4

Micro-finance in Rural Communities

4.1 OVERVIEW

Rural finance can be considered the stepchild of the broad micro-finance sector. Most efforts in the world to support micro-finance endeavours are in the urban or peri-urban context. Rural finance is often equated with agricultural finance, and associated with the general high risk of providing financial services to the agricultural sector. Rural finance basically refers to micro-finance in rural areas and it incorporates agricultural finance. This section gives an overview of rural finance issues, lessons learned and best practices.

Financial intermediation between banks and clients is more difficult and costly in rural areas than in urban areas because of three inescapable rural characteristics (Coetzee *et al*, 1996):

- spatial dispersion and the associated high information and transaction costs;

- specialization of rural areas in a few economic activities linked directly or indirectly to agriculture, which exposes rural clients to the vagaries of nature and leads to covariance of their incomes; and
- seasonality of production with its accompanying sharp and opposite fluctuations in the demand for credit and deposit services.

If a rural bank operated in a single small area such as a group of villages, it would be able to sharply reduce the information and transaction cost problems associated with spatial dispersion. However, covariance and seasonality would force it to operate with a large reserve ratio. A high reserve ratio requires large intermediation margins to make such rural banking profitable. Rural financial institutions conventionally use three ways to reduce the impact of covariance and seasonality on reserve requirements. Firstly, they diversify their client base and loan portfolio out of agriculture into agro-processing and other rural non-farm enterprises. Secondly, they link their operations to the urban economy through financial markets or by integrating the rural operations into a branch network that includes urban locations. Thirdly, they set up inter-regional risk pooling mechanisms via networks or federations of individual rural financial institutions.

But interregional links, whether through branch banking, federations or other risk pooling devices, still face special difficulties in supervising and monitoring operations of an individual rural branch or office. These difficulties are associated with the distance and fluctuations in branch performance that are induced by seasonality and covariance. Rescheduling of the debt of rural clients within a particular zone is occasionally required in order to tide them over years of bad crops or bad prices. This leads to opportunities for clients to collude against a single local institution, a branch, or an entire system, which further increases the supervision problem.

Specialized farm credit institutions, the mechanisms of the conventional supply-led approach to rural credit, are poorly adapted to address the difficulties associated with rural finance. They typically do not diversify their client base and portfolio inside the rural areas. They are usually not integrated into larger institutions with urban operations and have limited urban diversification and risk pooling opportunities. Even with inter-regional risk pooling they remain vulnerable to major droughts affecting an entire country and to international commodity price slumps.

Recently, a more diverse approach to financial intermediation in rural areas became apparent. This approach acknowledges the context and a range of institutional options in different contexts. In some settings co-operative or member-based institutions seem to be more appropriate; in other settings credit programmes combining individual and

group technology seem appropriate. Some reformed state banks have also been successful in improving access to financial services in rural areas. There is no single model that is applicable in all settings but there are some basic rules that are applicable in most settings. This will be explored further in this section.

The history of rural finance and the differentiation between a conventional supply-led approach and a new market based approach is aptly summarised in the table below.

FIGURE 4.1 Comparison of the Directed Debt Approach with the New Market Based Approach

Features	Directed Debt – conventional approach	Financial Market Based – new approach
Problem definition	Market imperfections	Transaction costs
Role of financial markets	Help the poor, technology, stimulate production	Allocation of resources
View of users	Beneficiaries	Clients
Subsidies and taxes	Dependent	Independent
Sources of funds	Vertical	Horizontal
Information	Not an issue	Central issue
Sustainability	Ignored	Emphasised
Evaluations	Bean counting	Performance of institution

Source: Adapted from Adams, 1999

Although the conventional approach is part of our history of rural and micro-finance, many challenges still remain. The following table summarizes recent development and continued shortcomings in rural finance and micro-finance.

