Rural Financial Services
Implementing The Bank’s Strategy To Reach The Rural Poor

March 2003

Agriculture & Rural Development Department
Rural Private Sector, Markets, Finance and Infrastructure Thematic Group
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### Abbreviations and Acronyms

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>AFCAP</td>
<td>Microfinance Capacity Building Program in Africa</td>
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<td>AfDB</td>
<td>African Development Bank</td>
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<td>AFR</td>
<td>Africa Region</td>
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<td>AFRACA</td>
<td>African Rural and Agricultural Credit Association</td>
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<td>APL</td>
<td>adaptable program loan</td>
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<td>AsDB</td>
<td>Asian Development Bank</td>
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<td>B.P.</td>
<td>Bank Procedure</td>
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<td>BAAC</td>
<td>Bank for Agriculture and Agricultural Cooperatives (Thailand)</td>
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<td>BDS</td>
<td>business development services</td>
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<td>BOT</td>
<td>build-operate-transfer</td>
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<td>BRAC</td>
<td>Bangladesh Rural Advancement Committee</td>
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<td>BRI-UD</td>
<td>Bank Rakyat Indonesia – Unit Desa</td>
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<tr>
<td>CABFIN</td>
<td>Partnership for Improved Capacity Building in Rural Finance</td>
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<tr>
<td>CAP</td>
<td>community assistance program</td>
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<tr>
<td>CAPAF</td>
<td>Microfinance Institution Capacity Building Program for Francophone Africa (<em>Le Programme de Renforcement des Capacités en Micro-finance pour l’Afrique Francophone</em>)</td>
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<tr>
<td>CBOs</td>
<td>community-based organizations</td>
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<td>CGAP</td>
<td>Consultative Group to Assist the Poorest</td>
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<tr>
<td>CMAC</td>
<td>Municipal Banks of Saving and Credit (<em>Credit Municipales de Ahorro y Credito</em>)</td>
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<tr>
<td>CVECAs</td>
<td><em>Caisses villageoises d’épargne et de crédit autogérées</em></td>
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<tr>
<td>DAI</td>
<td>Development Alternatives, Inc.</td>
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<td>DANIDA</td>
<td>Danish International Development Assistance</td>
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<tr>
<td>DFIs</td>
<td>development finance institutions</td>
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<tr>
<td>EAP</td>
<td>East Asia and Pacific Region</td>
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<td>ECA</td>
<td>Eastern Europe and Central Asia</td>
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<td>ESW</td>
<td>economic and sector work</td>
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<td>FAO</td>
<td>Food and Agriculture Organization</td>
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<tr>
<td>FECECAM</td>
<td>Federation of the Mutual Agricultural Credit and Savings Banks of Benin, (<em>Fédération des Caisses d’Épargne et de Crédit Agricole Mutuel</em>)</td>
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<tr>
<td>FIAS</td>
<td>Foreign Investment Advisory Service</td>
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<tr>
<td>FIL</td>
<td>financial intermediary loan</td>
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<tr>
<td>FSD</td>
<td>Financial Sector Department</td>
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<tr>
<td>FY</td>
<td>fiscal year</td>
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<tr>
<td>GTZ</td>
<td>German Technical Cooperation (<em>Deutsche Gesellschaft für Technische Zusammenarbeit</em>)</td>
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<tr>
<td>HIV/AIDS</td>
<td>human immunodeficiency virus/acquired immune deficiency syndrome</td>
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<tr>
<td>IADB</td>
<td>Inter-American Development Bank</td>
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<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>IDA</td>
<td>International Development Association</td>
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<tr>
<td>IDB</td>
<td>Inter-American Development Bank</td>
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<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
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<tr>
<td>IGA</td>
<td>income-generating activity</td>
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<td>IGVGD</td>
<td>Income Generation for Vulnerable Groups Development</td>
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<td>LAC</td>
<td>Latin America and Caribbean Region</td>
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<td>LIL</td>
<td>learning and innovation loan</td>
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<td>MENA</td>
<td>Middle East and North Africa Region</td>
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<td>MFI</td>
<td>microfinance institution</td>
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<td>MIS</td>
<td>Management Information System</td>
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<td>MSMEs</td>
<td>micro, small, and medium-sized enterprises</td>
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<td>Acronym</td>
<td>Full Form</td>
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<tr>
<td>NGO</td>
<td>non-governmental organization</td>
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<tr>
<td>O.D.</td>
<td>Operational Directive</td>
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<td>O.P.</td>
<td>Operational Policy</td>
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<td>OED</td>
<td>Operations Evaluation Department</td>
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<td>PFI</td>
<td>participating financial institution</td>
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<td>PPIAF</td>
<td>Public Private Infrastructure Advisory Facility</td>
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<tr>
<td>PRODEM</td>
<td>Foundation for Micro and Small Enterprise Promotion and Development (<em>Fundación para la Promoción y Desarrollo de la Microempresa</em>)</td>
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<tr>
<td>RMF</td>
<td>rural and micro finance</td>
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<td>RMFIs</td>
<td>rural and micro finance institutions</td>
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<td>SACCOs</td>
<td>savings and credit cooperatives</td>
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<td>SAR</td>
<td>South Asia Region</td>
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<tr>
<td>SCA</td>
<td>savings and credit association</td>
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<td>SDI</td>
<td>Subsidy Dependence Index</td>
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<tr>
<td>SEEP</td>
<td>Small Enterprise Educations and Promotion Network</td>
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<tr>
<td>SHG</td>
<td>self-help group</td>
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<tr>
<td>SIL</td>
<td>specific investment loan</td>
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<tr>
<td>SLA</td>
<td>savings and loans association</td>
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<tr>
<td>SME</td>
<td>small and medium-sized enterprise</td>
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<tr>
<td>TTL</td>
<td>task team leader</td>
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<tr>
<td>UNAIDS</td>
<td>Joint United Nations Program on HIV/AIDS</td>
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<td>UNDP</td>
<td>United Nations Development Program</td>
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<tr>
<td>UNOSCAL</td>
<td>United Nations Office of the Special Coordinator for Africa and the Least Developed Countries</td>
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<td>USAID</td>
<td>United States Agency for International Development</td>
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Executive Summary

