bank linkage is evidenced by the linkage of 231,336 SHGs to banks from 2002 to 2004. Since each SHG has about 15 members, over 3 million women have been able to access bank credit. Repayment rates are just below 100%.

Source: Kumar, V. and P. Shah, 2005.
There are several special-purpose institutions and products that are quite suitable for financing rural enterprises and farms, especially larger ones. They are also relevant for small farmers but to a lesser extent. The most important are outlined below.

Leasing, a source of investment capital for rural areas

In many countries, lack of access to long-term financing for capital investments is one the most pressing issues in rural areas. Leasing has long been recognized as one solution, as it allows the circumvention of such financial market imperfections as lack of a collateral registry and collection enforcement mechanism, two of the major obstacles in equipment financing (see Boxes 22, 23, and 24). Leasing is a financing tool where the provider (lessor) owns the equipment and permits the client (lessee) to use it in exchange for periodic payments (lease payments). Leases are also a means of eventually acquiring equipment (and not just its use), as ownership is generally transferred to the lessee at the end of the lease period, either automatically or at a token price.

Leasing is likely to be more accessible and affordable to rural enterprises than credit. Farmers and rural enterprises are particularly constrained by the lack of assets that can be used as collateral. Leasing overcomes this constraint, because no collateral needs to be registered. The lessor is the owner, not just the financier, and the equipment can quite easily be recovered from a lessee who is remiss in paying the lease obligations. Leases typically have lower down payments than loans, making them more accessible to lower income people. In a Bank survey of ten leasing companies in 2003, the surveyed companies indicated that they require down payments of 15% to 25% as compared to 30% to 40% required by banks in those countries for equipment financing. These advantages not only result in faster processing but lower overall transaction costs.

IFC has often initiated the establishment of leasing companies in countries where financial market conditions do not allow for long-term bank financing on commercial terms or where there are no suitable commercial banks. In more developed financial markets, commercial banks often establish leasing subsidiaries to provide long-term financing which are considered too risky for regular bank financing. There is experience, though limited, in micro-leasing and leasing for agricultural equipment.

In general, less rather than more regulation is useful. There should be clear regulations that classify leasing companies as non-deposit-taking financial institutions that are not subject to the restrictions of banking laws, including reserve and liquidity requirements. An enabling legal framework includes equally clear definitions for the legal ownership of leased assets, repossession of
leased assets in case of default, and liability in case of third-party losses. Leasing regulations are in general quite simple and uncontroversial, and thus offer a good opportunity for fast action by policy makers motivated to support rural development. Desirable but not required features include a functioning market for secondhand equipment and affordable and accessible repair and maintenance facilities.

**Areas for possible Bank interventions**

Since special-purpose leasing companies are not licensed to take deposits, they need to develop other reliable sources of refinancing, preferably in local currency. Credit lines from banks or international donors are quite often utilized and could present an opportunity for Bank intervention. Technical assistance and training to develop a skill mix among employees that includes technical knowledge about new equipment, assessment of used equipment and residual values, in addition to general credit skills, would also present a valuable contribution from international donors.

Potential World Bank interventions to support leasing should take advantage of IFC’s experience in this area. In order to achieve maximum impact, interventions should be coordinated with IFC and possibly complemented by an IFC investment. A possible model is IFC’s Private Enterprise Partnership (PEP) initiative, a multi-donor-funded and IFC-managed effort in countries of the former Soviet Union. PEP provided in-country support to introduce enabling legislation and direct technical support to leasing companies. In some cases, there was also an investment by IFC, but this was not PEP’s...
focus. Based on its good experience with PEP in the countries of the former Soviet Union, IFC has decided to extend PEP to Africa and in late 2004 established a PEP office in Johannesburg as a first step.

**Guarantee institutions and guarantee funds**

Loan guarantees are a financial instrument used to move all or part of the credit risk of a specific loan or a predefined group of loans from the underwriting institution, usually a commercial bank, to a guarantee fund or institution. The borrower is charged guarantee fees, in addition to interest costs. Guarantees have long been used to motivate financial institutions to provide credit to special groups, including farmers and SMEs that are considered too risky to be creditworthy on their own merit.

In some countries, such as Turkey, special loan guarantee institutions have been set up; in other cases, a loan guarantee fund may be housed in a regional development agency or other body. Germany, for example, has a whole system of regional guarantee banks in each state that provide guarantees for small business loans and that have been used extensively since reunification. Internationally, loan guarantee institutions and funds were seen as quite negative for some time, for the following reasons:

- **Moral hazard risk on the side of the borrowers** who may not feel a strong motivation to repay the loans, especially if they consider them to be another type of government grant;
- **Moral hazard risk on the side of the financial institutions** that might finance good credit risks without guarantees, and use the guarantees to underwrite loans with a high default risk ("cherry-picking") without proper evaluation and safeguards;
- **Additional transaction and guarantee costs** on top of interest, making a guaranteed loan quite expensive for borrowers, and in many cases not economically feasible;
- **Rapid depletion of loan guarantee funds** as high-risk loans are foreclosed and the guarantee is called;
- **Lack of sustainability of the guarantee institutions over the long term** because they are often not able to charge high enough fees to cover all transaction costs, in addition to the credit risk.

There is a wealth of experience available to underline that this approach is fraught with danger. However, there is a place for carefully designed guarantees that serve as policy instruments to reduce the credit risk for financial institutions interested in providing loans for agriculture, when the attendant risks can be reduced. The IFC, for example, has developed a partial guarantee instrument for portfolios of SME loans.

The most important **success factors** include the following:

- The underwriting institution, usually a commercial bank, should always hold a significant portion of the risk as a first loss to be carried before the guarantee can be called; usually this first loss provision is no less than 5%. The remaining risk should be shared based on a pre-agreed formula. The benefit of a first loss provision is that the bank incurs losses of its own before receiving any reimbursement from the guarantee; this helps to ensure that a thorough credit screening takes place and mitigates the moral hazard risk.
- All loans in a category must be put in the guarantee portfolio to avoid cherry picking, again mitigating the moral hazard risk.
- Early-warning monitoring procedures and strict reporting requirements should be in place and closely followed.

Since IFC has experience in issuing partial guarantees on portfolios of small loans, it is advisable that Bank efforts in that area be coordinated with IFC and focus on those countries and rural areas where IFC may not be able to directly invest.

**Supply chain financing**

Supply chain financing generally refers to the provision of short-term, seasonal credit to farmers by private firms such as input suppliers and processors. Typically, farmers receive inputs from the processor, or credit for inputs through a banking relationship established by the processor. Some arrangements provide additional credit to finance household needs until the harvest. Once the products are ready for sale, they are delivered to the processor, who deducts the credit from the value of the products. The farmer receives the surplus, if any, in cash.

There usually is an established business relationship between the parties, facilitated by mutual
knowledge, while collateral constraints are limited by linking credit with sale of the product financed. Both parties gain through the transaction: the farmer by obtaining working capital financing, a guaranteed market for his product, and technical advice in some cases to ensure that quality standards are met; the processor by securing a reliable source of product for his operation.

Nevertheless, supply chain arrangements can be quite risky for both parties. The risks for the farmers are that the agreed-upon price at contract time might be lower than the market price at harvest, even though it will be sufficient to cover loan and interest repayments. This can provide farmers with an incentive for side-selling; i.e., selling the products to another party at a higher price, repaying the loan from the proceeds and keeping the surplus, unless there are incentives to refrain from doing so. The reverse risk applies to the processors who are committed to purchase at an agreed-upon price, even if the market price at harvest is lower. Processors also run the risk of not being able to obtain sufficient product due to side-selling by farmers, and poor quality of the product supplied. Consequently, these relationships are rarely without hitches.

Credit from formal financial institutions with specialized knowledge of agricultural financing is preferable to supply chain financing, because farming households usually need a wide variety of financial products, rather than credit for one crop only (Box 25). Supply chain financing should, therefore, be considered a second-best solution to the lack of credit for agriculture in a given country. Often, however, in markets where there are no financial institutions providing agricultural loans, it is the only game in town.

Supply chain financing has taken place over many years and in all regions, usually without donor support and as an entirely private sector activity. Only recently has there been donor interest in supporting such activities as a way to increase financing for agriculture. There are several different ways to provide financing through the agricultural supply chain. All of them are directed at commercial, professional farmers who are able to earn sufficient amounts from their farming activities to repay the loans. In order for supply chain financing to be feasible, a sufficiently large volume of outputs needs to be generated so that transaction costs for processors do not become overly burdensome. However, this does not mean that supply chain financing is limited to large farmers only. Small family farmers in many countries have been able to organize input supply and marketing cooperatives that allow them to achieve sufficient economies of scale and some level of bargaining power for their member farmers in relation to processors and traders.

**Characteristics of supply chains**

Supply chains range from rather loose to very tight ties and interrelationships. This is often determined by the economic power of the participants within the supply chain. Tight supply chains bind both parties closely to each other, through enforceable contractual arrangements, as well as through business realities and incentives. Loose supply chains are often non-binding, there are opportunities to circumvent

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**BOX 25 Supply Chain Financing through Small Farmer Producer Organizations in Mozambique**

In Mozambique, small farmers have established self-managed out-grower schemes with assistance of the Cooperative League of USA (CLUSA) program. The program established a two-tier organization of producer organizations and their regional associations. The producer organizations serve as the intermediary between the individual farmer and the agribusinesses/processors that provide short-term production credit and purchase the produce. The producer organizations also provide extension services to the farmers to improve farming methods and quality of the produce, and provide storage and transport facilities.

While out-grower schemes are well established, particularly in the cotton and tobacco sectors, more loosely organized marketing arrangements are prevalent for the cashew, groundnuts, sesame, sunflowers, and maize sectors. At the end of 2002, the program had established over 840 producer organizations involving approximately 26,000 farmers. Repayment reached 96%. The program has been handed over to a local NGO, OLIPA.

Sources: Phillips, R. et al., 1999; and project information at CLUSA International Program Web resource at www.nbca.coop/clusa.cfm.
the arrangements, and the relationship is maintained mostly through mutual business interests.

Very tight supply chains leave little room for variant actions. These arrangements, often referred to as either coordinated supply chains or integration contracts, are durable arrangements between producers, processors and buyers about what and how much to produce, time of delivery, quality, safety conditions and price. Contract farming is one example of such a relationship. In this case, the farmer utilizes some of his own inputs (premises, land, labor, etc.) while other inputs are supplied by the contract partner. In return, there are relatively assured income streams if the agreed upon production goals are met. Examples are the poultry industry in Brazil, where the farmer supplies labor and buildings, but all other inputs are supplied by the processor; sugar beet growers in Poland; and sugar cane growers in Brazil as outlined in Box 26. This approach is extensively and successfully used in transition economies (Box 27).

