

Developing Rural Financial Markets

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Many developing countries have tried to spur income growth and reduce poverty in rural areas by making low-interest loans to farmers. The results have been disappointing. A broader approach emphasizing policy and legal reforms and savings mobilization has been more successful.

FOR THE past fifty years, governments throughout the developing world have tried, with the support of donor agencies, to encourage agricultural modernization and growth by channeling large sums of money to state-owned credit institutions for on-lending at below-market interest rates to farmers. The objective was to increase incomes and reduce poverty in rural areas by addressing acute credit shortages. This narrow approach has failed; it has stifled the development of rural financial markets and benefited only a small percentage of the rural population.

Since the 1980s, some countries have experimented with a broader approach that has focused on reforming the policy and legal environment for financial markets and improving the design of rural financial programs and institutions. This new approach has proven to be far more effective than government intervention

through concessional lending. Rural financial intermediaries (RFIs) have sprung up that are capable of reaching large numbers of people and surviving—even thriving—without government subsidies.

Challenges for rural finance

In many developing countries, financial markets—especially in rural areas—cannot operate efficiently because of an unstable macroeconomic environment, biased sectoral policies, excessive government intervention, and legal and regulatory barriers.

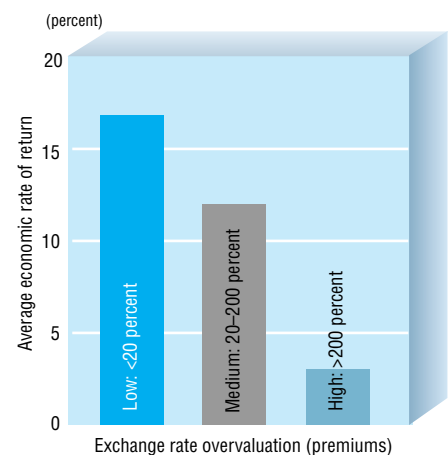
The macroeconomic environment. Macroeconomic instability affects RFIs directly, through such monetary variables as real interest rates, and indirectly, through effects on clients. For example, in the early 1980s, high real interest rates in the United States triggered massive farm failures and a crisis in the farm credit system. Persistent distortions, such as misaligned exchange rates, may lead to a misallocation of resources that is damaging to rural financial markets—other things being equal, the higher the black-market premium for foreign exchange, the lower the return on agricultural investments (Chart 1).

Sectoral policies. Rural development has been held back in almost all developing countries by policies that favor industry over agriculture and urban over rural areas (see box). Analyzing a sample of 18 countries during 1960–84, Schiff and Valdés (1992) estimate that direct and indirect government interventions depressed domestic agricultural terms of trade by 30 percent and resulted in an income transfer out of agriculture equal to 46 percent of agricul-

tural GDP. These policies proved to be shortsighted, as the countries with the highest degree of discrimination against agriculture had the lowest rates of economic growth.

Financial market rigidities. Government interventions such as excessive bank reserve requirements, channeling a large share of bank credit to state-owned enterprises and other unremunerative investments, fixed interest rates, and usury laws lead to rigidities that hinder the efficient allocation of resources and intensify problems arising from imperfect information about financial intermediaries, borrowers, and depositors.

Chart 1
Overvalued exchange rates dampen returns on agricultural projects



Source: Jonathan Isham and Daniel Kaufmann, 1995, *The Forgotten Rationale for Policy Reform: The Productivity of Investment Projects*, Policy Research Working Paper No. 1549 (Washington: World Bank).

Note: Economic rates of return calculated for agricultural projects undertaken with World Bank support.