The World Bank’s new rural development strategy, *Reaching the Rural Poor*, seeks to expand access of the rural poor to a suitable “diversity of products and institutions that fill the financial needs of low-income rural clients in income generation and reduction of vulnerability.” Well-functioning financial markets facilitate rural economic growth and poverty reduction by mobilizing and transferring funds, allocating them to productive investments (including improved agricultural technology and non-farm enterprises), and enabling households to smooth consumption and mitigate risks. The Bank’s strategy gives priority to “a proper enabling environment for the provision of financial services; the development of efficient, viable financial institutions and products; and investment in social and economic infrastructure” to improve financial management skills and business services in rural areas and establish an adequate economic base for extremely poor clients and communities.

The emphasis on developing rural financial systems emerged during the 1990s from: (i) recognition that supply-led, targeted credit through state-owned development finance institutions or farmers’ cooperatives had failed to achieve or sustain objectives; and (ii) growing evidence from “the microfinance revolution” that the poor can successfully save, borrow, and repay and that efficient rural and micro finance institutions (RMFIs) can serve them on a sustainable basis. Experience has shown that reliable access to credit when needed is more important to smallholders and the poor than the interest rate and that savings mobilization is an effective tool for expanding outreach and achieving financial self-sustainability.

The Bank supports the **financial systems approach** to developing rural finance based on the principle that commercially viable institutions are most likely to reach large numbers of clients on a sustained basis. The foundation for this approach – and the appropriate sphere for government action – is an **enabling environment**, including: policies that reduce historical biases against the rural sector and provide macroeconomic stability; a supportive **legal and regulatory framework** that facilitates secured transactions and contract enforcement and that permits a variety of both licensed and informal institutions to provide a wide range of financial services; and complementary market-enhancing **institutions** such as associations, credit bureaus, industry standards, and monitoring mechanisms.

To build up the supply of financial services, the emphasis of project intervention is on **building the capacity of RMFIs** to respond to demands from rural households and enterprises. **Institutional capacity** to deliver financial services efficiently and achieve high portfolio quality can be strengthened by supporting cost-effective training and technical assistance to RMFIs and by providing performance-based grants to help improve management information systems and cover costs of reaching out to new clientele in rural areas. Development of **savings mobilization** is useful both to serve the poor who may not desire credit or be creditworthy and to enable commercial RMFIs to reduce dependence on donor funds. This may include support for savings and credit cooperatives and credit unions. To reach different segments of diverse rural financial markets, institution-building should also include introduction and development of **new financial products** (such as warehouse receipts, leasing, and micro-insurance) and support linkages to **commercial sources of funds** (e.g., through commercial guarantees for wholesale credit from banks to RMFIs and through equity funds for transformation into licensed financial intermediaries).

Stand-alone operations, preferably in the financial sector, should be the primary vehicle for development of sound RMFIs to extend the reach of financial services to the rural poor, with success measured by standard indicators of outreach (including depth of penetration to underserved groups, as well as
numbers) and sustainability (including reduction of subsidy dependence, as well as high rates of loan and cost recovery). Credit lines are a suitable instrument only when assessment of RMFIs in a country demonstrates that liquidity is the primary constraint on their ability to reach targeted groups and that such funds can be provided at commercial wholesale rates without distorting financial markets, as required by the Bank’s Operational Policy 8.30 on Financial Intermediary Lending.

Nevertheless, implementation of this approach in Bank operations faces special challenges in two types of circumstances: in situations of extreme poverty or crisis where economic opportunities and the conditions for financial systems are lacking; and when financial instruments are used to serve a variety of sectoral objectives. Effective demand for rural financial services is often constrained by poor business skills and services, lack of social capital, and inadequate infrastructure. The increasing importance of RMF components in operations oriented toward social protection and poverty objectives raises the risk that a focus on direct resource transfer may undermine achievement of longer-run goals for development of sustainable financial systems. Efforts to use credit to stimulate private investment may founder on the absence of effective financial intermediaries or may risk re-introducing government directed credit schemes that undermine development of rural financial systems.

In such situations, the conditions for eventual development of rural financial systems may best be addressed through complementary investments in social and economic infrastructure to improve well-being, reduce vulnerability, and raise skills, assets, and debt capacity of target groups. Certain non-financial interventions, such as strengthening local groups and organizations, training in business and financial skills, and business development services that support both agricultural marketing and non-farm enterprises, can help build demand for and ability to utilize rural finance. In remote areas beyond the reach of RMFIs, training and support for the initial costs of local savings and credit associations can help communities to mobilize and manage their own financial resources on a sustainable, if modest basis, building a foundation for subsequent relations with RMFIs. Where extreme poverty or crisis situations make financial flows uncertain and sporadic, alternative interventions for poverty reduction are likely to be a more effective starting point than credit-based instruments or attempts to introduce RMFIs. The importance of empowering communities to develop infrastructural and social services adapted to their needs is increasingly recognized through government measures to decentralize responsibility and through supportive programs such as community-based rural development (CBRD) and social investment funds. Basic investment in water, sanitation, transport, energy, education, and health can help lower transaction costs and risks of both daily life and business operation, making it easier to take advantage of available opportunities and raising the productivity of labor. Nevertheless, increasing reliance on local private contractors and service providers makes it important to improve their access to financing and business development services in parallel with development of infrastructural and social services.