Other supply chains are organized much more loosely, with the respective bargaining powers of the partners based on economic realities. If farmers have opportunities to profitably sell outside the supply chain, they have a significantly better bargaining position.

Specialty arrangements

Agro-service centers

In a number of Bank partner countries, large international input suppliers such as Monsanto and Novartis have established distribution networks, which deliver their inputs to farmers on conditional sales of the crops, both in-kind and at predetermined prices. This solution, which is imperfect from the farmers’ standpoint, allows the companies to sell their products to farmers who have little bargaining power, as they have no other financing alternative.

Pre-financing of international commodity export trade

Pre-export financing is mainly done for non-perishable commodities like cereals, coffee, and cotton (Box 28). It only works for clients, such as well-managed cooperatives and commodity boards, that have an excellent export performance track record.

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**BOX 26  Supply Chain Financing in the Sugar Industry in Brazil**

Sugar mills in Brazil offer integration contracts to sugar cane farmers in order to secure access to their produce. Farmers who enter the annual contracts receive three payments, the first at contract entry, the second upon delivery of the product to the mill, and the final payment at the end of the season after the final prices for the end products, sugar and ethanol, are known. The advances are interest free, and allow farmers to smooth annual cash flows.


**BOX 27  Supply Chain Financing in Kazakhstan**

In Kazakhstan, commercial banks provide credit lines to processors of cotton, soy, and wheat. The processors then provide loans to their potential suppliers for agricultural inputs, rental of equipment, etc. Farmers producing these commodities have access to market information and are contractually free to sell their harvest to any party of their choice. However, all participating farmers are required to maintain accounts at the lending bank and the bank has the authority to transfer funds from the borrowers’ accounts to the processor’s account, up to the value of the loan. In reality, since the markets for these commodities are quite transparent, there is little advantage to farmers’ side-selling, not repaying the loan and thus risking the receipt of loans in subsequent years. Consequently, within this supply chain, there is a lasting client-customer relationship.

Medium-term supply chain financing through the banking system

A bank or other financier can play an important role in setting up a market-oriented supply chain, for the benefit of all segments and participants, by organizing a tailor-made credit line that connects the different segments (Box 29).

Areas for possible Bank interventions

Historically, supply chain financing has taken place in developing countries as a response by processors and traders to a lack of credit for farmers. It has usually been done on a fully commercial basis, without donor involvement or support. However, supply chain financing as a tool to increase the supply of credit to farmers offers several opportunities for Bank involvement:

- On the legal and regulatory level, assistance to develop transparent and enforceable contract law.
- Since all suppliers of credit to farmers need refinancing themselves, support to commercial banks to motivate them to undertake such financing.
- If the bank is providing the funding to the end-client under a tied arrangement with the processor, the support could be in the form of technical assistance to install monitoring and control systems within the bank or the processor’s specialized credit department.
- Financial assistance in the form of a credit line, where appropriate (see section on credit lines in Chapter 3), or a guarantee arrangement could also be envisioned.
- In order to facilitate the participation of small farmers in a supply chain financing arrangement, support to create and strengthen small farmers’ associations or cooperatives that would act as direct partners for processors and other purchasers. These associations, which would represent a number of farmers, would enable the processors to lower their transaction costs.

Setting up an arrangement for long-term financing requires the strong involvement of private sector agribusinesses and financial institutions, so is probably outside the scope of most Bank-supported rural finance projects. However, there is a significant role for IFC.

**BOX 28 Pre-Export Financing through Price Risk Management in Tanzania**

Tanzanian coffee cooperatives were restricted in their ability to obtain bank credit due to the risk of variations in international commodity prices that could compromise their ability to repay loans. Rabobank International developed a put-option for the coffee cooperatives, which assured the cooperatives a minimum price for their future produce. This provided the banks with more certainty with respect to the cash flow of coffee growers, resulting in increased credit to the cooperatives, which in turn extended loans to their members.


**BOX 29 Supply Chain Lease Contracts in Russia**

The Agricultural Finance Company (AFC) in Russia provides farm equipment leasing contracts to farmers in the dairy sector in the Moscow region. The dairy processor selects the farmers eligible for AFC leasing contracts. Farmers make down payments and agree to the processor’s withholding the balance of the lease contract. The processor transfers the payments directly to AFC. Equipment suppliers have entered into buy-back agreements with AFC in case of repossession of equipment due to default. The contract is advantageous for all parties involved: the processors secure their inputs from the farmers, the farmers obtain medium-term finance for capital goods, and the equipment vendors increase their market through this arrangement.

Cross-cutting issues of risk management, technological innovation and specialized collateral arrangements

There are many cross-cutting issues that fall into the area of general financial sector development but that are also important for rural finance. For the purposes of this approach paper, only those cross-cutting issues that are crucial for the development of sustainable rural finance or that apply specifically to financing for agriculture are covered.61

Technological innovations to reduce transaction costs and to achieve greater outreach for financial institutions

High transaction costs are one of the major factors limiting the expansion of rural financial services. Most financial institutions, even if interested in increasing outreach to rural areas, would be dissuaded by the high cost of processing a large number of generally small transactions in villages across a broad geographic area, and the challenge of maintaining the quality of such a portfolio. Small transactions in general require nearly as much oversight as larger ones, while providing a much smaller return.

Some commercial banks, as well as microfinance institutions, have developed technology-based solutions.62 These technologies range from debit and credit cards, to personal digital assistants (PDAs), to new delivery channels such as ATMs, mobile banking units, and internet banking.63 Use of many of these technologies for rural finance is still in the design or pilot stage, so the suitability has not yet been proven; however, there are some promising developments.

Technologies for rural areas in developing countries need to be adapted to the respective environment. Transferring solutions from developed countries with strong communication networks to developing countries with limited infrastructure may result in expensive yet unsustainable applications. The following principles are good benchmarks: simple and easy to use, wireless, low power, durable, reliable, with a low cost through shared access, low maintenance, or high volume.

Examples of rural finance institutions and companies in supply chains developing and implementing innovative technologies include Mongolia’s Khan Bank, Uganda’s Microfinance Union, and India’s ITC (Box 30).

Lessons learnt so far include the following:64,65

• Information technology (IT) does not replace poor management in financial institutions. On the contrary, good management practices must be followed in order to apply and extract the value of technology solutions.
• Deploying technology successfully involves much more than simply acquiring the technology; it requires a clear set of business goals, objectives and strategies in order to establish resource priorities and requirements.
BOX 30  Three Institutions using technological innovations

**Khan Bank of Mongolia**

*Increased security and ease of access through an extensive network of computerized branches*

Mongolia is a large country with vast and thinly populated rural areas traversed by nomadic herders. Khan Bank has a branch network of nearly 400 branches, of which 76 are currently online. They are working to bring the remainder of the branches online over the next few years. Historically, nomadic herders have not used banks, relying instead on a barter system for payment from customers. Through favorable interest rates on savings, the extensive branch network and targeted marketing, Khan Bank has drawn herders into their customer base. These nomadic herders have discovered the convenience, security and power of depositing their money into the Bank at one location, then following their regular seasonal patterns of movement across the country and being able to access their deposits from other branches of the bank. The bank has now provided herders with nearly 30,000 loans as well as deposit accounts.

**Cross-border debit cards**

In October 2004 Khan Bank began offering debit cards to cross-border traders traveling to China. Historically the traders would receive a loan from Khan Bank in the Mongolian currency, the togrog. Carrying the cash long distances, they would exchange the loan into Chinese yuan near the border, then purchase the goods and travel back to Mongolia to sell them for togrog and repay their loan. Khan Bank now cooperates with the Agricultural Bank of China, the fourth largest bank in China, to accept Khan Bank debit cards at ATMs and point of sale (PoS) devices, enabling cashless travel and transactions for the traders, who thereby have a greatly reduced risk of theft of funds. This in turn reduces Khan Bank’s risk of theft-related default. The bank is planning to offer the reverse opportunity for Chinese traders and to replicate the services along the Russian border.


**Uganda Microfinance Union**

*Using technology-equipped agents to create low-cost access to services in rural areas*

The Microdevelopment Finance Team led by Hewlett Packard is testing a point of sale (PoS) payment solution in Uganda with Uganda Microfinance Union (UMU). The system enables transactions to be made in rural locations at a much lower cost than equipping and operating a branch office. Agents with liquidity management skills and fixed locations in rural communities are provided with a wireless PoS device that has an 11-hour battery, smart cards, and a web-based transaction management application that can handle savings deposits, loan payments, withdrawals, and fund transfers. Transactions are transferred through the local mobile phone infrastructure to UMU’s management information system. Transactions are uploaded at least once a day, but can be sent more often depending on airtime charges and the volume of transactions. The application provides customers with longer hours of service than a bank, reduces the distance that customers must travel from 20 km to less than 5 km, thus reducing both transaction cost and risk, and creates more incentives to save. The system creates a customer payment history that can then be used for credit decisions, risk modeling and product development.


**The Indian Tobacco Company**

The Indian Tobacco Company (ITC) realized that the long supply chain for agricultural produce resulted in inefficiencies for ITC and high transaction costs for the farmers. In order to shorten the supply chain, ITC introduced its e-choupal initiative in 2000, setting up computer terminals and internet connectivity in villages (choupal means “village meeting place” in Hindi), to enable farmers to access information about prices, weather, farming methods and soil testing, as well as to order agricultural inputs. The terminals are operated by one elected farmer per village, the sanchalak, who earns a commission on each completed transaction. Farmers receive instant quotes for their produce, and instant payments for their sales after transporting it to ITC collection centers. This technology enables ITC to reduce its handling costs by 30% and farmers to reduce their transaction costs by up to 68%. Farmers also benefit from better availability of inputs, increasing productivity. As of December 2004, ITC has reached over 3 million farmers, creating links to companies, government departments and universities. Trials are underway to offer insurance products and agricultural credit.

• A centralized, reliable and robust management information system provides vast amounts of data. Learning how to analyze the data and use the resulting information for business decisions is in many cases a major challenge.

• Leadership within an institution is critical. Key decisions regarding technology strategy and initiatives must be made by senior executives, not left to the IT manager.

• Strategic partnerships with experienced technology providers are critical in making technology initiatives affordable. In many cases, shared infrastructure is a decisive element needed to reduce costs and make services affordable.

• Significant funding for quality technical assistance is imperative, so as to leverage the expertise of those who have gained experience doing this type of project, whether the services are procured from the vendor, a third party provider, or another financial institution that has been involved in a similar undertaking.