FIGURE 4.2 Recent Developments and Continued Shortcomings in Rural Finance and Micro-Finance

Topic	Recent Developments in Some Countries	Continued Shortcomings in the Majority of Countries
Policy environment	Macroeconomic stability; interest rate deregulation; ease of setting up banks or branches; low minimum capital requirements for MFIs	Inadequate policy and legal environment; slow implementation of deregulation; inadequate property rights and judicial procedures
Micro-finance institutions	New legal forms for commercially operating MFIs; privately financed start-up; increasing numbers of self-sustaining MFIs	Lack of appropriate legal forms; excessive capital requirements
Non-formal and formal non-bank financial institutions	New legal framework provides opportunities for upgrading to formal levels and for financial market integration	The potential for upgrading millions of informal financial institutions remains largely untapped

Figure 4.2 *continued*

Topic	Recent Developments in Some Countries	Continued Shortcomings in the Majority of Countries
NGOs	Innovative approaches to poverty lending in repressive environments; some successful conversions to formal intermediaries	NGOs are slow in mobilizing domestic resources and in striving for self-reliance; donors support unviable NGOs
Agricultural development banks	Incipient reforms towards autonomy, viability and self-reliance, with or without privatisation	Political interference; lack of viability; failure to meet demand for credit and deposit services
MFI regulation and supervision	Controversial discussion on the need for effective regulation and supervision of MFIs	Financial authorities unable to supervise MFIs; agricultural development banks (AgDBs) escape supervision; lack of MFI self-regulation
Agricultural finance	Self-financing from profits and savings plus non-targeted commercial credit replaces preferential sources	Self-financing and commercial credit insufficient to meet the demand for short- and long-term finance; inadequate savings mobilization
Access of the poor to financial services	Outreach of viable MFIs (including rural and other banks) to the poor as users and owners drastically increased	Vast numbers of poor people, particularly in marginal areas, lack access to savings and credit services

Source: IFAD, 2000

It is clear that major challenges still remain. In the next two sections the lessons of experience that can help to form a strategy on the best approaches in rural finance will be summarized, and the best practices in rural finance will also be highlighted

FIGURE 4.3 Some Frequently Asked Questions about Micro-Finance

What is meant by 'micro-finance'?	There is probably no universally accepted definition. But in the context of lending, a reasonable working definition is that it refers to loans to clients who are unable to gain access to conventional commercial bank loans. Such borrowers are often called "unbankable" – a complete misrepresentation when one recalls how many millions (at least eight million in South Africa alone) now borrow from the micro-finance industry. While reluctant to lend, commercial banks are quite willing to accept savings from "unbankable" clients. A reasonable working definition of micro-finance in a savings context might refer to the savings of all such "unbankable"clients, whether deposited with commercial banks or with any other financial institution (as well as any savings that "bankable" clients happen to lodge with informal, or unregistered, savings bodies). Micro-finance could also include any other financial services, such as transmission facilities or insurance, provided to "unbankable" clients.
What are micro-loans used for?	Almost anything that involves spending – consumption expenditure, from school fees to television sets, or capital outlays, from financing the purchase of goods to be sold to fund the acquisition of productive assets such as hairclippers or wheelbarrows. Some loans are made for specific purposes – e.g. credit advanced by the sellers of assets – and others are non-specific cash loans.

Figure 4.2 *continued*

What are micro-loans well adapted for?	Most micro-loans are for short periods, typically a few days to several months, and require frequent small repayments. Clients need to have a frequent and fairly regular flow of income to meet this requirement. Stable wage employment generates just such a cash flow and so do many micro-enterprises that manufacture goods or provide services. Micro-loans are well adapted to almost any purchase that is not too large to be repaid within a relatively short period, given the client's earnings level and pattern.
What are micro-loans generally not able to do?	Finance the purchase of capital items whose payback period is longer than a few months or that does not generate an adequate stream of earnings for some while after the date of purchase. Most "large" capital outlays fall into this category for micro-entrepreneurs, as (unfortunately) do even relatively small short-term outlays for most types of farming (dairy and poultry being two exceptions), unless the farmer is able to draw on income from other sources.
Why do micro-lenders normally insist on short repayment periods and on frequent payments?	Micro-lenders rely on traditional forms of security for loans, such as a mortgage bond on a house or on land, to a far smaller extent than commercial banks, if at all. This is because borrowers often do not have such assets to pledge – which is why commercial banks regard them as "unbankable" – and because, even if they do, the cost of legally securing such assets and then of actually taking possession of them in case of default is far too high to be covered by the interest that the lender earns on a small loan. Instead, most micro-lenders have to rely on clients' future flow of income for security. The shorter the term of the loan and the more frequent the repayments, the smaller the risk that current known income sources will evaporate before the loan is settled in full. As clients demonstrate the ability to pay, so most micro-lenders are prepared to lend more, regarding the risk as smaller even though the amount lent is larger. Track record serves as an excellent, low-cost substitute for the typical careful investigation into clients' background that commercial banks conduct before lending.