CBRD and social fund programs are also under increasing pressure to fund productive assets and “income-generating activities” for the poor, as are operations for post-conflict and disaster recovery and for communities affected by HIV/AIDS. RMFIs are best suited to the “entrepreneurial poor” and should not be expected to be able to address such problems directly. Special credit programs should be avoided in such situations, both because persistent low repayment of government-sponsored loans creates a “culture of entitlement” that undermines development of sustainable RMFIs, and because credit creates a debt burden that people in such situations are unlikely to be able to bear. Grant programs targeted to eligibility characteristics may be appropriate in such situations, provided that they are designed to avoid conflict with private and financial sector development objectives. Some Bank operations are experimenting with equity-enhancing grants in parallel with (but separate from) commercial credit through RMFIs.

These non-financial and grant-based interventions may be preferable alternatives to credit in situations where rural financial market development is not yet feasible or would take too long to serve other
objectives. Part of the strategy for implementing the financial systems approach in Bank operations is to analyze the extent to which it is constrained in meeting specific objectives and to design complementary or alternative measures that are consistent with long-term financial market development. For example:

- **Financing agriculture:** The proportion of agricultural investments and inputs that can be financed directly through RMFIs is often limited by low returns, lack of risk management mechanisms, lack of acceptable collateral (or enforcement), and absence of effective rural financial intermediaries. **Complementary financial measures** include developing suitable products (savings, insurance), special incentives for rural branch networks, and capacity-building for commercial savings and credit cooperatives. **Alternative interventions** include investment in infrastructure (especially transport) and marketing services, and grants to match equity contributions of the very poor to accumulate assets.

- Financing for private investment in **rural infrastructure and enterprise** is generally constrained by limited entrepreneurial skills, inadequate equity funds, lack of specialized intermediaries and instruments, and weak supporting services. **Complementary financial measures** include “smart subsidies” and build-operate-transfer approaches to bring in external investors. **Alternative interventions** include facilitation of market-based business development services, e.g., through demand-driven matching grants.

- **Poverty reduction in situations of extreme poverty, conflict, disaster, or HIV/AIDS:** Use of credit in safety net situations imposes a heavy debt burden on the recipients and undermines sustainability of RMFIs due to uncertain income flows and lack of social capital. **Complementary financial measures** include capacity-building and grants for initial expenses for local savings and credit associations. **Alternative interventions** include grassroots management training to raise skills and basic infrastructure development to improve economic opportunities.

The choice and sequencing of the strategic elements described above depends on prior analysis of the conditions prevailing in each country – particularly in rural and remote areas – and in the specific objectives being pursued. When the primary objective is increased access of the rural poor to financial services, development of the capacity of RMFIs to deliver services should follow – or at least parallel – establishment of a conducive policy, legal, and regulatory environment. In situations where extreme poverty, poor economic opportunities, or crisis preclude sustainable financial intermediation and make credit an unsuitable instrument, then complementary investments and alternative grant-based approaches should be undertaken first in order to establish effective demand and more suitable conditions for financial interventions.
1. Introduction

1. This paper elaborates rural finance aspects of the World Bank’s rural development strategy, *Reaching the Rural Poor*, by giving an overview of recent implementation experience, discussing current issues, and highlighting priorities for the future. The primary objective is to articulate how the Bank views current best practices in rural finance and attempts to incorporate them into its operations, as a common frame of reference for policymakers in client countries, Bank staff, and other donor agencies. In the process, it provides some operational guidance on the types of instruments suited to different circumstances, although it is not intended as a toolkit for project design.

2. During the 1960s and 1970s, multilateral and bilateral donor projects in the rural sector commonly supported directed credit projects to promote agricultural development. Although these interventions often helped improve agricultural yields in the short term, they overwhelmingly entailed high costs that were unsustainable over the long term and they failed to reach the majority of farmers. The 1980s witnessed a few instances in which donors assisted in the successful restructuring of specialized agricultural development banks to provide rural and microfinance (RMF)\(^1\) to large numbers of clients on a profitable basis (for example, in Indonesia and Thailand), applying microfinance methodologies that were emerging from a variety of practitioners around the world (Otero and Rhyne 1994; Committee of Donor Agencies 1995). At the same time, donors helped to improve the macroeconomic and policy environments for RMF through structural adjustment programs and to support a growing number of non-governmental organizations (NGOs), networks of savings and credit associations, and other microfinance institutions to achieve substantial improvements in terms of outreach and self-sustainability.

3. In recent years, international development organizations have focused increasingly on the policy environment, improving the legal and regulatory framework for RMF, building the institutional capacity of a wide range of rural finance providers, and introducing innovative products (especially savings) in order to expand outreach in a sustainable manner commensurate with demand (Empel and Sluijs 2001). The World Bank’s strategy likewise seeks to improve the demand and supply conditions for expanding access of the rural poor to a suitable “diversity of products and institutions that fill the financial needs of low-income rural clients in income generation and reduction of vulnerability” (World Bank 2002a).

### 1.1. The World Bank’s 1997 Rural Finance Strategy

4. Reflecting this trend, the primary objective for World Bank (including the International Bank for Reconstruction and Development [IBRD] and the International Development Association [IDA], hereafter referred to as “the Bank”) operations involving rural finance shifted during the 1990s, away from directed financing of particular crops or target groups toward supporting the development of rural financial markets that efficiently mobilize and intermediate savings to make financing more widely accessible to rural households, farms, and enterprises. The successes of different types of RMF

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1. Rural finance describes financial intermediation outside of urban areas, including deposits, loans, payment and money transfer systems, trade credit, and insurance, to rural households as well as to farm and non-farm enterprises. Microfinance refers to small transactions involving low-income households and microenterprises, using character-based methodologies. Microfinance tends to be short-term in nature and may not fully address the issues of agricultural and term finance that are important concerns of rural finance. “RMF” refers to the intersection of the two, focusing on increased access to financial services for the rural poor.
institutions in various countries around the world in providing financial services to large numbers of the rural poor while moving toward financial self-sustainability, together with the best practices that have been distilled from them, offer new options for using RMF as a cost-effective tool to achieve both rural income growth and poverty alleviation.