Supporting financial institutions to pilot innovative technology solutions that enable them to reach rural customers at a reasonable cost might present an area of intervention for the Bank, especially when there are strong private sector partners and significant potential for scaling up.

Risk management instruments for financing for agriculture

Farmers (and their lenders) are exposed to risks that are in addition to those facing other credit clients. Some of these risks are idiosyncratic risks that affect a single household, while others are covariant in nature and affect an entire region or country at the same time. Weather risk is probably the single most important risk influencing the outcome of a farmer’s investment. Price risk, especially for internationally-traded commodities, can also be quite substantial.

On an individual level, farmers have always developed risk management strategies, ranging from crop diversification, adoption of low-risk and low-yield crops and production patterns, to self-insurance through extended family relationships and use of money lenders in an emergency. However, these strategies do not protect a farmer when large amounts have been borrowed from a financial institution that need to be repaid following the harvest, but the harvest fails. Nor do they protect a financial institution that has made many loans for that crop.

Governments in developed and developing countries have attempted to manage these risks for their rural populations by establishing commodity price guarantees, buffer stocks or stabilization funds, and providing crop insurance in case of natural disasters. These efforts have had mostly negative results, such as huge inefficiencies and costs to the government budget, with a paltry payout for individual farmers. Moral hazard and adverse selection are also major factors, since these measures provide the same kind of protection to honest and dishonest and good and bad farmers alike. It is now Bank policy to discourage partner countries from adopting such policies, and the Bank is actively exploring other, private sector-based ways to manage agricultural risks.

Price risk management instruments for commodities

Strong price fluctuations for internationally traded commodities such as coffee, cotton, and maize can be managed through the purchase of hedging instruments that are available in international financial markets. However, derivatives contracts, futures and options are not traded for all commodities. For many products such as sesame and cashew, there are no contracts traded on international and local exchanges, and therefore, no price risk management instruments available. Even when price risk management instruments are available on international exchanges, the movements of prices on these markets may not be an accurate reflection of price movements in local markets. This disjuncture between local and international markets, called “basis risk,” often makes contracts traded on international markets inappropriate as instruments for managing price risks in local markets.

If a price risk management instrument is available, it might be quite expensive, so a financial institution would need to go through a series of steps in order to determine the suitability of using it. The institution would first need to determine the nature, level and timing of its primary risks. Once this has been done, and the financial institution has...
determined that a market-based price risk management instrument is the best way to manage that risk, the institutional capacity of the bank is the key to successful implementation. Success factors include the following:

• The financial institution should have a significant commercial stake in the use of the instrument;
• The hedging instrument should cover significant volumes of loans;
• Top management should provide strong support; and
• Managers and staff should receive in-depth training.

Although this approach has only limited applications for financing for agriculture within rural development, it can represent a breakthrough for some of the Bank’s partner countries, and pilots have been supported by Agriculture and Rural Development Department’s (ARD) Commodity Risk Management Group (Box 31).66

Index-based weather risk management instruments

Index-based weather insurance is based on objective, easily verifiable data. It uses official measuring stations to measure levels of annual or seasonal rainfall over time and determines the correlation of the level of rainfall to harvest success. Insurance can then be written against lack or excess of rainfall. Index-based weather insurance solutions can protect financial institutions that are exposed to weather risks against declines in repayment rates in the case of severe weather events and protect the farmers who have taken out loans.

Risk management products based on weather events and indices such as area yields avoid the problems of traditional crop insurance because they rely on objective observations of specific events that are outside the control of either farmers or insurance companies. They are also less costly to administer because they do not require individual contracts, on-field inspections and loss adjustments. These contracts are written as insurance or derivatives and rely on the close correlation between the farmers’ exposure, such as yields, to an index, such as cumulative rainfall per season. The contract payouts are therefore not settled on the basis of actual losses incurred, but on the basis of the index, which makes payouts more timely and objective. However, index-based contracts introduce basis risk; that is, the potential mismatch between payouts and actual losses.

The development of weather risk management programs generally entails the following:

• Identification and quantification of weather-related risks and correlation with production losses.

<table>
<thead>
<tr>
<th>BOX 31</th>
<th>Price Risk Management in Tanzania</th>
</tr>
</thead>
</table>
| Lending for primary commodities in Tanzania has faced traditional obstacles such as a lack of collateral, price and weather volatility, and often times poor management by borrowers. In the late 1990s, as a result of these constraints, an agricultural lending institution which was the third largest bank in Tanzania was faced with the prospect of withdrawing much of their lending to the coffee and cotton sectors. To overcome its exposure to weather risk, the bank used collateral management. But even with collateral management, the bank remained exposed to significant price volatility.

In order to continue lending and to protect itself against price risk, the bank began working with the Commodity Risk Management Group at the World Bank to learn more about price risk management instruments in order to manage their exposure and their clients’ exposure to price risk. The bank believed that by using price risk management instruments as well as collateral risk management, they would be able to better manage their exposure to commodity risk. To do this, CRMG helped train their staff on how to use these instruments and provide risk management services to their customers. In 2004, a large ginner located in the northwestern cotton growing area, purchased a price risk management contract in order to protect itself against a fall in the cotton price. During the 2005 crop season, the bank plans to introduce this product to additional customers.

Source: Bryla, E., Personal Communication February, 2005. 66
World Bank forthcoming a

• Assessment of the meteorological infrastructure. This is key, since good weather data and analysis that enable correlation of weather events to crop losses are central to the success of such programs.
• Design and pricing of prototype insurance contracts that compensate for losses.
• Explanation and testing of contracts with users/beneficiaries.
• Identification of institutions that are involved on the supply side of weather-based insurance, particularly insurance companies and international re-insurance companies.

The Bank, through CRMG, has supported a successful pilot project in India, as outlined in Box 32.67

There is significant interest world-wide in this product. Evidence from India, where self-help women’s groups have purchased the insurance, indicates that even smallholder farmers are willing and able to shoulder the costs of insurance premiums as well as interest charges on loans, if the cost of self-insurance through techniques such as well-digging or over-diversification are clearly greater. The mainstreaming and scaling-up of the weather insurance product for India for the 2005 and 2006 monsoon seasons is expected to demonstrate the applicability of this instrument to a wider market. However, pilots in other regions are needed, and issues such as the affordability of insurance premiums and basis risk have to be better understood before such programs can be extended to other regions on a large scale.

Insurance premiums, coupled with the interest charged by financial institutions on their loans might well make a farmer’s investment unprofitable except for high return crops. In addition, the ability and willingness of local lending banks to recognize the risk reduction for individual agricultural loans, and reward this risk reduction through a reduction in the interest rate charged to the client is quite unclear. Recent experience on lenders’ willingness to reduce interest rates, based on the reduction of risk from credit guarantee mechanisms, suggest that this could be difficult.68

Specialized collateralized lending

Traditional bank lending always requires collateral. The underlying collateral of a bank loan is, however, only considered as a secondary source of repayment, to be mobilized in case of default. The first source will be the enterprise’s operating performance, i.e. revenue earned. In contrast, in specialized arrangements, specific goods are dedicated as collateral and secured for the use of the financial institution at the time the loan becomes due. The creditor has no right to other assets of the borrower. These arrangements considerably reduce the risks to the bank if the goods given as collateral are easily identifiable, there are officially recognized quality standards, the goods can be securely stored, title to the goods can be assigned fast and at low cost,

BOX 32  Weather Risk Management in India

In 2003, BASICS, a microfinance organization in Andhra Pradesh, India whose principal customers are small rural farmers, introduced the first index-based weather insurance program in the developing world, in collaboration with a local insurance company. The farmers who borrow from BASICS are affected every year by monsoon rains. When faced with excess rainfall, they lose their groundnut crop. This risk has implications for farmers even in years when monsoon rains are good, because they worry about the adverse effects of a bad monsoon and alter their production patterns to be less risk adverse. BASICS faces the same negative impacts of the monsoon due to increased defaults.

As a result, both BASICS and the farmers had a mutual interest in the development of a product that would protect them against this risk. In conjunction with a large insurance company that was looking to expand its outreach into the rural sector, BASICS developed an index-based rainfall insurance product. This insurance product triggers an insurance payment to farmers when the amount of monsoon rains rises significantly above the mean. These insurance contracts were sold to farmers in the rural sector, protecting both the farmer and the lender against bad monsoon rains.

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and there is a ready market for sale of the goods. One such arrangement of special relevance for rural finance with regard to financing for agriculture is warehouse receipts.\(^{69}\)

In warehouse receipts financing, the underlying collateral is a commodity such as grain, cotton, coffee, cocoa and vegetable oil, to name a few. The process works as follows. After harvest, the goods are graded and stored in a warehouse. The farmer receives proof of ownership and proof that he cannot access the goods without release from the bank. With these instruments, he can then apply for credit from a bank against the stored goods. The amount of the loan depends upon the value of the underlying collateral, the transaction costs that the bank will incur when selling the commodities in case of loan default, and the potential decrease in value due to price fluctuations. At a later time, presumably when the price level is more favourable to the farmer than right after harvest, the farmer sells the coffee to a trader or processor. The purchaser pays off the loan plus interest and obtains release of the coffee from the warehouse by showing proof of ownership of the coffee (provided by the farmer) and payment of the loan (provided by the bank).

A specialized form of warehouse receipt are repurchase agreements (repos), where the financial institution actually purchases the goods and obtains clear title, while at the same time signing a repurchase agreement with the seller, obligating him to repurchase the goods at a certain point in time at a pre-agreed price reflecting the costs of the funds advanced to the farmer. Repurchase agreements are advantageous in environments with inadequate laws and regulations, or weak enforcement with regard to registration of pledges and foreclosure mechanisms.

Warehouse receipt financing and repurchase agreements allow farmers to choose the timing of their sales; as a result, they often obtain better pricing than would be possible at harvest time. This type of collateralized financing is used extensively in developed countries; in developing countries, there are often significant obstacles that need to be overcome.\(^{70}\)

### Possible areas for Bank interventions

All three cross-cutting issues outlined above offer areas for Bank interventions. Since the enabling legal and regulatory framework is often the decisive factor in the success of such an approach, interventions at that level are desirable.

A second important area of intervention is capacity building within local banks. Instruments such as weather insurance, hedging instruments for price risk management and specialized collateral are fairly complicated and sometimes counter-intuitive. Local banks need to learn about these instruments, preferably firsthand. Once a decision has been made to utilize one of these instruments, procedures for approval, monitoring, and collection need to be developed and installed, and management and staff need to be trained. Information and training need to be provided to the farmers and other stakeholders as well, in order for them to make informed decisions.