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Urban-biased policies

Government policies and public investment priorities that favor urban areas are pervasive in the developing world, largely because many countries see development as synonymous with rapid industrialization—and also because many governments have succumbed to pressures from vocal urban populations for low food prices. Urban-biased policies rest on eight pillars:

- an overvalued exchange rate;
- low, controlled, and seasonally invariant prices for agricultural products;
- high rates of protection for domestic industry, whose outputs are used as agricultural inputs;
- excessive taxes on agricultural exports;
- disproportionately high budgetary allocations for urban rather than rural infrastructure (roads, electricity, and water supply);
- disproportionately high investment in human resources (for example, health and education) in urban, rather than rural, areas;
- usury laws that make it impossible to make the kinds of small, risky, high-cost loans that are typical in rural areas; and
- underdeveloped legal and regulatory provisions regarding land titling and collateral for typical rural assets (land, crops, and farm implements) relative to urban assets (cars, other durables, and homes).

In rural financial markets, these rigidities are compounded by difficulties peculiar to rural areas, such as poverty, low population densities, isolation, seasonality of incomes, limited opportunities for risk diversification, and lack of traditional collateral. These difficulties, combined with high transaction costs because of the small size of most loans, discourage for-profit financial institutions from establishing themselves in rural areas.

Legal and regulatory barriers. In many countries, deficiencies in laws, regulations, and institutions discourage the formal sector from offering credit to rural producers and even to nonbank creditors such as traders (Fleisig and de la Peña, 1996). Creating a mortgage or claim on movable property can be difficult because of untitled land, high registration costs, and the absence of legal provisions for future interests. Perfecting a claim (finding out whether other claims exist on a security interest) may be impossible because of the lack of easily accessible registries or high search costs. Enforcement of claims can be costly, lengthy, and uncertain. Other impediments to the development of rural financial markets include usury laws and regulations that prevent smallholders from using their land as collateral.

The traditional approach

Although agriculture has traditionally been viewed as a tax base for promoting rapid industrialization rather than as a growth sector in its own right, governments have recognized that rural areas need modern technology and access to

credit. Because they considered rural inhabitants too poor to save money, governments intervened to make cheap credit available to farmers, drive moneylenders out of business, and “compensate” for low prices for agricultural goods and other distortions. The standard approach was to set up state-owned, specialized institutions that received concessional loans to be on-lent at below-market interest rates to targeted agricultural producers for specific types of inputs or investments. Performance was assessed by the volume of loans disbursed and the impact of loans on production.

These interventions did boost agricultural production. But, because they addressed the symptoms rather than the causes of inadequate rural financial intermediation, they did not lead to sustainable income growth or poverty reduction. There was a strong emphasis on loan disbursements, while matters such as portfolio quality, nonfarm rural development, savings mobilization, and the efficiency of financial markets were neglected. The availability of cheap loans and debt forgiveness weakened the repayment culture and made lending unprofitable. Subsidized interest rates had costly macroeconomic implications. Targeting ignored the fungibility of money and the fact that the existence of distortions such as low food prices made agricultural investments less attractive than they would otherwise have been. Finally, most cheap credit was captured by a small number of higher-income farmers.

A new approach

The new approach to rural financial

intermediation that emerged in the 1980s favors a more indirect role for governments, emphasizes savings over credit, and avoids subsidized interest rates. More broadly, it calls for governments to identify the causes of market failures and correct them through reforms rather than through direct financial-intermediation interventions.

Higher economic growth rates may not suffice to reduce rural poverty, if the benefits of growth are not widely shared. A program of targeted interventions may therefore be justified if it improves the poor's access to credit. However, while efficient financial-intermediation schemes can improve the poor's access to financial services, they are not necessarily the best vehicle for helping the poorest of the poor.

The right environment

Creation of a favorable policy environment for rural financial intermediation requires macroeconomic stability, elimination of urban-biased policies, and promotion of integrated and resilient financial markets. Steps to reform the legal and regulatory frameworks can be taken even before the appropriate policies are put in place.