5. In its 1997 strategy paper, *Rural Development: From Vision to Action*, the Bank described its new approach to rural finance, based on the “growing consensus on rural finance:

- Credit cannot compensate for urban bias.
- Credit subsidies almost never reach the poor.
- Providing financial services to poor people can be good business.
- Rural financial systems and institutions must be judged by outreach and self-sustainability.

6. There is also consensus on the characteristics that make rural finance institutions successful. Successful institutions are:

- Rural-based but not specialized on agriculture
- Autonomous
- Able to charge market interest rates
- Able to mobilize savings and reduce reliance on donor or state funds
- Able to collect on loans and have fewer losses
- Able to provide staff incentives.”

7. The Bank elaborated that it would actively support the development of promising rural and microfinance institutions (RMFIs) and that “in particular the Bank will work to remove legal and regulatory constraints for small, often informal and unsecured loans; help build social infrastructure; promote new ways of managing microfinance;…and link the Consultative Group to Assist the Poorest (CGAP) initiatives systematically to Bank operations.” The Bank also summarized what it would *not* do relating to rural finance, ruling out lending “where financial sector policies, legal frameworks, and agricultural incentives were not supportive; for credit lines rather than institution building; to government-owned rural financial institutions that are unwilling to change; and where there is inadequate monitoring of outreach and sustainability” (World Bank 1997).

8. The Bank has prepared a new Rural Development Strategy, *Reaching the Rural Poor*. The major objective of this exercise is to prepare an operational framework for the Bank and its regional operations to revitalize rural development activities. In the process, the Bank has refined rather than replaced its earlier strategy regarding rural finance activities. Strategic priorities for the expansion of RMF services in rural areas are to: “(a) pursue a proper enabling environment for the provision of financial services; (b) support the development of efficient, viable financial institutions and products; and (c) promote investment in social and economic infrastructure” to improve financial management skills and business

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development services (BDS) in rural areas and establish an adequate economic base for extremely poor clients and communities (World Bank 2002a).

1.2. The Need to Review and Reorient the Strategy

9. The actual implementation experience of many recent Bank projects containing components aimed at increasing the availability of rural, micro, or small enterprise financial services has been mixed. While financing has been provided to targeted groups, progress has been weak in establishing viable institutions that offer sustained financial services to the poor. This uneven performance has prompted further elaboration of the Bank’s rural finance strategy in terms of its implications for successful project design and implementation, taking into account lessons learned in microfinance (often an important component of rural financial markets) and a variety of country contexts.

10. Three other important recent trends have prompted this review and reorientation of the Bank’s rural finance strategy. First, the importance of developing sound approaches to rural finance has been highlighted by the decrease of credit for agriculture in Bank lending and the increasing role expected for private enterprise in rural infrastructure projects. Second, the Bank’s poverty focus has led to the introduction and use of more varied lending instruments and the application of microfinance to a wide range of sectoral objectives, posing a challenge for consistent application of best practices and Bank policies. RMF projects are increasingly using new, more flexible instruments such as Learning and Innovation Loans, Adaptable Program Loans and Credits, Poverty Reduction Program Credits, and other forms of programmatic lending. Third, the scope of measures aimed at promoting rural financial markets and reaching particular target groups has broadened beyond credit to a range of methodologies used in various sectoral operations. These include: (matching) grant-based approaches for infrastructure development and income-generating activities; social intermediation, such as group formation and “grassroots management training” in basic skills; and promotion of business development services (BDS) to provide training of workers and entrepreneurs, technology transfer, technical assistance, consultancy, marketing, and other services to facilitate business operation and productivity. The current challenge is to apply the principles of financial market development to integrate these different instruments into a comprehensive strategy for expanding access of the rural poor to financial services over time, and to avoid short-term measures that may undermine sustainability and outreach over the longer term.

1.3. Report Organization

11. Four sections make up this report. Section II explores the characteristics of rural financial markets and constraints to their development, analyzes why the traditional paradigm of directed agricultural credit was replaced by a financial systems approach, and explains how this new paradigm is incorporated into institutional policies. Section III reviews recent implementation experience of Bank RMF operations and emerging issues. Section IV develops approaches for strengthening implementation of the Bank’s strategy for rural financial market development at the levels of macro policies, institutions, communities and clients, and concludes with recommendations for improved consultation, both internal and external.
2. The New Paradigm in Rural and Micro Finance


12. Rural financial markets are important because financial intermediation facilitates general economic growth and poverty reduction. Financial intermediaries mobilize funds, allocate them among competing uses, create money, and function as a payments system. The efficient provision of loan, deposit, payment, and insurance services enables entrepreneurship, innovation, and production to develop and flourish. Safe savings facilities, payment services, access to credit, and reliable insurance mechanisms enable poor households to reduce vulnerability by smoothing consumption and mitigating risks. Because rural income cycles are particularly volatile, financial intermediation is especially important to shift purchasing power over time, as well as between net savers and net investors or spenders at any given time.

