MICROFINANCE INSTITUTIONS MOVING INTO RURAL FINANCE FOR AGRICULTURE

Microfinance institutions (MFIs) have tended to avoid less densely populated or diversified rural areas, and financing of seasonal or longer-term crop and livestock activities. However, a few innovative MFIs have recently led the way in adapting their operations and products to expand into agricultural lending. Techniques used have included tailoring procedures and products to agricultural seasonal needs, applying risk management techniques, and adopting new technologies. Successful MFIs have important strengths, such as financial sustainability, excellent portfolio quality, financial products that fit diverse client needs, and a clear commitment and orientation to the poor. Prudent risk management techniques can increase the outreach of MFIs to less affluent, more remote rural areas and more diversified farmers.

Rural financial services have benefited significantly from treating the rural household as a unit with diverse activities and sources of income and financing, instead of maintaining a narrow focus on agricultural credit. However, financing for agriculture still tends to fall outside the scope of the mainstream microfinance industry. Where rural microfinance providers do exist, they are mostly limited to diversified rural economies and to clients with a number of income sources. Rural areas that are not densely populated, or that are dependent on a few principal crop and livestock activities, tend to be avoided by MFIs, because of higher transaction costs, price and yield risks, seasonality, and collateral limitations in the agricultural sector. Conventional microcredit relies heavily on short-term loans with frequent, regular repayments, which does not fit well with seasonal crop production or livestock production (except for poultry).

INVOLVEMENT OF MICROFINANCE INSTITUTIONS

Public investments can help microfinance providers meet the challenges of financing for agriculture. These require adaptations to conventional financial products and delivery mechanisms, including the following:

Matching disbursement and repayment to agricultural production cycles. Flexibility in loan disbursement and repayment is needed, with finance made available when farmers need it and repayments matching income from produce sales. PRODEM, a rural MFI in Bolivia, redesigned its lending products by using market research to understand the financial service demands of agricultural clients (see box 7.8).

Several other leading MFIs have also adapted their lending methodology to fit agricultural activities. For example, the agricultural loans product of Calpiá, an El Salvadorian MFI, have been successful largely as a result of their flexibility on timing, amount disbursed, and repayment schedules. With regular bimonthly, trimester, semester, annual or even end-of-crop-cycle and irregular payment options, repayment schedules are sufficiently flexible to be attractive to a range of agricultural activities. Calpiá's agricultural lending product still treats the farm household as a financial unit, basing lending decisions on overall repayment capacity.

Flexibility in collateral requirements. Land may hold little value as collateral, as land-use rights may be difficult to prove, clients may not own land, land markets may be weak, or cost of registering land as collateral may be high. Financial service providers therefore need to be more flexible in terms of the collateral required, even if the value of nonmortgage guarantees is sometimes more significant as a repayment incentive than its real resale value. Personal guarantees, movable assets, and group guarantees can all be adequate alternatives. Because it is time consuming and more expensive to get the notarization required for a mortgage guarantee, Centenary Rural Development Bank (CERUDEB) in Uganda

also accepts livestock, personal guarantors, land without a title, household items, and business equipment. Since women may be disadvantaged by traditions of registering property in the husband's name, women tend to rely more heavily on their human capital for accessing loans (shown by women's greater participation in solidarity groups).

Using technology. Technological innovations can increase operational efficiency and lower costs of operating in rural areas, while improving financial services available to rural clients. ATMs, point-of-sale machines, and smart/debit cards provide flexible payment options and more convenient access to client accounts. They can also reduce branch infrastructure and employee costs. A major advantage of their use in rural areas with poor infrastructure and communications is that financial transactions can be conducted entirely offline with all account information stored in the chip.

Personal digital assistants (PDAs) can streamline loan officer activities and speed decision-making. The value of fast, in-the-field decisions can be enhanced by incorporating credit scoring into palm pilots or hand-held computers. However, this requires well-developed client information systems. ADEMI in the Dominican Republic has developed a credit scoring system linked to laptops and PDAs, and estimates that it will substantially reduce loan disbursement time in rural areas.