The Bank could conceivably take on a role to kick-start the development of such mechanisms in selected countries, in cooperation with private sector partners. Once a pilot demonstrates the merits of such an undertaking, the private sector actors would carry it forward.
The preceding chapters have discussed the three pillars of rural financial sector development: policy, infrastructure and the development of financial institutions. The success factors related to many delivery channels have been outlined and models discussed that could potentially be relevant for Bank programs. The use of products such as leasing, guarantees and financing through supply chains have also been covered. How, then, can task managers decide on a set of interventions for a rural finance program or component from among all these options?

The following matrices were developed as decision tools for both stand-alone rural finance projects and for project components. They provide the framework for a first and preliminary analysis, allowing an informed stop-go decision. If the decision is made to go ahead, then the matrix will guide in the choice of delivery channel. The budget for the analysis, as well as complexities within a country and availability of other relevant studies, will determine the level of analysis. This could range from a two-week consulting assignment for a desk study that seeks to inform the design of a project component, to an in-depth analysis that uses the matrices as a roadmap to develop a rural finance strategy for a country.

As rural finance is a complex subject, design and implementation requires specialist knowledge. It is therefore suggested that all project teams include an experienced rural finance specialist. Failure to identify the need for rural finance during project design can lead to the belated design of “a credit patch” that does not lead to the creation of sustainable institutions. The matrices might be helpful in such a situation, as well as in post-conflict, post-disaster situations where there is a political mandate “to do something now,” i.e. without systematic analysis and transparent process. However, the limitations of this type of use must be recognized.

This chapter outlines a three-step approach to strategy formulation. In the first step, information on the key elements of the policy context, enabling environment and financial institutions are collected and analysed, along with information on the characteristics and structure of the real sector. The findings from this analysis are then coupled in the second step with an analysis of the demand for financial services in the proposed project area. Taken together, this analysis should enable the principal strategic focus of the project to be developed. The third step concludes the analysis with the identification and prioritisation of intervention options. This three-step process is obviously a simplification of the project design process; the intent is to provide a structure that will guide task managers and help to ensure that all important elements are considered.
### MATRIX 1. Country diagnostic matrix: rural financial sector development

<table>
<thead>
<tr>
<th>Real sector</th>
<th>Policy and enabling environment</th>
<th>Financial sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geographic and climatic aspects</td>
<td>Policy and enabling environment</td>
<td>Banking sector</td>
</tr>
<tr>
<td>• Population density</td>
<td>• Macro economy</td>
<td>• Financial sector depth/breadth</td>
</tr>
<tr>
<td>• Mix of cities, towns and villages in rural areas</td>
<td>• Political stability</td>
<td>• Financial institutions efficiency/soundness</td>
</tr>
<tr>
<td>• Influence of disasters, epidemics, etc.</td>
<td>• Direct participation of government in the rural financial sector</td>
<td>• Presence of larger banks, including state-owned banks, in rural areas and the extent to which they serve farmers and low-income people</td>
</tr>
<tr>
<td>• Soil fertility</td>
<td>• Subsidies that distort rural financial markets</td>
<td></td>
</tr>
<tr>
<td>• Rainfall</td>
<td>• Presence of credit information registries, training institutes, and other financial sector</td>
<td></td>
</tr>
<tr>
<td></td>
<td>infrastructure</td>
<td></td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Legal (real economy)</td>
<td>Nonbank financial institutions (NBFIs)</td>
</tr>
<tr>
<td>• Transportation</td>
<td>• Creation of laws for secured transactions</td>
<td>• Presence and composition of NBFIs in rural areas (finance companies, cooperatives, MFIs, etc.)</td>
</tr>
<tr>
<td>• Communication</td>
<td>• Bankruptcy laws</td>
<td>• Depth and breadth of outreach to farmers and low-income people</td>
</tr>
<tr>
<td>• Water and sanitation</td>
<td>• Leasing laws</td>
<td>• Efficiency/soundness</td>
</tr>
<tr>
<td>• Electricity</td>
<td>• Land rights</td>
<td>• Grants and subsidies that may create an uneven playing field</td>
</tr>
<tr>
<td>• Market infrastructure</td>
<td>• Degree of enforcement of above laws</td>
<td></td>
</tr>
<tr>
<td>• Availability and affordability of high-quality inputs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production and processing</td>
<td>Regulatory and supervisory (financial sector)</td>
<td>Products and services</td>
</tr>
<tr>
<td>• Agriculture production structure</td>
<td>• Banking regulation in general</td>
<td>• Availability of and access to household saving facilities</td>
</tr>
<tr>
<td>• Structure of supply chains</td>
<td>• Regulation and supervision of nonbank rural finance institutions</td>
<td>• Supply chain financing</td>
</tr>
<tr>
<td>• Level of know-how</td>
<td>• Analysis of above with respect to expansion of access to financial services</td>
<td>• Rural leasing products</td>
</tr>
<tr>
<td>• Market penetration (commercialisation)</td>
<td></td>
<td>• Risk management instruments</td>
</tr>
<tr>
<td>• Degree of specialization, maturity of rural economy</td>
<td></td>
<td>• Warehouse financing facilities</td>
</tr>
<tr>
<td>• Prevalence of rural non-farm private enterprises, including agribusinesses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>and processors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Access to agricultural extension and business support services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural finance, relevant donor-financed activities and projects in the real sector</td>
<td>Rural finance, relevant donor-financed activities and projects on the macro and meso levels</td>
<td>Rural finance, relevant donor-financed activities and projects at the institutional level</td>
</tr>
</tbody>
</table>

Source: Project team.
Step 1: Preparation of a country diagnostic matrix

Strategy formulation starts with data collection and analysis. The country diagnostic matrix (Matrix 1) provides an overview of all relevant aspects of the real economy, as well as the policy context, enabling environment, and financial sector of a country, including the financial institutions that provide services to rural residents. The range of topics in this matrix is a fairly complete list and could be narrowed depending upon the context and the available resources.

Within the real sector, the current production structure and the potential for farming and non-farming private enterprises should be analysed, along with relevant aspects of geography, climate and infrastructure. In addition, existing support services such as extension services or business development services should be identified.

The data gathering for the financial sector includes information on all types of financial intermediaries, from commercial banks to nonbank financial institutions to semiformal and informal financing mechanisms. It should include supply chain financing, which quite frequently is at the core of the financial services supply for rural producers. The availability of risk management instruments should also be evaluated. As rural finance is an integral part of the country’s financial sector, a special effort should be made to understand the strengths and weaknesses of the financial sector overall, as well as the rural finance subsector. The extent to which the various types of financial intermediaries serve farmers and low-income people, including those in remote rural villages, should be analysed as well as the features of the products and services that are provided.

The laws governing the real economy and the financial sector, as well as the meso-level institutions that support them, drive the analysis of the policy and enabling environment. This analysis covers the macroeconomic situation, regulatory framework, supervisory structures, and laws that affect financial transactions, including the level of enforcement of these laws. Initiatives that could at least partially compensate for a poor legal environment should be analysed as well.

For all three categories, relevant donor activities should be identified, as proposed strategies should build on these or at least guarantee consistency.

Step 2: Formulation of core strategic focus

This step adds an assessment of the demand for financial services to the information gathered within the country diagnostic matrix. Based on this information, a first assessment of the nature and extent of the problems that the project wishes to tackle can be made, as well as a preliminary identification of the main strategic focus.

“Effective demand” is defined as demand from people who would be willing and able to utilize and pay for the financial services demanded. In rural areas with high effective demand, many commercially-oriented farmers operate and the nonfarm rural sector is dynamic. At the other extreme are rural areas where farmers produce crops primarily for household consumption and there are few nonfarming economic activities. In the middle are rural areas that have characteristics containing elements of both of these more extreme cases: many small farmers have commercial activities, and the nonfarm sector is a mix of medium and small companies, as well as family-based micro enterprises.

Each of these scenarios for effective demand requires a different set of interventions. For example, in a country, or region of a country where effective demand is low because most farmers are producing crops primarily for household consumption and there is a low level of economic activity not related to agriculture, it would be difficult for most formal financial institutions to cover the cost of extensive rural outreach due to a small customer base with small financial requirements. In such a situation, encouraging banks to reach out to the rural areas might not be the best intervention. Instead, a program might focus on activities that would translate potential demand into effective demand. This could include creating awareness of economic opportunities, providing extension services to farmers and building essential economic infrastructure, such as farm to
market roads. Over time, such assistance would lead to the creation of economic opportunities for households, small entrepreneurs and smallholder farmers who only then would be in a position to actively demand and utilize a broad range of financial services.

The critical determinants for the evolution of the supply of financial services are the regulatory, legal, and enabling environment, as well as the level of government intervention. As with demand, the supply side can be subdivided into three broad categories. The first category comprises rural financial sectors that show very promising developments in the supply of financial services, such as successful reforms of publicly-owned rural banks; privately-owned commercial banks with innovative delivery channels for rural clients; microfinance institutions that are expanding into rural areas; and/or rural financial cooperatives that are profitable and have strong governance and management systems that are likely to be operating within a supportive regulatory, legal, and enabling environment. The second is defined by some deficiencies in the environment that have constrained the number of financial intermediaries that are operating profitably and are interested in serving farmers and low-income clients. The third has such a poor environment that the development of the rural financial sector is very difficult.

Although it goes without saying that countries, and regions within countries, when analysed in detail, are rather different from each other, a typology can be developed that categorizes countries, or specific regions within countries, according to the level of development of these related factors. A typology has been developed to provide task managers with a framework that enables them to compare the strategic approach contemplated for the project under design with that of other similar countries. The typology is a matrix that outlines seven different combinations of interventions that could form the core strategic focus of a project with differing levels of demand for and supply of financial services, as well as differing levels of development of the policy and enabling environment.