13. The availability of appropriately-designed financial services is an essential component of the enabling environment for rural economic growth and poverty reduction. Access to working capital or investment credit offered by rural finance institutions can substantially accelerate the adoption of modern agricultural technologies and production patterns which improve the ability of the rural sector to provide for the subsistence needs of the poor, produce the surplus in primary and intermediary products required for urban consumption and export, and avoid environmental degradation. Suitable credit products can also permit entrepreneurs to take advantage of investment opportunities in processing and off-farm enterprises. The availability of liquid and term deposit services encourages remunerative saving and the accumulation of financial assets, whether for “lumpy” investments and expenditures or for consumption smoothing by offsetting irregular income flows and mismatched expenditures (expected or unforeseen). Other means of coping with vulnerability to income and expenditure shocks include reliable payment services for transfer of remittances between rural and urban areas and affordable insurance services (crop, life, health, etc.).

2.2. Rural Financial Market Characteristics and Development Constraints

14. Rural populations in most Bank member countries are mainly engaged in small-scale agriculture or agriculture-related activities and are generally poorer than their urban counterparts. The characteristics of rural financial markets are largely determined by the spatial, temporal, and covariant nature of most rural economic settings and include the following inherent impediments to efficient markets:

- Low population density, small average loans, and low household savings increase the transaction costs per monetary unit of financial intermediation.

- Lack of infrastructure (communications, electricity, transportation, etc.) and social services (education, health, etc.) and low integration with complementary markets result in highly fragmented financial markets that involve high costs of overcoming information barriers and limit risk diversification opportunities.
Seasonality of agricultural production and susceptibility to natural disasters (such as flood, drought, and disease) heighten the probability of covariant risks (in prices and yields) and add to the risks and costs of rural financial intermediation.

15. Further country-level constraints that can prevent rural financial markets from operating efficiently include: (a) unsound macroeconomic management; (b) restrictive agricultural or financial policies (particularly interest rate controls); (c) insufficient institutional capacity within rural financial institutions to achieve high levels of outreach in a sustainable manner; (d) underdeveloped legal systems, particularly with respect to marketable property rights, resulting in weak collateralization of claims and inadequate contract enforcement mechanisms; (e) inadequate prudential regulation and supervision of financial intermediaries; and (f) poor governance, corruption, and other political factors that raise risks.

16. For these reasons, formal financial institutions (such as commercial banks) have largely avoided serving rural areas. In many instances, the only financial services available are provided by informal agents or mechanisms, which offer a narrow range of financial services to limited customers. Lack of access to financing at reasonable cost leaves most microentrepreneurs dependent on self-finance or very costly, short-term credit and limits their ability to actively benefit from investment opportunities and contribute to growth. Many poor and low-income households also lack access to formal or semi-formal credit for consumption smoothing and to other services such as savings, money transfers, and insurance. Excess demand for deposit services is evident in the common practice among the poor of paying someone to hold lump sums for them; in West Africa, informal savings collectors earn a living from commissions on daily savings (Aryeetey and Steel 1995). In many cases, concessional, directed credit and bailouts of state-owned, agricultural credit institutions have “crowded out” private, for-profit rural financial institutions from establishing themselves. The political weaknesses of the rural poor and their institutions also contribute to their reliance on informal rather than formal rural financial services.

17. The most common factors inhibiting the efficient provision of rural financial services in Bank operations that were identified through Regional background papers for Reaching the Rural Poor include:

- weak institutional capacity of RMFIs due to poor governance and operating systems and low skills of managers and staff;
- low business and financial skills of potential clients (especially in Latin American and Caribbean countries);
- policy constraints on financial and agricultural markets that limit profitability of both RMFIs and their clients (especially in the Africa, South Asia, and East Asia and Pacific Regions);
- inadequate physical and financial infrastructure to penetrate rural areas (especially in Africa);
- dominance of state-owned banks operating on non-commercial principles (especially in the East Asia and Pacific and the Middle East and North Africa Regions);

3. While the environment for rural finance can be adversely affected by political instability, conflict, and financial crises, well-designed, grassroots-based microfinance programs have demonstrated remarkable resilience under such circumstances in countries ranging from Albania and Indonesia to Eritrea and Rwanda.

4. “Formal institutions are defined as those that are subject not only to general laws and regulations but also to specific banking regulation and supervision. Semi-formal institutions are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under bank regulation and supervision. Informal providers (generally not referred to as institutions) are those to which neither special bank law nor general commercial law applies, and whose operations are also informal so that disputes arising from contact with them often cannot be settled by recourse to the legal system” (Ledgerwood 1999).
The New Paradigm in Rural and Micro Finance

18. The transition economies may be differentiated into at least two groups by the speed of their transition. Most of the Asian countries in transition have been undertaking gradual reforms from the 1980s, with early emphasis at the microeconomic rather than macroeconomic level. The majority of the Eurasian transition economies became independent only in the 1990s, and their reforms have been more simultaneous with market liberalization, including redistribution of formerly state-owned assets to the public through the creation of private enterprises. Both groups, however, can be considered to be suffering from at least five common constraints not only on rural financial services but also on financial intermediation in general. These include: (a) inefficient and passive banking sectors with generally low levels of understanding about the roles of financial intermediaries and the professional skills needed for commercial banking; (b) weak rule of law and contract enforcement due to fledgling legal systems and institutions to perfect property rights; (c) ineffective prudential regulation and supervision of financial intermediaries with accounting practices and auditing procedures not yet standardized; (d) limited information regarding credit histories and combined low levels of technical skills to formulate business plans (production and marketing decisions) or to evaluate them; and (e) adverse cultural norms resulting from traditionally widespread corruption, fraud, and political interference as well as continued implicit subsidies and guarantees (Meyer and Nagarajan 2000). In addition, transition economies typically lack the tradition of informal rural financial mechanisms that might serve as a basis for more institutionalized microfinance methodologies.