4.2 LESSONS FROM EXPERIENCE

The experience gained in many developing countries in operating rural finance and agricultural credit systems is extremely important in considering the redesign of the rural finance system in the specific countries Southern African countries covered in this report. Generally, the performance of many rural finance systems in developing countries has failed with respect to both efficiency and equity considerations. However, over the last two decades, several successful institutions and programmes have emerged, scoring high when assessed with respect to the **two overriding criteria**:

i) outreach to the targeted population; and

ii) achieving full self-sustainability or significantly reducing subsidy dependence.

The experience gained in other developing countries can be instrumental in adopting policies, modes of operation and procedures that have been introduced in the few

successful rural finance institutions and in refraining from repeating widely spread errors. Such errors have often drained scarce budget resources and have frequently benefited well-to-do, influential farmers rather than the more needy, low-income farmers and rural entrepreneurs.

The Performance of Specialized Agricultural Credit Institutions (SACIs)

In general, specialized institutions established to implement targeted and often subsidized loans were frequently planned and operated in a non-viable manner, or within economic, political, social and institutional environments, that hampered their effectiveness. Among the most important deficiencies of the state-sponsored SACIs has been the conspicuous absence of balance between voluntary savings mobilization and the institutions' sizeable loan portfolios. Inadequate, depressed deposit interest rates, which have resulted from and co-existed with easy access to cheap funds of state or international donors, have discouraged savings mobilization. As a result, these SACIs have often emerged as mere credit disbursement windows rather than as balanced, full-service financial institutions. Often the aggregate cost to society of maintaining continued operations of the institutions involved, including the value of the subsidies in the form of access to cheap and subsidised sources of finance, has not been properly disclosed.

Since their operations have not been motivated by commercial financial performance objectives, these institutions, by and large, have suffered from inadequate credit evaluation, management and follow-up procedures. This, in turn, resulted in very poor loan collection performance. Instead of gradual growth and prudent expansion, whereby collection performance and other financial viability criteria serve as prime indicators in assessing the soundness of the institutions involved, these institutions have practised lax screening of investment plans, rapid disbursements and imbalanced steep growth in lending volume and loan portfolio. Deficient financial reporting practices have often made it almost impossible to determine when and which payments are overdue, as well as what part of the loan portfolio is non-performing or beyond recovery. Arrears have often been measured against the total value of the loan portfolio, thus grossly underestimating the severity of the arrears problem when the portfolio has grown rapidly in nominal terms (which regularly happens in highly inflationary economies), when the loan portfolio has consisted of a substantial share of long-term loans, and when grace periods have been granted. Generally, adequate provision for bad debts has not been made and a proper assessment of the institution's sustainability has often been impossible. The financial results disclosed by these institutions have often been too rosy, as loan losses have not been accounted for properly. The actual dismal financial position would only be discovered when the institution lost its liquidity.

By attempting to ensure that eligibility criteria have been met and to avoid the diversion of funds, these SACIs have not only incurred high costs but also have imposed high transaction costs on borrowers by, *inter alia,* forcing them to wait long periods for loan disbursement. Control of on-lending interest rates, a widespread practice in developing countries, has not allowed compensation for the high level of risk involved in lending to agricultural operations, given their exposure to the vagaries of nature. In addition, medium and long-term loans have been granted without adequate analysis of the investments or adequate collateral. To maximize the return on these institutions' loan portfolios, when constrained by legally imposed ceiling interest rates, large borrowers have often been favoured in an attempt to minimize risk and administrative costs per dollar lent, thereby crowding out small-scale entrepreneurs.