Strategies for stabilizing the macroeconomic environment should include the pursuit of prudent fiscal and monetary policies to reduce the incidence and impact of shocks to the economy. Improving the environment for agricultural and rural development requires a neutral trade regime between agricultural exportables and importables, removal of nontariff barriers, realignments of overvalued currencies, reduction of excessive industrial protection, a shift of public investment priorities toward rural areas, and greater community participation. States should avoid intervening in activities, such as input supply and marketing, that are better left to the private sector and focus on the provision of essential public goods such as roads, agricultural research, and public registries. Governments can increase the efficiency of financial markets by liberalizing them (for example, deregulating interest rates, reducing high reserve requirements, and relaxing credit controls) and strengthening the supervision and prudential regulation of financial intermediaries. Special prudential requirements—for example, lower statutory capital requirements with higher capital-to-assets ratios—may be needed for rural banks and semiformal institutions.

Other measures should include reforming laws dealing with the titling and registering of land and with secured transactions (to allow for nonstandard forms of collateral);

upgrading legal registries and expanding the scope for private operation; lowering the costs of registration and foreclosure; drafting clear, limited homestead provisions; and removing interest rate ceilings.

Government interventions

While policymakers have reached a consensus on what measures can be taken to indirectly promote rural finance, issues related to direct government interventions are still hotly debated. Poorly conceived interventions—unsustainable, state-owned agricultural credit institutions and actuarially unsound crop-insurance schemes—have a long history. Direct interventions can work, however, when they are appropriate and adhere to sound operating principles.

When to intervene? Direct interventions in rural financial markets are warranted only when they address specific market failures and their expected net benefits are positive, or when they reduce poverty in the most cost-effective way.

How to intervene? Public support for rural financial intermediation need not mean public provision of credit. Interventions can take many other forms—for example, provision of seed capital, support for pilot programs, training, and dissemination of best practices. Governments may also provide support for products or services (for example, savings and insurance) and for various modes of operation (for example, group lending and mobile banking). They can channel their assistance through a range of institutions, such as commercial banks, state-owned RFI, cooperative banks, and nongovernmental organizations.

Targeting. Targeting and explicit subsidies can be used to overcome barriers to financial intermediation and accelerate institutional development. Distortions can be minimized by ensuring that targeted funding remains the exception; phasing out subsidies over a specified period; continuously assessing performance against stated objectives; increasing access to financial services, rather than underpricing them; designing transfer mechanisms that encourage self-selection and minimize incentive distortions; and ensuring a level playing field for all RFIs.

Designing successful RFIs. Good governance may well be the most important factor in the success of an RFI. All decision makers must have clearly defined, consistently enforced powers and responsibilities. Management must be autonomous, as well as accountable for operational decisions, and clients' interests must be fully

represented. The appropriate form of supervision and prudential regulation depends on the RFI's size, type, and ownership structure. External supervision is particularly important for institutions that mobilize voluntary deposits from the general public. Other key requirements include

- clearly defined corporate strategies and objectives;
- motivated and skilled staff;
- innovative, low-cost ways of providing financial services;
- positive real interest rates on both loans and deposits;
- careful monitoring of portfolio quality, incentives for timely and full loan repayment, and active pursuit of delinquencies;
- risk reduction through diversification and integration into the broader financial system; and
- advanced management information systems that permit performance to be continually monitored.

Assessing performance

Evaluating the impact of agricultural credit is fraught with methodological problems. Rigorous econometric studies are often costly and highly specific. One framework for evaluating RFIs that has gained wide acceptance is based on two crite-

ria—*outreach and self-sustainability* (Yaron, 1992)—on the assumption that RFIs that efficiently provide a broad range of services to the target clientele are likely to have the desired effect on income growth and poverty reduction. While these primary criteria do not entail a full cost-benefit analysis, they provide easily quantifiable proxies.

Outreach is a hybrid index that is weighted to reflect the objective of a given intervention. Here it is measured by several indicators, including the number of clients, the average loan size (as a proxy for income level), and the percentage of female clients. *Self-sustainability* is assessed by calculating an RFI's subsidy dependence index (SDI)—the percentage by which an RFI's average on-lending interest rate would have to increase to make the RFI financially viable without subsidies. By comparing the cost of subsidizing an RFI with the interest earned by the RFI, the SDI also captures the notion of matching grants and indicates the extent to which the RFI relies on these grants.