2.3. Reasons for the Failure of the Directed Agricultural Credit Paradigm

19. Efforts to expand access to agricultural credit in the decades following World War II usually emphasized supply-led government interventions in the form of targeted credit through state-owned development finance institutions (DFIs), or farmers’ cooperatives in some cases, that received concessional loans and on-lent to customers at below-market interest rates. The emphasis on disbursing agricultural credit meant that the development of sustainable financial institutions and markets was neglected.

20. Some of the reasons for the disappointing performance of credit programs designed under the traditional approach include:

- Perception of rural communities as too poor to save, so efforts concentrated almost exclusively on the provision of credit.
- DFIs were often seen as government disbursement windows, resulting in a poor loan repayment culture.
- Subsidized agricultural credit at times resulted in production inefficiencies by targeting the wrong products and creating artificial preference for capital-intensive investments that “crowd out” labor-intensive investments more appropriate for the rural poor.
- The focus on lending for agricultural purposes ignored the potential benefits of supporting the growth of small, off-farm rural enterprises.
- Channeling public concessional funds through DFIs discouraged private, for-profit financial institutions from engaging in rural financial intermediation.
21. Failure of the traditional approach to achieve its objectives in a sustainable manner led critics to question whether scarce public resources could be applied more effectively and efficiently in other ways for rural income expansion and poverty reduction.

2.4. The Microfinance Revolution and the Financial Systems Approach

22. Meanwhile, some microfinance institutions and programs took the initiative to raise interest rates, reduce expenses, and innovate in ways that greatly reduced donor dependence and increased the scale of their operations (Otero and Rhyne 1994). It was their success that drew attention to the persistent high costs relative to the ephemeral benefits of most programs that were in place at this time. The success of these new institutions prompted a serious rethinking of the strategy for RMF.

23. The revolution in microfinance for the poor over the last two decades was led by practitioners who developed methodologies that achieve very high rates of repayment and cost recovery and also reach predominantly poor clients, especially women (Robinson 2001). Greater sustainability means that donor subsidies can be leveraged to reach greater numbers of poor clients. In the past, the failure to charge interest rates sufficient to cover costs and enforce repayment meant that subsidies were largely absorbed in covering operating costs and loan losses, while only the select few benefited from the limited number of subsidized loans that could be delivered. Today, the emphasis is on building sustainable RMFIIs that can increase both scale and outreach to the poor through a range of reliable financial services (including savings, money transfers, and insurance, as well as credit) with decreasing dependence on external donor funding.

24. It is now widely acknowledged that subsidized credit leads to excess demand and that the benefits of receiving cheap loans are generally reaped by relatively wealthy and politically connected farmers than by the targeted smallholders. Experience has shown that reliable access to credit when needed is more important to smallholders and the poor than the interest rate in influencing production and investment decisions. In addition, a significant proportion of the rural community proved to have the willingness and ability to save, as deposit mobilization was increasingly used as a tool for expanding outreach and achieving financial self-sustainability. Table 2.1 outlines these and other primary features of the old and new paradigms.

Table 2.1 Primary features of the old and new paradigms in rural finance

<table>
<thead>
<tr>
<th>Features</th>
<th>Directed Ag. Credit Paradigm</th>
<th>Financial Systems Paradigm</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Chief aims</td>
<td>Boost agricultural production Reduce poverty</td>
<td>Reduce market imperfections and transaction costs for income expansion and poverty reduction</td>
</tr>
<tr>
<td>2. Role of financial markets</td>
<td>Help the poor Stimulate production</td>
<td>Intermediate efficiently</td>
</tr>
<tr>
<td>3. View of users</td>
<td>Beneficiaries: borrowers</td>
<td>Clients: borrowers and depositors</td>
</tr>
<tr>
<td>4. Subsidies</td>
<td>Heavily subsidy dependent</td>
<td>Increasingly independent of subsidies</td>
</tr>
<tr>
<td>5. Sources of funds</td>
<td>Vertical: governments and donors were targets met?</td>
<td>Horizontal: primarily voluntary deposits</td>
</tr>
<tr>
<td>6. Associated information systems</td>
<td>Dense, fragmented, and vertical – management information</td>
<td>Less dense and mainly horizontal –</td>
</tr>
<tr>
<td>7. Sustainability</td>
<td>Largely ignored</td>
<td>Major concern</td>
</tr>
<tr>
<td>8. Outreach</td>
<td>Mostly ignored</td>
<td>Primary concern</td>
</tr>
<tr>
<td>9. Evaluations</td>
<td>Credit impact on beneficiaries – mainly primary data</td>
<td>Performance of financial institutions – mostly secondary information</td>
</tr>
</tbody>
</table>

Source: Adapted from Vogel and Adams 1997; and Yaron, Benjamin, and Piprek 1997.
25. The financial systems approach focuses on the primary goals of rural development: income expansion and poverty reduction. It is based on the principle that a commercial approach is most likely to reach large numbers of clients on a sustained basis. It recognizes that financial services are part of an interactive system of financial institutions, financial infrastructure, the legal and regulatory environment, and social and cultural norms. Government has a role to play in establishing a favorable or “enabling” policy environment, infrastructure and information systems, and supervisory structures to facilitate the smooth functioning of rural financial markets, but a more limited role in direct interventions. The financial systems approach emphasizes three strategic priorities in rural financial market development:

- Creating a favorable policy environment, including not only macroeconomic stability but also reductions in historical biases against the rural sector;

- Strengthening the legal and regulatory framework, including improving the legal basis for secured transactions and adapting licensing requirements and regulation so that a few, well-performing RMFIs can legally provide a variety of financial services, not just credit, to low-income households and their microenterprises; and

- Building the capacity of RMFIs to deliver demand-driven credit, savings, and insurance services in a self-sustaining manner.

26. At the same time, it is recognized that financial services may not always be the most cost-effective way of addressing the very poor and that effective rural financial intermediation can often benefit from complementary investments to build their assets and skills, including economic and social infrastructure at the community level, social intermediation to facilitate formation of solidarity groups or cooperatives and to build social capital, training in both technical and management skills, and supporting business development services.