The seven different country typologies are shown in Matrix 2. There are seven typologies rather than nine, because the two extreme cases will hardly be found in reality. In each case, a different emphasis and focus should be applied when strategies are formulated. For example, if a country performs poorly at the macro and enabling environment levels but demand is already evolving and financial intermediaries are providing some services to farmers and low-income people, policy dialogue and enabling environment obstacles could be emphasized. If the macro and enabling environments are moderately acceptable, addressing the needs of financial intermediaries could be the cornerstone. But if low effective demand is combined with strong deficiencies that distort the development of financial markets, normally only state-owned banks and informal/semiformal financial providers could be expected to provide services to small farmers and low-income villagers. Under such circumstances, the strategy should focus on measures that support effective demand, such as infrastructure improvements and production-enhancing technologies, as well as policy dialogue.
## MATRIX 2. Typology of countries (or regions within countries) and examples of core strategic focus

<table>
<thead>
<tr>
<th>Good enabling environment, many providers of financial services to farmers and low-income people in rural areas</th>
<th>Some deficiencies within enabling environment, some providers of financial services in rural areas but not providing a diverse range of services to farmers and low-income people</th>
<th>Significant deficiencies in enabling environment, few providers of financial services to farmers and low-income people</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Demand</strong></td>
<td><strong>Demand</strong></td>
<td><strong>Demand</strong></td>
</tr>
<tr>
<td><strong>High effective demand: many commercial farmers and off-farm economic activities</strong></td>
<td><strong>Evolving demand: farmers have a mix of consumption and commercial crops, which supports a growing set of off-farm economic activities</strong></td>
<td><strong>Low effective demand, with farmers mainly producing crops for consumption and few opportunities for off-farm economic activities</strong></td>
</tr>
</tbody>
</table>
| Focus: Advanced products and efficient financial institutions (FIs)  
- Technical assistance to develop advanced products, including risk management instruments  
- Technological innovations to reduce FI transaction costs  
- Lines of credit to improve access to term financing | Focus: Enhanced demand and efficient financial institutions (FIs)  
- Improved access to markets and information  
- Increased farmer productivity  
- Technical assistance to FIs to broaden range of products  
- Technological innovations to reduce FI transaction costs | Focus: Enhanced demand; enabling environment and economic infrastructure improvements; focus on savings; efficiency of FIs  
- Production-enhancing technologies and extension services  
- Enabling environment improvements  
- Improved economic and social infrastructure such as small-scale irrigation, roads, health, and education  
- Technical assistance to low-cost FIs that can operate in low-demand environment (e.g. membership-based institutions such as village savings and loan associations)  
- Matching grants for asset acquisition by very poor |
| **Supply** | **Supply** | **Supply** |
| **Low effective demand, with farmers mainly producing crops for consumption and few opportunities for off-farm economic activities** | **Evolving demand: farmers have a mix of consumption and commercial crops, which supports a growing set of off-farm economic activities** | **High effective demand: many commercial farmers and off-farm economic activities** |
| Focus: Efficiency and outreach of FIs; enabling environment improvements  
- Technical assistance to FIs to expand ability to profitably provide products and services to a broader set of rural people  
- Enabling environment improvements such as credit information systems | Focus: Enhanced demand; efficiency and outreach of FIs; enabling environment improvements  
- Improved access to markets and information  
- Increased farmer productivity  
- Technical assistance to FIs to expand ability to profitably provide products and services to a broader set of rural people  
- Enabling environment improvements | Focus: Policy dialogue, enabling environment improvements; enhanced demand; informal and semiformal delivery channels  
- Policy dialogue on key issues in policy and enabling environment  
- Improved economic and social infrastructure such as small scale irrigation, roads, health, and education  
- Improved access to markets and information  
- Increased farmer productivity  
- Membership-based institutions such as financial cooperatives  
- Informal and semiformal savings & loan groups |
| Focus: Policy dialogue, enabling environment improvements; enhanced demand; informal and semiformal delivery channels  
- Policy dialogue on key issues in policy and enabling environment  
- Improved economic and social infrastructure such as small scale irrigation, roads, health, and education  
- Improved access to markets and information  
- Increased farmer productivity  
- Membership-based institutions such as financial cooperatives  
- Informal and semiformal savings & loan groups | Focus: Advanced products and efficient financial institutions (FIs)  
- Technical assistance to develop advanced products, including risk management instruments  
- Technological innovations to reduce FI transaction costs  
- Lines of credit to improve access to term financing | Focus: Enhanced demand; enhanced demand and efficient financial institutions (FIs)  
- Improved access to markets and information  
- Increased farmer productivity  
- Technical assistance to FIs to broaden range of products  
- Technological innovations to reduce FI transaction costs |

Source: Project team.
Step 3: Prioritising the options and coming to a decision

The country diagnostic matrix and the typology of countries provide the basic information that allows for a formulation of a rural finance strategy for a specific country. Once the core strategic focus has been identified, intervention options can be listed and prioritized, according to the broad categories already defined within the country diagnostic matrix: the real sector, the financial sector and the policy and enabling environment. For a relatively transparent process of prioritization, a simple decision matrix as shown in Matrix 3 can be applied according to the following three criteria: proposed output or results of a specific intervention, comparative advantage of the Bank, and level of resources required.

The assessment should in all cases take into account the status of existing or planned projects of other donors, government priorities, and the respective Country Assistance Strategy (CAS) and Poverty Reduction Strategy Paper (PRSP). In addition, Financial Sector Assessment Papers (FSAP), which have very restrictive confidentiality requirements and often do not focus on rural finance, can be useful for those countries where they include rural finance and their content can be made available to a wider audience.

However simple the decision matrix structure may be, following the procedure helps create a certain degree of transparency, as priorities have to be made explicit from among the range of possible interventions. In addition, it forces analysts to be systematic and to ensure that all important elements are considered. Even if most cases will be more complex than what can be captured within this three-step process, this approach to strategy formulation provides a logical and straightforward basis for decision taking.

Conclusion

This paper has attempted to create awareness of the complexities of rural finance and its relevance for rural development, and to explain the principal methods and solutions that have been successful. Many of the challenges that have confounded efforts to increase the access of rural populations to sustainable financial services have now been overcome in a number of countries. Over the years, the World Bank has been an integral part of the international effort that has led to the current state of knowledge. It is now time to increase that effort as an indispensable part of the fight against poverty.

**MATRIX 3. Decision matrix**

<table>
<thead>
<tr>
<th>Level of Intervention</th>
<th>Option</th>
<th>Output</th>
<th>Competitive Advantage of the Bank</th>
<th>Resources</th>
<th>Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Sector</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy/Macroeconomics</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enabling Environment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Sector/Supply</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Project team.
Appendix 1

Rural finance portfolio analysis at entry 2004 and 2003

Rural finance lending FY2004—a desk review

This note presents the results of a desk review of 20 World Bank projects approved in FY2004 that either exclusively focused on rural finance or had components/activities/conditionalities directly relevant for rural finance (hence referred to as RF projects). Two groups of projects that have an indirect impact on rural finance are included under this review. These are projects that aim to strengthen the financial sector in general and projects that improve access to land and property rights.

The objective of this review is to identify key elements of the project/component design and assess the quality of sector assessment, strategy, and monitoring framework (of the component). Good practices, innovations, and practices to avoid are identified. The review primarily involved review of the key project document (Project Appraisal Document, Program Document, etc.) and interviews with task managers where necessary. The review does not include any analysis of implementation or impact.

Overview

Twenty FY2004 projects included a component or activity related or benchmark (policy-lending project) related to rural finance. This was approximately one out of ten FY2004 projects in the rural space. However, only two projects are stand-alone projects that aim to increase access to financial services. The remaining projects are multi-sector projects that have a component that aims to increase access to a one (mostly credit) or few financial services, or those that use financial instruments to deliver other services. The number of RF projects is higher in FY2004 compared to FY2003 although RF portfolio is lower. Portfolio for to rural finance could only be disaggregated for 12 projects, and this was estimated to be $288 million.²²

Projects with rural finance components, activities, and/or benchmarks

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Number of Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>17</td>
</tr>
<tr>
<td>2004</td>
<td>20</td>
</tr>
</tbody>
</table>

Source: Ajai Nair, Project Team
The higher portfolio in FY2003 was primarily because of a large adjustment project (US$506 million).73

### Volume of rural finance lending

![Graph showing rural finance lending](source: Ajai Nair, Project Team)

### Regional distribution

SAR had both the largest number of projects (six) and the largest share of the FY2004 rural finance lending (55%). As in FY2003, most of the lending volume comprises a small number of projects; three projects make up 86% of the estimated rural finance lending amount.

### Regional distribution of rural finance lending, FY04

![Graph showing regional distribution](source: Ajai Nair, Project Team)

### Sector board distribution

In terms of sector boards, ten projects are rural sector operations, five are finance and private sector operations, two are social protection, and one each is infrastructure, social development and public sector development operations respectively. The large number of non-rural sector board operations indicate the need for a Bank-wide approach to rural finance.

### Distribution of rural finance lending by managing sector board

![Graph showing distribution by sector board](source: Ajai Nair, Project Team)

### Targeting

Most projects do not target any particular economic sector or population group. Among those that have sector targeting, two projects, both in China, target agriculture and two projects target infrastructure, supporting renewable energy development. Only one project has a population targeting, that of providing support for savings and credit groups among the very poor.

### Financing scale

Three projects support small-enterprise finance, six projects support both microfinance and small-enterprise finance, and the remaining 11 support only microfinance.
Activities supported

This analysis and the next two sets of analyses are done only for 15 projects for which most of the required information are available. The major activity supported continues to be delivery of financial service at the retail level. An activity is defined to fall into this category if a credit line or revolving funds are being used to support it. Eleven projects support this activity. The other retail-level activity supported is creating effective demand for financial services. An activity is defined as doing this if it involves support to entrepreneurs for preparing business proposals or if it involves technical support for development of community-based financial organizations. Five projects do this. Market facilitation activities are meso-level interventions that support the development of financial markets in rural areas. These include support for setting up credit bureaus, property registries, retail and apex service providers, industry associations, industry standards, etc. It is a welcome feature that a significant number—eight—of projects support this critical but often neglected activity. However, only one project supports macro-level activities that create an enabling environment for the development of rural financial markets. These involve activities that involve legal, regulatory, and policy reforms.

Financial services supported by rural finance lending, FY04

<table>
<thead>
<tr>
<th>Service</th>
<th>Number of Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit provision</td>
<td>11</td>
</tr>
<tr>
<td>Market facilitation</td>
<td>8</td>
</tr>
<tr>
<td>Demand development</td>
<td>5</td>
</tr>
<tr>
<td>Enabling environment</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Ajai Nair, Project Team

Service-providers supported

A wide variety of providers are supported. Five projects support MFI, four each involve financial cooperatives and savings and credit groups, and three projects involve banks or nonbanking financial institutions. The last category contains the most rigorously regulated institutions. This also explains the very low number of projects supporting services other than credit because provision of all other services are normally permitted only by regulated institutions in most countries. The predominance of unregulated institutions supported is also of concern from the perspective of sustainability of financial services supported.
Service providers supported by rural finance lending

Instruments used

It is a welcome feature that the largest proportion of projects—10—involves capacity building in the form of technical assistance or training. Start-up grants, either for operations or technology improvement, are still a relatively less used nonfinancial instrument. Only two projects use this instrument. Among financial instruments, four projects use revolving funds (three other projects not included in the 15 analyzed here also mention revolving funds as an activity that while six projects use traditional credit-lines. Two projects are piloting the use of credit-guarantees. The large number of projects using revolving funds is an area of concern, particularly so when provided without adequate capacity building.