A success story

The outstanding performance of Bank Rakyat Indonesia's Unit Desa (BRI Unit Desa), which provides banking services to millions of low-income rural families in

BRI Unit Desa: Indicators of outreach and financial self-sustainability

	1985	1990	1995
Outreach			
		(million dollars)	
Average annual loan volume	162	562	1,178
Average annual deposit volume	49	685	2,382
		(millions)	
Number of outstanding loans	1.0	1.9	2.3
Number of deposit accounts	n.a.	7.3	14.5
		(dollars)	
Average loan amount	162	296	512
Average deposit amount	n.a.	94	164
Financial self-sustainability			
		(percent)	
Nominal average yield on loan portfolio	27.4	31.5	31.6
Nominal average interest rate on deposits	10.5	11.3	9.7
Nominal interest rate spread	16.8	20.2	21.8
Real average yield earned on loan portfolio	21.7	22.4	20.2
Real average interest rate paid on deposits	5.6	3.6	0.3
Lowest nominal lending interest rate needed for financial self-sustainability	36.2	27.2	17.5
Lowest real lending interest rate needed for financial self-sustainability	30.1	18.4	7.3
Operating costs as a percentage of			
Average annual net loan portfolio	20.5	12.9	12.6
Half of the average annual net loan portfolio and deposits	31.5	11.6	8.3
Average annual total assets	15.1	8.0	5.3
Profits (million dollars)	(0.8)	34.3	170.2
Percentage of profitable units	48.3	89.1	95.7
Average annual deposit volume/average annual loan portfolio volume	0.3	1.2	2.0
Subsidy dependence index	32.2	(13.7)	(44.5)
Sources: BRI Unit Desa and authors' calculations. Note: Inflation was 4.7 percent in 1985, 7.4 percent in 1990, and 9.4 percent in 1995. n.a.: Indicates data not available.			

Chart 2
Increase in actual and forecast employment cost indexes for wages and salaries
 (percent)

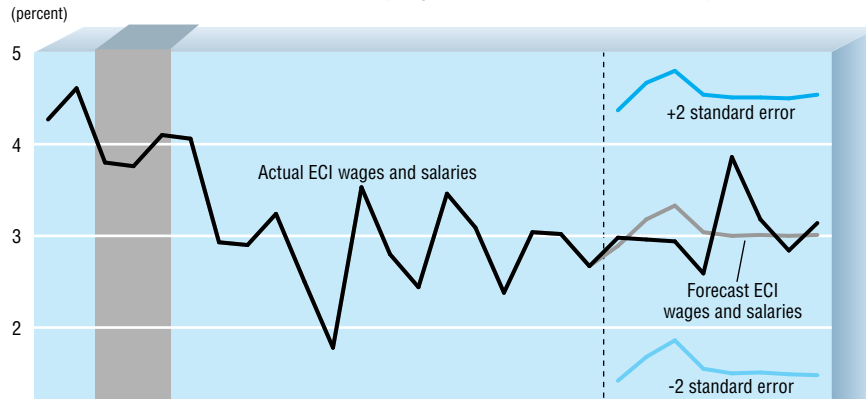
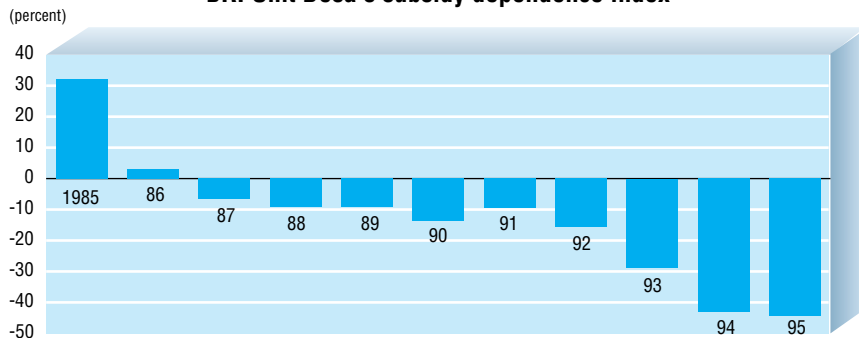


Chart 3
BRI Unit Desa's subsidy dependence index
 (percent)



Source: Authors' calculations.