2.5. Incorporation of Financial Systems Development into Institutional Policies

27. The financial systems paradigm was popularized in the early 1990s, became widely accepted by the donor community by the mid-1990s, and was gradually incorporated into the policy framework of the Bank and other donors. This new approach to rural finance was detailed in the Bank’s 1997 rural finance strategy paper, “Rural Finance: Issues, Design, and Best Practices” and incorporated in the Bank’s 1997 “Rural Development: From Vision to Action” strategy (Yaron, Benjamin, and Piprek 1997; World Bank 1997). The Africa Region issued its rural finance strategy based on elements of the financial systems approach in August 1998 as part of a framework for the development of micro, small, and medium-sized enterprises (MSMEs) and rural finance in the region (World Bank 1998b). The Bank’s rural finance strategy was operationally reinforced by its July 1998 issuance of Operational Policy (O.P.) 8.30 and Bank Procedure 8.30 on Financial Intermediary Lending (World Bank 1998c; World Bank 1998d).

28. Like the Bank, other major donors fundamentally changed their rural finance strategies to reflect this new approach. In 1996 the Food and Agriculture Organization (FAO) and German Technical Cooperation (GTZ) launched the joint initiative “Agricultural Finance Revisited” in order to analyze the specific challenges of agricultural finance and the impact of the new rural financial market approach and microfinance technologies on the provision of financial services for farm and off-farm production (FAO, GTZ 1998). The International Fund for Agricultural Development (IFAD) places special emphasis “on

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5. Adams, Graham, and Von Pischke 1984; Von Pischke 1991; Rhyne and Otero 1991; and Christen, Rhyne, Vogel, and McKean 1995; and Otero and Rhyne 1994 are a few of the most influential early works.
women and the poor, not as beneficiaries of charity, but as commercial users or user-owners of sustainable financial institutions” (IFAD 2000). The Inter-American Development Bank’s (IDB) rural finance strategic objective is to promote efficient and sustainable rural financial intermediation by adopting “a systematic approach: (i) creating a favorable policy and legal environment; (ii) developing financial retail capacity; and (iii) promoting other financial services (warehouse receipts, credit cards, leasing, insurance, etc.) in those markets where the first two elements of the approach are well advanced” (IDB 2001). The Asian Development Bank’s (AsDB) “Finance for the Poor: Microfinance Development Strategy” promotes microfinance as a means to develop rural financial markets (AsDB 2000). The African Development Bank’s (AfDB) “Policy Guidelines for the Rural Financial Sub-Sector” provides operational guidelines to “facilitate rural financial intermediation by supporting bottom-up, demand driven, micro and rural finance schemes aimed at assisting the poor and vulnerable groups of society” (AfDB 2001).

2.6. Assessing Operational Performance: Outreach and Sustainability

29. The framework for assessing performance under the financial systems approach that has gained wide acceptance among academics and practitioners focuses on two primary criteria: outreach and self-sustainability. Although neither fully addresses the effects financial intermediation has on the borrower’s well-being, these criteria indicate the extent and efficiency with which financial intermediaries serve the poor. They should be examined jointly: only by achieving a high degree of self-sustainability have RMFIs gained access to the funding they need over time to reach significant numbers of low-income clients (Rhyne 1998).

30. Outreach is a measure of the scale and depth of penetration of RMFIs service to targeted clientele – generally the rural poor. Sustainability addresses the ability of an RMFI to survive over the long term, and includes ownership, governance, and management dimensions as well as financial ones. This is achieved when the return on equity, net of subsidies received, equals or exceeds the opportunity cost of the equity funds. See Annex 1 for key performance indicators.

31. The two primary assessment criteria can be represented on two axes (Figure 2.1). While a trade-off between financial self-sustainability and outreach may be apparent under some circumstances, many operational policies and procedures that improve one may also promote the other, especially for the majority of RMFIs that have not yet reached their potential in either efficiency or clientele. Improvement in the overall performance of an RMFI requires improving at least one criterion while maintaining performance in the other dimension.
32. Many RMFIs, especially those serving poorer rural clients, charge low to negative real interest rates, which can de-capitalize loan funds and eventually lead to failure of the RMFI if grants and subsidies decline. For this reason, the interest rates that the RMFI charges its clients must be sufficient to cover not only short-term operating costs of delivery but also progress to full financial self-sufficiency and long-term outreach. When financial self-sufficiency has been achieved, any excess funds can help to strengthen the RMFI’s liquidity and capitalization. Once the RMFI is in a strong financial position, it can invest excess funds in expansion of outreach, including the costs of non-financial services that may be needed as “social intermediation” to prepare new target groups. Box 2.1 elaborates on additional equity and efficiency reasons for insisting that RMFIs use interest rates consistent with full cost recovery financial self-sustainability.

33. Loan portfolio quality is a particularly useful indicator of the health and strength of an RMFI and whether its clients value its services – and hence in assessing whether RMF operations have achieved their development objectives. Repayment is linked to the profitability of the activity financed in that borrowers who expect to have to repay their loans tend to be more careful in their choice of projects than those who do not expect to repay. Low repayment, like a low interest rate, may lead to capital misallocation, since borrowers can make money even from socially unprofitable projects. This broad empirical association between loan collection and efficient capital allocation also supports the concern of the Bank in improving bank supervision and regulation in its borrowing countries (World Bank 1995).