Innovative practices

Practices identified in this section reflect relatively new approaches. It is expected that identifying these would encourage innovations in general and also flag them for future assessments for effectiveness.

Supporting technology development for enhancing quality of services and reducing transaction costs

The US$160 million Savings and Rural Finance (BANSEFI) Phase II Project in Mexico funds the initial costs (US$56 million) to set up a technology platform for savings and credit institutions in Mexico. The activities financed include hardware costs, software development, and technical assistance. The platform would be at the national level, rather than at the savings and credit institution level or at the level of the federations, for economies of scale reasons and because it would make monitoring and learning across the supported entities feasible. The supporting entities are expected to bear part of the installation costs and all the operational costs. Additionally, it is expected that the national support agency can charge reasonable license fees from the supported entities after two years of installing the platform. Supporting the development of a modern technology platform to be used by a wide variety of independent savings and credit institutions is an innovative practice. The project expects the platform to significantly enhance the quality of services delivered by the supported institutions and reduce the transaction costs of providing the services.

Start-up grants for small business enterprises to leverage credit

The US$19 million Village Investment Project in Kyrgyz Republic provides start-up grants for new business enterprises. These grants are provided by local governments based on project proposals that
have been independently appraised by established lenders such as commercial banks and MFIs and for which they have committed credit financing. The grant is expected to be a small portion of the total project costs (a maximum of $1000 per proposal) with the major portion expected to be from credit financing. Other requirements for release of the grants include legal registration of the group (cooperative, company, partnership, etc.) and their having obtained adequate training in business planning and management by a recognized institution. These requirements reduce the likelihood that grants are provided for proposals that are not commercially viable. Start-up grants that only fund a small portion of the project costs is also in contrast to funding of productive activities under most CDD projects where the grants fund up to 90% of project costs. While start-up grants to help small urban businesses have been used for a long time in developed economies, their use to encourage enterprise development in rural areas is relatively new and innovative.

**Good practices**

The review identifies the following projects on the basis of specific features in project design or implementation arrangements that are generally considered a good practice in microfinance and rural finance literature.

**Public-private partnership to increase access to credit in rural areas**

The US$258 million Second Poverty Alleviation Fund in Pakistan is a good example of public-private partnership. While the government sponsors the project implementation agency by providing equity and borrowing from the World Bank on its behalf, the organization board has majority of members from the private sector. The implementation is carried out by MFIs and NGOs who are provided with both a credit line and significant technical assistance.

**Stand-alone monitoring & evaluation component to evaluate outcomes in an innovative project**

The Savings and Rural Finance (BANSEFI) Phase II Project in Mexico includes a large (US$7.5 million) stand-alone monitoring and evaluation component. This component finances independent household surveys, case studies, and institutional performance assessments, as well as evaluation of project outcomes to be carried out internally. The significant investment envisaged for Monitoring and Evaluation (M&E) studies is justified by the innovative nature of the project and its expected sector-wide impact.

**Combining grants and loans without creating perverse incentives for lenders and borrowers**

Two FY2004 projects use innovative means to combine grants and loans for final clients while minimizing the risks of creating perverse incentives such as reduced incentive for lenders to enter the market and reduced incentive for borrowers to repay loans. The $27 million Rural Power Projects in Philippines includes a credit line that provides loans to financial intermediaries for on-lending to renewable energy technology (RET) suppliers and users. The project also provides grants to technology suppliers and users to reduce cost of the systems. However, neither recipient of the grant and loan receive them from the same entity. Provision of the grant and loan from separate entities prevents the borrower from considering the loan as grant, an issue typical in several projects where both the loan and the grant are provided by the same entity. The grants provided by the US$19 million Village Investment Project in Kyrgyz Republic are also unlikely to create perverse incentives for the same reasons (see under innovative practices for project modalities).

**Practices to avoid**

These practices could adversely affect effectiveness of rural finance activities in World Bank operations.

**Lending to local governments and government-controlled cooperatives for on-lending**

The Jiangxi Integrated Agricultural Modernization Project and Gansu & Xinjiang Pastoral Development Project in China envisage providing loans to farmers for various farm-related investments. However, the institutional arrangements for
this do not follow the recommended good practices for rural financial institutions. The project envisages the loans to be provided either by local government departments or by the rural credit cooperatives. There is little evidence globally of successful management of loans by government departments or agencies. The rural credit cooperatives are still effectively state-controlled organizations and management of loans by such organizations too do not have a history of success. The project appraisal document (PAD) also does not provide any information on why this approach has been adopted, what—if any—is the strategy to ensure successful management of the credit line, and does not include any indicators to monitor the repayment performance of loans to farmers.

Providing revolving funds to community groups without adequate support for institutional development and capacity building

The US$89 million Uttaranchal Decentralized Watershed Management Project in India and the US$81 million Second North-East Irrigated Agriculture Project envisage providing revolving funds for community groups without adequate technical assistance arrangements. Available evidence for the performance of community-managed revolving funds suggest that external capital is likely to be beneficial only when they are provided in combination with adequate technical assistance.

Recommendations

General

1. Issue: Only four out of 20 FY2004 RF projects focus on specific sectors—two on agriculture and two on infrastructure; other projects either focus broadly on enhancing access to finance for the underserved or focus on enhancing access to credit for specific population groups such as women or the very poor. While having a broader rural finance approach (in contrast to single-sector, credit-only projects) is in keeping with the consensus about the need for a financial system approach, it is unknown if this approach addresses the financial needs (particularly credit) of key sector in rural areas, particularly agriculture and infrastructure. Recommendation: Sector-work that investigates demand and supply of financial services for agriculture and rural infrastructure should be carried out. In economies where supply constraints are established, further investigations can be carried out on possible reasons and means to address these. Based on such studies, projects can experiment with financial and nonfinancial instruments to address the constraints.

2. Issue: Many multi-sector projects that include rural-finance components or activities do not include a rural-finance specialist in the project preparation team. Recommendation: All projects that have rural finance components or activities should have specialists with rural finance expertise in the project preparation team. As a rule of thumb, if the component is considered too small to justify having a specialist, it is unlikely to be significant enough to be included in the project.

3. Issue: Most multi-sector projects that have a rural finance component or activity do not give the rationale for including the component/activity or for using the particular project implementation mechanism being adopted. This makes it difficult to understand whether a strong rationale exists for inclusion of the component and whether alternative implementation mechanisms were explored. Recommendation: Multi-sector projects should provide clear rationale for inclusion of the rural finance component/activity in the project and for the mode of its implementation. Additionally, where the component is relatively significant, projects could also include an annex that provides a rural finance sector assessment and explains how the rural finance strategy being adopted by the project fits in with national strategy (if this exists).

4. Issue: Most RF projects do not include well-specified outcome and output indicators in the project results-monitoring framework. Recommendation: All RF projects should include RF well-specified output and outcome indicators in the results-monitoring framework. When provision of credit is supported (through credit lines or revolving loan funds), include key indicators such as loan repayment performance is critical to estimating the performance of the component/activity.

5. Issue: Projects that support provision of financial services in both rural and urban locations (typically finance sector projects) do not include
output and outcome indicators that are disaggregated geographically (rural/urban). **Recommendation:** Projects that support provision of financial services in both rural and urban areas should disaggregate outputs and outcomes indicators geographically (rural/urban). PADs should also clearly indicate how rural/urban locations are defined.

**Project design**

1. **Issue:** Some projects provide revolving funds for community groups without also providing the required technical assistance to ensure effective use of the funds and their sustainability. **Recommendation:** Globally, available evidence indicates that groups that receive external capital assistance tend to have higher failure rates when compared to projects that only receive support for group mobilization, provide training, and offer advisory services. Projects should provide revolving-funds only when a strong justification for the need is made and is accompanied by institutional development and capacity-building support. It should also be ensured that the recipient of the revolving funds have ownership structures that have incentives to ensure the sustainability of the fund and the project design does not introduce rules or incentives that operate in the reverse.

2. **Issue:** In multi-sector projects, implementation of rural finance activities are often carried out by project implementation units or local governments that do not have adequate rural-finance expertise. **Recommendation:** Multi-sector projects having rural finance components should contract out implementation of rural finance activities to institutions with the required specialist expertise. If this is not feasible, it should be ensured that adequate expertise in rural-finance expertise is ensured at all levels of implementation.

3. **Issue:** Supply of financial services by government departments or agencies have traditionally not been successful. Yet, some projects continue to support this means of delivering financial services, particularly credit. **Recommendation:** Support should primarily be provided for supply of financial services by specialized organizations such as banks, MFIs, financial cooperatives, and savings and credit groups. If supply by an organization (including any of the types just referred to) in which governments have an ownership-stake is supported, it should be ensured that the ownership-stake is not likely to translate into interference in management and operational decisions. This is critical to ensure effectiveness and sustainability of interventions supported by the project.

### Rural finance lending FY2003—a desk review

This note presents the results of a desk review of 17 World Bank projects approved in FY2003 that either exclusively focused on rural finance or had components or conditionalities directly relevant for rural finance. The objective of the review was to capture nature of support and identify innovations, good practices, and practices to avoid. The analysis focuses solely on design elements and not on implementation or impact. The review draws on information in project documents and on interviews with project task managers.

**Overview**

After significantly declining in the 1980s and early 1990s, rural finance lending \(^6\) started increasing in mid-1900s. The average number of projects per year during the period FY 1992-2000 was 19 and the lending was $630 million.\(^7\) The number of projects in FY2003 is lower than the averages for the last decade and the last two FYs, but the volume is slightly higher.

**Trends in number and volume**

In FY2003, 12 investment projects supported activities aimed at increasing access to financial services in rural areas. Five adjustment projects had conditionalities or benchmarks connected to rural finance. Among these 17 projects, portfolio for rural finance could not be disaggregated for the three adjustment projects and one investment...
project. In the remaining 13 projects, the rural finance portfolio is estimated to be $666 million. As in the past years, AFR has the largest number of projects. The largest share of the portfolio is in LAC (the two projects in Mexico make up over 90% of the total FY2003 portfolio).

**Regional distribution of projects**

Ten projects exclusively target rural areas and seven have no targeting. Two projects work exclusively with women and two have explicit poverty targeting. As for sector targeting, one project targets agriculture, two target infrastructure sector (energy production) and 15 do not target any particular sector. Twelve projects focus on microfinance while one focuses exclusively on small energy enterprises. Four projects support both microfinance and small enterprise financing.