The main lessons learnt over recent years can be summarized as follows:

Rural finance entrepreneurs, including small farmers, wish to have access to efficient formal financial services. The access, not the subsidization of the lending interest rates, is extremely important to their livelihood. Access to efficient formal finance systems, even without subsidized interest rates, would likely improve their situation as they would be paying less than the interest rates charged by informal moneylenders or less than interest rates that reflect the sum of financial and transaction costs associated with borrowing from less efficient supply-led programmes. Almost invariably, the design of such a system faces a dilemma: whether, subject to budget constraints, priority should be given to servicing more people with less subsidy per unit lent, or fewer people with higher subsidy per unit lent.

The rural poor have often greatly benefited from and appreciated the design of sound saving schemes that ensure convenient access to their secured and liquid deposits and pay adequate return on their savings.

"Urban Biased" Policies

Many developing countries have implemented "urban biased" policies that have adversely affected the performance and profitability of the agriculture sector over the recent decades. These policies have been: (i) over-valued rate of exchange; (ii) price control on agricultural produce; (iii) over-protection of outputs of domestic industry that are used as agricultural inputs; (iv) inadequate investments in rural infrastructure (roads, health, education, water supply, etc); and (v) direct, over-taxation of agricultural export.

In an attempt to compensate the sector for the results of these deficient policies, directed, concessional credit programmes have often been introduced. This "second best" compensation mechanism, however, cannot efficiently offset the adverse impact of

these discriminatory policies. This "second best" approach is neither capable of ensuring the realization of the potential growth of the agriculture sector nor is it capable of mitigating equity issues. Furthermore, the subsidized interest rates of directed credit schemes are likely to **benefit only a part, frequently a small part, of the farming sector** because these schemes are invariably budget constrained, while the "urban biased" policies would continue to affect adversely the agriculture sector as a whole. In addition, it is often well-to-do farmers who are the likely beneficiaries of the directed, concessional credit scheme. Therefore, this compensation mechanism of subsidized interest rates is likely to worsen the income distribution.

Thus, these deficient policies ought to be tackled directly and removed to allow the agriculture sector to maximize its growth potential. The "second best" policy of partial compensation through subsidized credit is often a futile exercise that only augments distortions by adding financial intermediation distortions to the already existing deficient policies and distortions prevalent in the agriculture sector.

Interest Rate Policy

There is no *a priori* economic justification for general subsidization of on-lending interest rates to ultimate beneficiaries in the agriculture sector. Scarce resources will be required, however, to finance the start-up activities and institutional strengthening of emerging rural finance institutions. These institutions could benefit from gradually decreasing subsidies/grants provided in a time-bound manner. When income redistribution is pursued on equity grounds, a grant is a preferred mode over subsidized interest rates.

The use of grants, which should be budget funded, generates transparency and fiscal discipline. It also improves the likelihood of the adequate delivery of the intended grant. In contrast, a subsidized loan of the type extended by, for example, the typical SACI in South Africa (Agricultural Credit Board, now closed) – namely, a loan for the purchase of land for up to 25 years, with nominal interest rate of 8% per annum and a grace period of five years – results in a financial contract, the actual grant element of which is determined only ex-post by the difference between the rate of inflation and the 8% lending interest rate over the loan duration. The full extent of such subsidy is often hidden from both decision makers and the public, thereby making it impossible to assess the merits and costs of the subsidized terms of the loan compared with other public investments options.

Interest Rate Subsidies

Subsidized interest rates have been found to create a number of undesirable outcomes. Subsidizing interest rates creates a bias toward acceptance of investment projects with

low returns. These projects do not enhance sectoral productivity and growth as much as projects with higher returns. If subsidies are to be given, they must be carefully designed not to distort the market, but rather to promote its development. Subsidies for technical assistance and location subsidies for reducing transaction costs are preferable to interest rate subsidies. However, directed lines of credit frequently involve below-market interest rates.

Interest rate subsidies have been found to encourage the substitution of credit for the borrower's own funds (or the funds of other lenders), promote excessive indebtedness, skew incentives in favour of capital-intensive techniques of production, encourage corruption and the rationing of credit, and weaken borrowers' incentives to repay and lenders' incentives for debt recovery. Interest rate subsidies also result in lower return to savers and higher costs for non-subsidized borrowers, unless the subsidy is fully paid by the budget instead of the banks. Finally, interest rate subsidies have added significantly to fiscal deficits and inflation in many countries.