Indonesia, demonstrates that RFIs can achieve financial self-sustainability and a high degree of outreach (see table).

BRI Unit Desa was established in 1984 as the successor to BIMAS (Mass Guidance), a program of directed credit that facilitated Indonesia's self-sufficiency in rice production. BIMAS had become unsustainable because of subsidized interest rates, a poor loan repayment record, and an emphasis on disbursements over sound financial performance. BRI Unit Desa was required to provide rural financial services on a self-sustaining basis; if it did not, it would be disbanded. With a relatively small initial subsidy in 1984, BRI Unit Desa became a leading rural financial intermediary in just a few years. By the end of 1995, it no longer needed a subsidy; it had made a profit of about \$170 million and was serving about 2.5 million borrowers and 14.5 million savers. A number of factors have contributed to BRI Unit Desa's success.

Innovative operating policies and autonomy. The fundamental difference between BRI Unit Desa and other RFIs has been its broadening of the target clientele to the low-income rural population, rather than just farmers. In addition, not only were its loan and deposit interest rates

much higher, but the spread between them was sufficient to cover the costs of servicing small loans and deposits (Chart 2). Incentives for both clients and employees were put in place to ensure timely and complete loan repayments. The focus thus shifted from credit disbursement to loan recovery and savings mobilization. Extremely efficient management information systems were established. BRI Unit Desa operates as an independent profit center, with its own management tools, within the state-owned Bank Rakyat Indonesia.

Low-cost delivery. Loans generally have a maturity of one year, and all income-generating activities are eligible for financing. The application process takes about one week for a new borrower, less for a repeat customer. Collateral is considered desirable, but is not mandatory. Mobile units that provide limited services make several visits a week to areas where the volume of business is relatively small—and which previously had no access to banking services.

High-quality portfolio. Portfolio quality is heavily emphasized, because the small loan amounts and relatively costly legal procedures make foreclosure prohibitively expensive. Clients are carefully screened

and given incentives for repayment (such as substantial interest rebates and the promise of future, larger loans), and staff incentives are linked to loan portfolio performance.

Substantial spreads. The interest rates on loans are designed to cover the full financial, operational, and credit risk costs. The average annual interest rate on loans has hovered at around 32 percent in recent years, while average annual financial costs have been about 10 percent; thus the average spread has been substantial, at more than 20 percent.

Self-sufficiency. BRI Unit Desa has been self-sufficient since 1987. In 1995 it could have reduced its on-lending rates by more than 40 percent (from 31.6 percent to 17.5 percent) and still have remained subsidy-independent (Chart 3).

Conclusion

Considerable progress has been made over the past two decades in developing cost-effective approaches to rural financial services. As demonstrated by BRI Unit Desa's success, financial services can not only be provided to low-income rural clients at lower costs than was previously thought possible but also with smaller or no subsidies. BRI Unit Desa has helped remove what has often been considered a major obstacle to rural development in Indonesia—rural households' lack of access to financial services.

The challenge now is to implement the policy, legal, and regulatory reforms needed to create an environment in which rural financial markets can develop and flourish, and to determine when and how governments should intervene, to complement the work of markets. [F&D]

This article is based on Jacob Yaron, McDonald Benjamin, and Gerda L. Piprek, 1997, Rural Finance: Issues, Design, and Best Practices, No. 14 in the World Bank's Environmentally and Socially Sustainable Development Studies and Monograph Series (Washington: World Bank).

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