### What is being supported?

The major activity supported continues to be service provision. Five projects each support creation of an enabling environment, market facilitation, and support for creating effective demand for financial services. Enabling environment involves support for legal, regulatory, and policy reforms. Market facilitation involves support for asset registries and credit bureaus. Support for creating effective demand involves financial counseling services and support to enterprises for preparation of credit proposals.

### Activities supported

Among the projects involving support for service provision, credit is the predominant service being provided. This could be because provision of other services involves significant regulatory constraints. However, inadequate recognition of the importance of other financial services (especially savings and insurance) by project teams could also explain the predominance of credit.

A wide variety of providers are involved in service provision. Three projects each involve microfinance organizations and community-based organizations, and two each involve state-owned

### Regional distribution of rural finance lending, FY03

![Graph showing the regional distribution of rural finance lending, FY03](Source: Ajai Nair, Project Team)

- South Asia: 1
- Middle East and North Africa: 2
- Latin America and the Caribbean: 3
- Europe and Central Asia: 1
- East Asia and the Pacific: 2
- Africa: 8

The Numbers = the Number of Projects

### Activities supported by rural finance lending, FY03

![Bar chart showing the number of projects by activity supported](Source: Ajai Nair, Project Team)

- Service Provision: 13
- Enabling Environment: 5
- Market Facilitation: 5
- Demand Development: 5

Source: Ajai Nair, Project Team
banks, commercial banks, and cooperatives. It is not, however, clear if all these institutions are envisaged to be sustainable.

What are the innovations?
Practices identified in this section reflect relatively new approaches. It is expected that identifying these would encourage innovations in general and also flag them for future assessments for effectiveness.

- The Rural Finance Sectoral Adjustment Loan in Mexico supports creation of a non-deposit taking, state-owned bank focusing exclusively on lending to middle-income rural producers. While the state ownership of the bank does raise concerns on its ability to operate on commercial basis, not having the ability to mobilize deposits and being required by charter to maintain the real value of its assets is more likely to make it do so.
- It is generally agreed that sustainability of microfinance institutions is critical. The Andhra Pradesh Rural Poverty Reduction Project in India envisages this by supporting the development of federations of community-based organizations and specialized second-tier microfinance organizations.
- As was mentioned earlier, most projects focus on provision of credit services. In contrast, the Third Malawi Social Fund Project focuses on supporting community groups that provide saving opportunities. The groups are not envisaged as clients for lending by banks or microfinance organizations (they are, however, expected to lend their savings among their members).
- Inadequate capacity of entrepreneurs to submit bankable proposals is one of the several constraints that limit poor people’s access to financial services. The Savings and Credit Sector project in Mexico and Small-scale Commercial Agriculture Development Project in Bosnia have sub-components that support the provision of technical support for this purpose.
- Commercial financing of rural infrastructure is expected to enhance creation and improve maintenance of such infrastructure. The Off-grid Rural Electrification Project in Nicaragua and Decentralized Rural Electrification Project in Guinea envisage bank financing of small energy projects and household electrification.
- Financial services aligned with social and cultural contexts have relevance in areas with limited economic activity. The Matruh Resource
Management Project in Egypt has a microfinance component that supports credit financing in ‘in kind’ (not cash) and in keeping with Islamic financing principles.

What are the good practices?
Most of these are design features in projects that are generally considered a good practice in microfinance and rural finance literature.

- In the Third Kecamatan Development Project in Indonesia, support for revolving fund management units (UPKs) of the subdistricts (Kecamatsans) is based on the assessment of their viability potential and classification into four categories. This helps the project to provide need-based support to the UPKs, including support for termination of operations when necessary.
- Several multi-sector projects are contracting out implementation of the microfinance components. This is a good practice because project implementation units of multi-sector projects usually do not have the capacity to implement microfinance activities. The Small-scale Commercial Agriculture Development Project in Bosnia and Herzegovina goes one step further and contracts out supervision of the microfinance organizations supported.
- Well-functioning industry associations of microfinance organizations facilitate the development of a robust microfinance sector. The Savings and Credit Sector Strengthening and Rural Microfinance Capacity Building Project, Mexico and Competitiveness and Enterprise Development Project, Burkina Faso support such associations.
- Appropriately regulated and supervised savings and credit institutions can have a significant role in providing financial services in rural areas. The Mexico Savings and Credit Sector Project supports capacity building for such an institutional framework.
- Linkages with mainstream financial institutions can provide sustainability to community-based financial institutions. The Andhra Pradesh Rural Poverty Reduction Project in India envisages community-based organizations using funds provided by the project to leverage additional investment funds from banks.

What are the practices to avoid?
These include practices that could adversely affect effectiveness of rural finance activities in World Bank operations.

- Most projects do not report a microfinance component under the relevant sector code. Not doing so makes identification of the rural finance portfolio a cumbersome process.
- One project supports formation and strengthening of community-based organizations that provide microfinance services in rural areas, but does not classify this support under a microfinance component or subcomponent. Doing so makes identification of the component and adequately monitoring it difficult.
- Credit lines or revolving funds need to be avoided under budget-support loans. When required, these are best provided under investment projects.
- Two projects have microfinance components that are too small to make a significant impact or be monitored effectively.
- Implementation of microfinance activities are best carried out by specialized institutions rather than by project implementation units or local governments. Yet, several projects continue to have microfinance components implemented or supervised by project implementation units or local governments.
Appendix 2

Diagnostic matrix: Rural financial sector development—An example from a developing country—Uganda

<table>
<thead>
<tr>
<th>Real sector</th>
<th>Political and enabling environment</th>
<th>Financial sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geographical/climatic aspects</td>
<td>Macroeconomic and policy environment</td>
<td>Banking sector</td>
</tr>
<tr>
<td></td>
<td>• Macroeconomic stabilization since 1987; strong growth during last ten years</td>
<td>• Shallow banking sector (200,000 persons per branch; very low ratio of loans to private sector/GDP; dominated by four foreign-owned banks)</td>
</tr>
<tr>
<td></td>
<td>• GoU reduced its participation within the financial sector nearly completely</td>
<td>• Some large loans for commodity processing firms or large exporters are available</td>
</tr>
<tr>
<td></td>
<td>• Acceptable environment</td>
<td>• Leasing is available (DFCU, new entrants expected)</td>
</tr>
<tr>
<td>Infrastructure/human capital</td>
<td>Legal (real economy)</td>
<td>• Checking, savings and deposit services in rural towns</td>
</tr>
<tr>
<td></td>
<td>• Deficient infrastructure</td>
<td>• Some banking services for MFI available</td>
</tr>
<tr>
<td></td>
<td>• Unreliable electricity</td>
<td>Nonbank financial sector</td>
</tr>
<tr>
<td></td>
<td>• Deficient market infrastructure</td>
<td>• Dominated by NGOs, SACCOs and DFCU, Ltd.</td>
</tr>
<tr>
<td></td>
<td>• Lack of qualified personnel</td>
<td>• 4–7 stronger NGOs, up to 5 in transformation process</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Clients: mostly small-scale traders in peri-urban areas</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• SACCOs: some loan extension to farmers, rural traders</td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Real sector</th>
<th>Political and enabling environment</th>
<th>Financial sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production structure</td>
<td>Information sharing</td>
<td>Trade finance; buyer and supplier credit</td>
</tr>
<tr>
<td>• Agriculture still dominant (80% of workforce)</td>
<td>• A market information service (Foodnet) sponsored by the government is in place (future funding insecure)</td>
<td>• In-kind and suppliers credits for buyers, sellers and farmers throughout the production marketing chain</td>
</tr>
<tr>
<td>• Around 60,000 farmers and fishermen operate commercially (the basic need is term finance, which is not available; leasing,)</td>
<td>• Information sharing systems are not in place</td>
<td>• Hedging possibilities for price risks are not available</td>
</tr>
<tr>
<td>• Semi-commercial farmers with similar needs as the commercial farmers but on a smaller scale</td>
<td>• Generally: lack of information on investment opportunities</td>
<td>Projects by USAID and probably GTZ/KfW are in preparation</td>
</tr>
<tr>
<td>• Subsistence farmers and villagers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Availability of support services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural finance, relevant donor-financed activities, and projects in the real sector</td>
<td>GTZ/SIDA financed financial sector project with focus on MF; implementation of adequate supervisory mechanisms for NBDI</td>
<td></td>
</tr>
</tbody>
</table>
1World Bank, 2003a.
3World Bank, 2003d.
5For an overview of the role of finance in economic development see for example Caprio G. and Honohan P., 2001 and Hermes, N. et al., 1996.
6Butzer, R. et al., 2002.
7Rural finance used to be defined as agricultural finance by donor agencies and governments for much of the period from the 1950s to the 1980s. Donor agencies provided resources for agricultural finance, often through subsidized credit lines for state-owned agricultural development banks. In the 1950s and 60s, projects tended to promote the adoption of productivity-increasing technologies and methods, often following a one-model-fits-all approach. The 1960s and 1970s also saw a trend in development thinking emphasizing industrial over agricultural development, resulting in increasing biases against, and deteriorating terms of trade of, the agricultural sector. Given deteriorating agricultural prices, subsidized finance was seen as the only means to induce farmers to adopt new technologies. FAO/GTZ, 1998.
9The concurrent decline in agricultural credit programs has also led to a decline in available finance for agriculture. For example, World Bank lending for agriculture in the 1990s represents only one-third of the volume of agricultural lending of the 1980s (FAO/GTZ, 1998). This statement is corroborated by the Bank’s “Reaching the Rural Poor” strategy which states that “lending for agricultural activities declined dramatically from about 31% in 1979–81 to less than 10% in FY 00 and FY01.” The largest declines occurred Inter alia in the sector of agricultural credit, because of the shift away from commodity targeted credit. (World Bank, 2003b; p. 15) However, rural finance lending started increasing in the mid 1990s, after large declines in the 1980s and early 1990s. (World Bank, 2003c; Appendix 3 Rural Finance, p. 28)
10In July 2004 IFC closed on a 34% Partial Credit Guarantee to the bond issue of 500 million pesos (approx. $43.4 million) for Compartamos, a major microfinance institution in Mexico.
12World Bank, 2005a.
13World Bank, 2005c. See Appendix 1 for the complete text.
14Regulatory environment for cooperative financial institutions, for example, is of specific concern to rural finance, since financial cooperatives and credit unions are often regulated by bodies outside the general financial sector, often by Departments of Agriculture.
15See for example Miller, M., 2003; and Maimbo, Samuel M., 2003.
16Deininger, Klaus, 2003.
17The World Bank’s Integrated Development Program for Irrigated Agriculture in Mauritania supports the expanded and transparent registration of land in order to assist farmers to be eligible for long-term investment credit. By the end of the first phase of the project in 2004, approx. 36,000 hectares have been registered. The project also provided technical assistance and a credit line for UNACAEM, the National Union of Agricultural and Credit Cooperatives, which is now able to provide short-, medium- and long-term credit for all agricultural activities, year-round. For details see World Bank, 2005d. See also Deininger, Klaus, 2003.
18For example, cooperative financial institutions and credit unions in many countries are not counted as part of the financial sector.
19One can distinguish direct and indirect supervision systems. Direct supervision systems are those where all supervision tasks are carried out by the agency responsible for the oversight of financial institutions, such as the central bank. Indirect supervision systems involve designated agencies, such as specialized government agencies, audit firms or federation networks, in all or some supervisory tasks. Within the indirect systems, one can further distinguish auxiliary and delegated supervision. The term auxiliary supervision is usually used to indicate a supervision system where the primary supervisor, such as the Central Bank, retains most of the sanctioning powers while only using the supervisory agent to undertake routine supervisions—both off-site and on-site. In contrast, the term delegated supervision is used to indicate a system where the supervisory agent has
significant powers of sanction also, although the ultimate power of closure and liquidation of a financial institution is retained by the primary supervisor. For more details on the advantages of the different systems see Kumar, A. et al., forthcoming, p. 11ff.