Savings Mobilization

Poor people, especially the rural poor – who are subject to the vagaries of nature, face a high covariance risk and highly fluctuating incomes – need savings facilities. Often, access to savings is their only recourse in case of emergency. Therefore, the design of rural finance schemes should incorporate the provision of savings services. The latter includes, among others, the safeguarding of deposits and savings through adequate institution building in the rural finance institutions' concern, regulation and supervision. All the successful rural finance schemes have recently increased the financial ratio of voluntary savings over outstanding loan portfolio, thereby progressing towards subsidy independence and reduced reliance on donor or state funds. Furthermore, rural finance institutions have demonstrated a more efficient financial intermediation performance when they have operated on both sides of the balance sheet and have reduced the transaction cost compared with rural finance institutions that have extended only loans.

Rural Finance vs Agricultural Credit

When rural development is pursued, ensuring the availability of efficient rural finance services (including savings) is preferable to extending credit to finance exclusively agricultural production. There is nothing "sacred" about income generated from agriculture compared to income generated from any other rural activity. Furthermore, given the high covariant risk associated with agriculture, other non-agriculture activities would often mitigate such risk. Rural finance intermediaries have often

obtained a more balanced and less risky arrears “contaminated” loan portfolio when launching credit in an indiscriminate manner to all segments of the rural economy, thereby considering the creditworthiness of the borrower and the merits of the investments financed.

Rural Finance, Rural Infrastructure and Complimentary Services

When rural finance schemes accompany investments in rural infrastructure, their performance is often more efficient and less subsidy dependent. They also achieve increased outreach and contribute more to the welfare of the rural population. Appropriate investments in rural roads, water supply, electricity, health and education are likely to increase the economic and financial return on private investments that, in turn, would facilitate improved loan collection and financial viability of the rural finance institutions involved.

Where land reform is implemented and new entrants lacking adequate skills are the beneficiaries, it is essential that they should benefit simultaneously from access to other complimentary services. This enhances the likelihood of successful settlement and prompt debt repayments (extension, etc.). Defaulters should be foreclosed as soon as it is realized that they cannot become viable farmers. This ensures financial discipline and adequate resource allocation within a framework of a well-defined exit strategy. Concerted efforts are essential to ensure the optimal mix of support granted to institutions that provide financial services, investment in rural infrastructure and provision of supplementary services.

Financial infrastructure is another extremely important consideration. South Africa’s success emanates from its large existing infrastructure. Micro-credit is an easy add-on if people already have bank accounts. This refers not so much to the “unbanked” as to those who do not have access to credit. Countries with better overall financial infrastructure (including successful agri-credit banks) can adapt much more rapidly to successful rural finance.

Across Africa, the carrying potential of the market is a critical determining factor in the successful establishment of viable MFIs. Top-down, credit-driven institutions are often too expensive to operate successfully unless they have extremely high interest rates (well over 120% effective), which implies that the economic activities must be that profitable. The best financial intermediaries in poor rural areas reduce the “leakage” and financial transactions costs to a minimum, reinvesting the hard cash (which is the scarce resource) back into the programme. These tend to be savings based with transparent, simple systems for management. As noted above, areas with efficient rural

infrastructure and intermediaries can help to reduce these costs by simplifying transactions and reducing their costs.

4.3 BEST PRACTICES

The International Experience

A growing literature on rural finance has recently based its assessment of programmes' performance on two criteria – **the level of outreach and the degree of self-sustainability achieved**. The main performance **indicators of outreach are**:

- the value of total savings;
- the average value and number of savings accounts;
- the value of the outstanding loan portfolio;
- the average value and number of loans extended;
- the real annual growth of assets in recent years;
- the number of branches or units established;
- the percentage of the targeted rural population actually served;
- the level of participation of women, small-holder farmers, the poor or any other underserved segment of the population that is intended to be serviced; and
- the outcome of the administrative intervention in the financial markets.

In addition, outreach has also recently been measured in softer terms, incorporating measures of the poverty levels of clients.