However, while the potential offered by new technologies is significant, experience has been mixed. There has been a tendency to overestimate the short-term benefits and underestimate the up-front implementation costs. In India, the Swayam Krishi Sangam's experiment combines smart cards with hand-held computers to streamline meetings between clients and borrowers in remote areas. However, this did not produce the dramatic time savings expected, and expansion of the project has been put on hold.[7]

7. See the IAP, "India: Piloting of Smart Cards in Rural Areas"

Flexible delivery mechanisms. Making use of existing delivery outlets, rather than investing in expensive new branch networks, can significantly lower the cost of providing financial services, and can also allow a wider range of services to be provided. This also holds potential for rural women whose opportunity cost of engaging in financial transactions, due to time constraints, not only involves lost income but also internal household substitutions (for example, child labor for female labor).

Options include: working with/through rural post offices, retail stores, rented offices in schools and hospitals, or shared offices with other financial institutions. Mobile staff can help reduce operating costs and improve access in more remote areas. For example, Constanta, an MFI in Georgia, uses temporary "service points" (typically rented rooms in a bank branch) coordinated by nearby branch offices, and linked to mobile loan officers. In Latvia, the Agricultural Finance Company used mobile credit officers to overcome transportation problems faced by farmers. This mobility also enabled loan officers to visit clients frequently and encourage loan repayment.

Box 7.8 Bolivia: PRODEM—using market research to adapt lending methodology

PRODEM is one of the largest providers of rural financial services in Bolivia. It conducted donor-supported market research and product development to adapt its range of financial products to suit client needs, including the financing needs of small farmers. A customized repayment scheme was introduced for small farmers, with differing repayment schedules even for members within a solidarity group to fit harvest calendars. Individual agricultural loans were also introduced, with collateral at a ratio of 1.5:1 to the loan amount. PRODEM further minimizes risk by restricting final loan payments to a maximum of 60 percent of the loan amount, and by limiting each office's portfolio in each economic sector to 30 percent. Money transfer, microleasing, and savings products were also designed. Agricultural lending now accounts for about one-fifth of PRODEM's loan portfolio.

Sources: Lee 2000; Rubio 2003, Internal report prepared for CGAP.

Risk management techniques. A principal factor discouraging MFI lending to small farmers is the systemic risk inherent in much smallholder agriculture. Most MFIs that have successfully moved into agricultural lending have used a diversification strategy to reduce lending risk, both in their portfolio and at the household level.

Portfolio diversification helps ensure that a loan portfolio be diversified across sectors and regions/communities, and that repayments do not fall due at the same time. This increases the stability of the portfolio and reduces lending risk from weather events and from price fluctuations in certain crops. Confianza, a Peruvian MFI, which developed from a purely agricultural portfolio, has now set a target percentage for agricultural lending of 30 percent of its overall portfolio. Uganda's CERUDEB, which reached out to rural areas from an urban base, set its upper limit at 25 percent. Household diversification is also important, as many of those MFIs that have developed a stable agricultural lending portfolio minimize risk by excluding households that are reliant on only one or perhaps two crops and have no off-farm income. Other risk management techniques include:

- Limiting the length of loans to agricultural smallholders. However, this can result in a lack of term finance important to agriculture, for such investments as tree crops, erosion control, some livestock activities, and equipment and machinery.

- Testing a new rural market before investing in a branch office. This reduces the risks involved in expanding rural finance outreach. Calpiá reduces the risk of establishing new rural branches by first building the portfolio from neighboring branches and conducting market studies of a new region. Rural branches are set up only if the portfolio size merits the investment in infrastructure and human capital.

- Purchasing hedging instruments on international markets helps to manage potential losses from price or weather risk, and allows greater confidence in moving into agricultural lending. However, this can be expensive and is still to be tested for MFIs.

BENEFITS

Increased MFI activity in more difficult rural areas and in financing agriculture, results in increased competition, higher volumes of finance, and a wider range of financial services available to farmers and their households. The rapid growth of the agriculture portfolio of MFIs such as Bolivia's PRODEM and Caja los Andes, and El Salvador's Calpiá, suggests that there was significant unmet demand for financing for agriculture.

MFIs can offer credit not just for agriculture but also for nonfarm, household, and emergency needs, as well as savings and transfer payment services (if they are appropriately licensed). Increased competition between financial service providers operating in rural areas (such as product-market credit providers, moneylenders, credit unions) can lead to more favorable and transparent terms of access for the poor. Good practice MFIs can also bring a commitment to efficiency, transparency in reporting, high portfolio quality, and sustainability.

POLICY AND IMPLEMENTATION ISSUES

Policy environment. Expansion by sustainable microfinance providers into financing for agriculture will ultimately be limited by underlying constraints arising from poor infrastructure, high-risk or low-return agriculture, deficient client information, poorly functioning property registries and markets, and policy biases/distortions. Improving the enabling environment for rural finance remains an urgent priority.