Deposit insurance programs might help in promoting savings in rural areas where the confidence of potential clients in formal financial institutions is low. In order to mitigate the moral hazard problem, a deposit insurance scheme would need to be designed in such a way that participating financial institutions are screened for financial strength, standardized procedures, etc. This would, however, give the participating institutions an additional competitive advantage. Schemes can also be adapted to the type of participating institution. In the USA for example, the deposit insurance differs for commercial banks or credit unions. See Carter, M. et al., 2004.

Cash-flow lending based on household income refers to credit technologies which tie the repayment schedule to the borrower’s expected cash flow from a variety of sources, rather than simply the cash flows from the activity financed. This method is being used by microfinance institutions in many countries. For example, commercial rural banks in the Philippines have adopted cash-flow lending through participation in an institution building assistance program. See for example Campion, et al., 2003.

In 2003, a group of commercial banks agreed to adopt the IFC’s environmental and social safeguards as their guidelines for project finance in emerging markets. The guidelines, or Equator principles, include issues of environmental assessments, natural habitats, involuntary resettlement, indigenous people and child labor, and apply to projects above US$ 50 million. As of January 2005, 28 private banks have adopted the Equator principles. Critics point out that attempts to set international industry standards are laudable, but that the principles do not include mechanisms for external monitoring and enforcement.

The “double bottom line” refers to business objectives that include social as well as financial objectives. The “triple bottom line” includes environmental protection. The triple bottom line has been incorporated by many financial institutions, such as the Equator principle banks (see endnote 22), and has for example led to the publication of annual sustainability reports in addition to annual business reports. For a good overview of current thinking see Bouma, J. et al., 2001. An example for an annual sustainability report can be found at Rabobank’s website at http://www.rabobank.com.

The Economist, 2005.

World Bank, 2005a.


IFC, with its 2001–2002 initiative “How to make small business finance profitable for financial institutions,” initiated an international discussion focused on such an approach. In order to tap new markets in an increasingly competitive environment, financial institutions can expand “downwards” to reach smaller businesses and rural enterprises. This requires a shift in emphasis away from delivering credit to individual clients to providing a full package of financial services to mass customers. The new approach requires the development of new products and the use of new or improved financial information and communication technologies. Examples include the use of multiple channels for service delivery, such as mobile phones and mobile branches, as well as the introduction of credit scoring technologies for managing a large portfolio (see Box 5 for a brief explanation of scoring). The IFC has launched two new facilities, the Global Microfinance Enhancement Facility and the Global SME Enhancement Facility, which provide credit guarantees and technical assistance to banks trying to expand into these sectors. See IFC, 2001.

An example are Ghana’s rural banks that in the past functioned essentially as deposit collection institutions. As a result of macroeconomic policies, government securities were by far the most lucrative investments, effectively crowding out loans to customers. Therefore, the banks never had to develop a credit system that enabled them to service retail and corporate clients. Their most urgent task is now to develop the appropriate credit technology for different lines of business.

See World Bank, 2005b.

World Bank, Forthcoming.

World Bank, 2004c.


See endnote 23 on double bottom line objectives for financial institutions. See also CGAP, 2004a.

Seibel, H. D., et al., 2005, show that private providers, particularly microfinance organizations, could not replace the vast branch network that many agricultural development banks had. Microfinance providers, such as NGOs, do furthermore often show an urban bias, with credit technologies adopted to the urban environment, but not necessarily suitable for agricultural finance. The closures of agricultural development banks particularly in Latin America and West Africa therefore left the rural populations without formal financial services. A case in point is the Banco Agricola del Peru, which was closed in 1991, and where no private providers have filled the gap. For more details on this case see Vogel, R. C. et al., 1997.


See CGAP, 2004c.

70 Endnotes
NMB currently does not publish any financial and business data because of its upcoming privatization which is expected to be completed in mid-2005. However, according to the Parastatal Sector Reform Commission in Tanzania, the National Microfinance Bank (NMB) was the largest bank in Tanzania in terms of customer deposits and in terms of branch network. As of December 2003, NMB comprised four agencies and 104 branches. Its deposits stood at approx. US$361 million. DAI has estimated the loan portfolio at US$61 million (see http://www.dai.com for details). The ratio of savings to loans thus stood at approx. six to one.

BRI in Indonesia and AgBank of Mongolia have the same experience; see Robinson, M. S., 2001; and Agricultural Bank of Mongolia (undated).


CGAP has established a rating fund that provides partial funding for ratings of microfinance institutions. The website of the fund http://www.ratingfund.org provides general information on the rating process and rating and assessment agencies.

An ESW on cooperative financial institutions is being prepared by FSE. In addition, in 2004, the World Bank organized a series of conferences on Strengthening of Cooperative Financial Institutions. These were held in Washington, DC; Recife, Brazil; and Baku, Azerbaijan. Proceedings of these conferences are available on the Bank’s Rural Finance website.

See World Bank, 2004a.

A profile or history of most of these institutions can be found on their respective websites: For Rabobank, see http://www.rabobank.com; for DZ Bank, see http://www.dzbank.de; for Raiffeisenbank, see http://www.vr-networld.de; and Credit Agricole, see http://www.credit-agricole.fr.


See World Bank, 2004b.


Arzbach, M., 2004; see also World Bank, 2004b.


For a detailed discussion see Nair, A. et al., 2004.

See Nair, A. et al. Forthcoming.


Risk Sharing Facilities for SME Financing, internal IFC publication, contact Peer Stein. In July 2004 IFC closed on a 34% Partial Credit Guarantee to the bond issue of 500 million pesos (approx. US$43.4 million) for Compartamos, a major microfinance institution in Mexico.

See World Bank, 2004c, Module 7, Agricultural Investment Note on Production Credit from Input Suppliers, Processors and Buyers.


Rabo International Advisory Services (RIAS), 2004.

World Bank, Forthcoming a.


For more information see Africap, 2004; and Profund, 2003.


The Commodity Risk Management Group (CRMG) provides technical assistance to lenders and other farmer risk-exposed institutions in developing countries to bridge the gap between supply and demand of market-based risk management instruments. See http://www.itf-commrisk.org.

World Bank, Forthcoming a.


IFC experience in SME lending.

Another specialized collateralized financing arrangement is factoring, whereby an enterprise sells its accounts receivable to a specialized financial institution. Factoring is a popular financing mechanism in developed countries because the credit risk can be diversified from the single credit risk of the original borrower to the credit risks of multiple customers. In spite of these advantages, factoring has rarely been introduced in developing countries and is not of any great relevance in rural finance.

For further information see Counter, J. et al., 2005.

The rural finance lending volume is an approximation. In most multi-sector projects, such as CDD projects, the project appraisal documents (PADs) do not provide costs for sub-components with rural finance lending activities. In finance sector projects, the PADs do disaggregate the project clientele by their geographic location. Hence, the volume was arrived at through discussion with task managers. The following methodology was used for estimating RF lending volume.
• When the project is an exclusively rural finance project, the WB share in total project cost is taken as the RF amount.
• When only a component is for rural finance, WB share in the component costs was estimated using the WB share in total project cost.
• When no separation of rural finance component is made but a portion of project beneficiaries are located in rural areas, the share of such beneficiaries was used to estimate the RF amount.
• In projects where ex-ante estimate of rural/urban beneficiary distribution is not possible or the project is of a budget support nature—multi-sector adjustment loans and PRSCs, the projects are identified but portfolio amount devoted to rural finance is not estimated.

73 The US$506 million Rural Finance Sector Adjustment Loan.

74 The first phase of this project, the Savings and Credit Sector Strengthening and Rural Microfinance Capacity Building Project, was among the most well-designed rural finance projects approved in FY2003.

75 Only projects that have a direct impact on rural finance are included. These are defined as investment projects or budget support projects that included activities aimed at creating an enabling environment for financial services, supporting financial service provision, development of market facilitating institutions, or development of viable proposals in rural areas. Projects that could have an indirect impact—projects that improve property right regimes (land titling), restructure the banking system, and provide grant funds for income generating activities—are not included. Some state-bank privatization/restructuring projects might have implications for rural finance if the state-banks concerned had significant rural lending. This is often not obvious from the PDAs. Policy measures such as creation/reform of deposit insurance and credit bureaus supported by some projects can have positive implications for rural finance in the long run.

76 Includes agricultural finance, microfinance and SME projects with a rural focus.

77 When the project is an exclusively rural finance project, the share of IDA/IBRD in the whole project is taken as the portfolio. When only a component is for rural finance, the share of the IDA/IBRD component in the whole project is used to estimate the IDA/IBRD share in the component. When no separation of rural finance component is made but a portion of project beneficiaries are located in rural areas, the share of such beneficiaries was used to estimate the rural finance IDA/IBRD portfolio amount. In the case of projects where such estimation is not possible (ex-ante estimate of rural/urban beneficiary allocation is not possible or the project is of a budget support nature—multi-sector adjustment loans and PRSCs), the projects are identified but portfolio amount devoted to rural finance is not estimated.

78 However, it is not possible to say if this indicates low financing for agriculture since the credit going to the agriculture sector from general microfinance and enterprise finance is not known ex-ante.
Bibliography