Financial self-sustainability of a development finance institution is achieved when the return on equity, net of any subsidy received, equals or exceeds the opportunity cost of funds. To eliminate or significantly reduce subsidy dependence, a development finance institution needs to have:

- a positive lending rate, which is high enough to cover its costs;
- a high rate of loan collection; and
- relatively low administrative costs.

It is also highly desirable that the development finance institutions develop an active policy towards promoting voluntary savings mobilization in pursuit of substituting funds sourced from the state or donors.

There are by now several well-documented cases of financial intermediaries, which have succeeded in reaching the rural poor in an efficient, innovative and sustainable manner. Perhaps the best known are the BRI – Unit Desa (BUD) in Indonesia, the Grameen Bank[1] in Bangladesh (GB) and the Bank for Agriculture & Agricultural Co-operatives in Thailand (BAAC). These three programmes differ in many respects. Nonetheless, an examination of both their differences and similarities has highlighted what may well explain their success in reaching a wide segment of their targeted clientele, achieving significant presence in their countries' formal finance sector and either fully reaching self-sustainability or making significant progress toward subsidy independence.

All these programmes have charged positive real interest rates on their loans. BUD has provided financial services exclusively and obtained a real interest rate exceeding 20% on its loan portfolio. It started by successfully restructuring its loan products and system. Following this and based on demonstrated demand by its clients, it included savings products in its product range. Lacking any subsidy over recent years, it has relied on a plethora of savings facilities to tap rural savings.

BUD's success in mobilizing savings is unprecedented. Its outstanding value far exceeds (2.1 times) its outstanding loan portfolio, which has grown at a rapid rate over recent years. BUD used high interest rates for both its lending and savings mobilization, thereby **refuting two myths**:

a) that the poor cannot pay sufficiently "high" interest rates to fully cover financial, administrative and credit risk costs; and

b) that the poor cannot save.

While administrative costs were high because of the small average loan size, loan recovery was excellent. The flexible mode of operations and the sophisticated set of incentives to staff, managers and clients, supported by an extremely efficient managerial information system, contributed to BUD's outstanding financial results, including the achievement of full subsidy independence. Currently, BUD has two million borrowers, and 12 million depositors.

[1] Although there are varied opinions on whether the Grameen Bank is a successful micro-finance institution and its current status in terms of sustainability is in question we still feel that it was one of the pioneers in the micro-finance world and that many strategies it followed can serve as an example for new programmes. Two other institutions in Bangladesh, BRAC and ASHA, are good examples of successful and focused micro-finance institutions, which warrant more attention than they get in the international arena.

GB in Bangladesh is probably the best-known programme aimed at poverty alleviation through credit granted to borrowers who comprise small groups while using joint guarantees. GB has succeeded in achieving prominence in rural Bangladesh and in providing a wide range of financial and non-financial services to its clientele, the lion's share of whom are poor women. It has also made significant achievements in empowering women while improving their income and socio-economic status. GB targeted lower income strata than BUD, with an average loan size below US$100 equivalent, and succeeded in achieving exceptionally high loan recovery. GB has consistently expanded its clientele to about two million and has eZonesiched and diversified the variety of services it offers.

BAAC in Thailand has reached unprecedented outreach in rural banking. About two thirds of agricultural households in Thailand benefit from having accounts with the BAAC, which directs its lending to agricultural production, unlike BUD and GB, which do not confine their lending to agricultural production. BAAC uses small group joint liability as a mechanism to generate cost savings, and harnesses peer group pressure to ensure adequate screening and prompt loan repayment by borrowers. In recent years GB has made major progress towards self-sustainability, while BAAC and BUD have already achieved full subsidy independence.

Despite variations in their modes of operation, these institutions score well **in terms of significant outreach and sustainability**. Their successful performance is based on the application of positive lending interest rates, increasing reliance on savings mobilization to finance lending, emphasis on very high loan recovery and efficient, innovative modes of operation to guarantee reduced administrative costs.

An increasing number of younger institutions, particularly in Latin America, have successfully adopted similar principles. Some models, such as village banking, train community groups to mange their own savings and loan operations to meet low-income households' productive and consumption needs. Others, such as ACCION's affiliates throughout Latin America provide working capital to solidarity groups and individual micro-enterprises with job creation potential. Financial performance has been outstanding, confirming the lessons demonstrated by the Asian success stories.