Services for the poor. Even those MFIs that have successfully expanded into financing for agriculture have mostly been limited to farmers with diversified household incomes in less-remote areas. Portfolio diversification is a widely used

risk management strategy. Although effective, it has a clear drawback, from a poverty reduction and market development perspective, of limiting access for poorer farmers from marginal rural areas. Other institutional models also have this problem, although less formal membership-based financial organizations may have a greater tolerance for operating in these areas, given their responsiveness to their members, and also their relatively low cost.

Term finance. Term finance is more costly and risky than short-term finance, since it ties up larger amounts of money for longer periods, and requires the mobilization of long-term funding. It requires more careful screening and selection of borrowers, increasing transaction costs. Term finance is best provided by competent financial institutions within a well-developed rural financial system, as increased attention is needed to maintain a good lender-borrower relationship over time, and techniques are needed to manage increased lending risks. BAAC in Thailand, a large state-owned bank and one of the largest MFIs in the world, reportedly has over half of its outstanding loans (which total US$5.6 billion) with terms over one year. BAAC uses donor and government funding and term deposits to supplement its commercial borrowings to match its liability-asset structure. Longer-term donor funding can potentially address the funding constraint for term loans, but not the higher risk involved.

Liquidity management. Disbursements in several installments over a cropping period, repayments at harvest, and a lean time characterized by repeated requirements for cash, all present a liquidity management challenge to providers. An institution's cash flow can therefore become more cyclical, with suboptimal asset productivity. To improve the productivity of staff and assets, and to improve liquidity management, alternative financial products can be developed, such as nonseasonal loans for household needs and deposit facilities. However, in communities that are highly dependent on a few agricultural activities, the demand for these products will also be seasonal. Transfer payments from urban areas or from abroad do not follow the same seasonal patterns, and can smooth demand for loans and facilitate repayment in periods of low agricultural income, as can savings deposits.

LESSONS LEARNED

Principal lessons learned for supporting MFIs to move into agricultural finance are:

- Flexible disbursement and repayment schedules are key to successful agricultural lending, although they may increase default risk and present liquidity management challenges.
- Diversification at the portfolio and client household levels can reduce the risk for MFIs of expanding into financing agriculture. However, it can also restrict access to financial services for farm households dependent on agriculture. Nonfinancial interventions to improve market access and infrastructure may make these clients more attractive in the longer term.
- Technology can help lower costs and expand rural finance operations, but a careful cost-benefit analysis should first be conducted, and the MFI's management information system (MIS) may first need to be upgraded.

RECOMMENDATIONS FOR PRACTITIONERS

Recommendations for practitioners involved in MFI related investments include (see box 7.9):

- Plan feasibility studies, piloting, and market research to reduce risks of moving into financing for agriculture and enhance usefulness of financial services to farmers.
- Assess the impact on the financial institution itself (for example on cash flow, loan repayment, and staff productivity) of adapting loans to fit agricultural cycles.
- Focus on other financial services as well as credit, as access to remittance monies and

Box 7.9 Potential investments

- Funding for product design (savings facilities and transfer payments, and not just loans), including funds for market and client research, piloting new products and staff orientation.
- Support for replicating proven approaches (PRODEM or Calpiá) with other MFIs.
- Funding for piloting adoption of technologies (ATMs, palm pilots, and smart cards) and/or the use of flexible delivery mechanisms (postal offices, retail stores, and schools).
- Feasibility studies to assist MFIs in making decisions on introduction of new technology.
- Management information systems and equipment for their effective operation.
- Investment in a positive enabling environment to enhance the viability of rural finance for agriculture, through developing infrastructure, legal systems, and communications.
- Research and piloting of innovative sources of collateral for the agricultural sector, to allow economically active poor who are landless or asset-poor, to qualify for loans.
- Nonfinancial support to farmers, through business development services, infrastructure improvements and other means, to bring clients up to a level where they are creditworthy.

Source: Authors.

deposit services can help clients (and MFIs) smooth seasonal income flows.

- Expansion costs (for example, setting-up new rural branches) may merit funding support, but more cost-effective alternatives, such as sharing facilities with other financial or nonfinancial entities (post office, stores), should be explored first.

SELECTED READINGS

Asterisk (*) at the end of a reference indicates that it is available on the Web. See the Appendix for a full list of Web sites.

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