Banking with the Poor

Two recent World Bank initiatives have been aimed at extending improved rural financial services to the poor.

For example, the World Bank has launched a programme of research into Sustainable Banking with the Poor (SBP), designed with the objectives of improving the ability of

policymakers, managers of financial institutions, NGOs and other organizations to design and implement policies and programmes aimed at providing financial services to the poor, women and other under-served groups in a manner that strengthens rather than undermines the financial sector and builds sustainable institutions. One of the goal is to identify ways in which to provide effective subsidies for institution building in participating financial institutions in order to build institutional capacity and enhance the efficiency of their operations. The SBP:

- examines bank and non-bank experience focusing on financial service systems that have successfully reached the poor;
- assesses the financial performance and degree of self-sustainability achieved by these systems, the policy environment in which they function and the mechanisms they have used to achieve outreach in order to draw conclusions concerning best practice; and
- distils these findings into a number of accessible dissemination formats including seminars, short publications and a source book on Sustainable Banking with the Poor.

At the International Conference on Actions to Reduce Global Hunger hosted by the World Bank in 1993, the Bank expressed a willingness to join with other donors in an effort to explore ways of systematically increasing the resources available to the very poor. Over the past decade, provision of micro-credit and savings services has proved to be an effective means of job creation and income generation among the very poor. Participation of the poor in credit and savings systems has been correlated positively with betterment of family welfare, including improved nutritional and educational status among children and lower birth rates. To broaden and deepen this success, the Consultative Group to Assist the Poorest (CGAP) was established to address the provision of assistance to the poorest, initially through a micro-finance programme.

The CGAP is not a social safety net. It focuses on enabling very poor men and women to become progressively more productive, with the expectation that some participants will eventually move on to use formal banking services. The CGAP aspires to:

- expand the level of resources reaching the poorest of the economically active poor, initially by channelling funds through sound micro-finance institutions that meet the eligibility criteria approved by the CGAP;
- improve donor co-ordination for systematic financing of such programmes; and

- provide governments, donors and practitioners with a vehicle for structured learning and dissemination of best practices for delivering financial services to the very poor.

Adequate Policies and their Impact on Promoting Viable Rural Finance Markets

It is useful to summarize the major lessons learnt regarding the development of viable rural financial markets and institutions. These lessons fall into three primary policy categories: macro-economy, financial sector policies and institutions, and agricultural and rural development. These policy prescriptions are essential elements of a framework for the successful implementation of agricultural credit projects.[2]

Macro-economy

- Stabilize price level
- Avoid overprotection of industrial products used as agricultural inputs
- Maintain a sound exchange rate policy

Financial Policies and Institutions

- Apply positive real interest rates on loans and savings
- Rely on domestic saving mobilization to enhance self-sustainability of participating institutions
- Provide an adequate regulatory and supervisory framework, but ensure the full autonomy of rural finance institutions
- Apply outreach (to a well-defined target clientele) and self-sustainability as the two key criteria to assess the desirability of intervention
- Avoid ceilings on lending interest rates (unless for a short period in economies that go through radical transition)
- If justified, apply subsidies to institution-building to cover transaction costs related to higher risk and larger administrative costs, rather than to interest rates
- Insist on achieving a high loan repayment rate – the common denominator of all successful rural finance institutions

[2] An elaboration of these policies can be found in Chapter 4 of Yaron, Benjamin and Piprek, 1997.

- Identify and remove unwarranted institutional constraints that inhibit the smooth flow of financial resources (e.g. excessive collateral requirements, enforcement problems and poorly-defined property rights)
- Invest in institution-building and MIS development in infant rural financial institutions to ensure sustainability and shortening the transition to viability

Agricultural and Rural Development Policy

- Align relative domestic input-output prices with international prices
- Remove price controls and other distortions from agricultural product prices
- Avoid over-taxation of agricultural exports
- Improve market access and information services to farmers
- Avoid using subsidized interest rates as a "second best" measure in order to compensate for distorted "urban-biased" policies that suppress product prices or tax agriculture indirectly (e.g. overvalued exchange rates)
- Invest adequately in rural infrastructure and human resources