34. Loan collection can be a useful proxy for portfolio quality, which many RMFIs do not assess appropriately. The ability of the RMFI to collect loans on time indicates in most cases that the ultimate borrower was benefiting from the loan, had a positive cash flow that allowed repayments, and generated a net income beyond repayment of principal and interest payments. Achievement of repayment rates of 96 percent or more by leading RMFIs indicates that loan funds are being recycled efficiently. In contrast, in many countries – and in many Bank RMF operations – poor loan collection poses the major threat to achieving sustainability and avoiding over-reliance on continuous subsidies.

**Box 2.1 Equity and efficiency reasons for full cost recovery interest rates**

**Equity:** Directed credit programs invariably face an inherent dilemma of whether to lend to more clients with no subsidy or to fewer people with a higher subsidy per dollar lent. High subsidies tend to attract pressure from the politically powerful, with the benefits going disproportionately to those who are relatively well off. With the
Box 2.1  Equity and efficiency reasons for full cost recovery interest rates

primary objective of redressing the inadequate access to formal credit of the rural poor, equity argues for an emphasis on greater outreach – a choice that implies minimizing or eliminating the subsidy per dollar lent.

**Efficiency:** Several studies show that liberalized financial markets generate a more efficient allocation of resources and higher rates of economic growth (McKinnon 1976; King and Levine 1993; Jaramillo, Schiantarelli, and Weiss 1994). Other studies point to a positive relationship between savings and real interest rates in developing countries (Fry 1988). The importance of FIs in offering and charging positive real interest rates is clearly shown in King and Levine 1993, which finds that real GDP growth during 1974-89 for a sample of 76 countries was more than 2 percent higher for those offering the highest deposit interest rates than for those offering the lowest deposit rates. Indeed, growth was negative for the latter group of countries.

Source: Adapted from Yaron, Benjamin, and Piprek 1997.
3. Review of Implementation Experience

3.1. Portfolio Performance Concerns

35. Concerns about the design and performance of the RMF portfolio arose during the mid-1990s from two main sources: a growing consensus on principles to implement emerging best practices based on extensive documentation of successful RMFIs; and portfolio reviews by the Africa Region, CGAP, and the Financial Sector Department. These reviews found that a substantial share of RMF components, especially in social sector loans, had been designed under the old paradigm that emphasized delivery of subsidized credit and did not meet the emerging standards that stress building up RMFIs’ institutional capacity to serve the poor, small farmers and microenterprises on a sustainable basis. A more recent Operations and Evaluation Department (OED) review came to similar conclusions, recommending that operations “should show evidence of overall consistency with O.P. 8.30 and the financial systems strategy” and that “in-depth policy-oriented economic and institutional analysis should remain a central feature of Bank interventions… to extend the mix of financial, analytical and advisory services that may be needed over a long period of time” (World Bank 1999). All these findings were critical of past performance of Bank projects with respect to financial impact and sustainability, as a consequence of heavy emphasis on credit delivery (often at subsidized interest rates, with poor recovery mechanisms). As such, they indicated the need to shift fundamentally Bank operations to incorporate principles of the Financial Systems Approach.

36. This section summarizes findings from two more recent reviews of the Bank’s portfolio in rural and microfinance. The first gives an overview of trends in the portfolio and its sectoral allocation since 1992 (including some microfinance operations that do not necessarily have an explicitly rural focus). The second is an in-depth review of operations with a rural finance focus that were approved during FY94 through FY99, which was intended to investigate reasons for poor portfolio quality as a basis for reviving the growth of support for agricultural finance.

3.2. Trends in Rural and Micro Finance Portfolio. FY92-FY01

37. The 1990s saw a steady increase in the average annual number of World Bank (including IDA) operations with components for rural and microfinance, with a slight decline in FY01 (22 projects—still well above the levels that prevailed before FY97; Table 3.1). The average annual amounts allocated to

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7. Of 223 operations in the database, 37% involve only rural finance and 17% involve only microfinance. The regional distribution of projects with RMF components differs considerably by number of projects as against the value of component amounts because of relatively low average component size in the Africa Region and relatively large components in East Asia and Pacific (EAP) for FY92-97 and South Asia (SAR) for FY2001. In terms of number of projects, the Africa Region continues to lead, followed closely by Europe and Central Asia (ECA); their combined share rose from 47% in FY95-97 to 59% in FY2001. Their combined shares in component amounts rose even more sharply, from 14% in FY95-97 to 40% in FY2001. The share of EAP fell sharply over the same period from 25% to 9% in terms of number of projects and from 52% to 7% in amounts. The Middle East and North Africa and the SAR Regions have consistently had the lowest number of projects, although a large
RMF components have fluctuated around $630 million. About 10 percent of the FY01 projects identified as pertaining to “rural space” involved explicit RMF or development of off-farm small and medium-size enterprises (SMEs). Operations with SME components have risen especially rapidly, reaching 14 in FY01, about half of them also involving RMF components. These trends indicate that the development of non-farm enterprises of all sizes – micro, small, and medium – is now an important feature of the landscape in rural development, involving both financial and non-financial support mechanisms.

Figure 3.1 Trends in rural/microfinance portfolio, FY92-94 through FY01

A. Average Number of Rural Microfinance Projects

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Total Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY92-94</td>
<td>43</td>
</tr>
<tr>
<td>FY95-97</td>
<td>53</td>
</tr>
<tr>
<td>FY98-00</td>
<td>78</td>
</tr>
<tr>
<td>FY01</td>
<td>22</td>
</tr>
</tbody>
</table>

B. Average RMF Component Amount

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Average Component Amount (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY92-94</td>
<td>1.9</td>
</tr>
<tr>
<td>FY95-97</td>
<td>1.8</td>
</tr>
<tr>
<td>FY98-00</td>
<td>2.0</td>
</tr>
<tr>
<td>FY01</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: Rural Development Department Portfolio Review based on Business Warehouse data.

Microfinance loan in Bangladesh gave SAR a relatively large share (39%) by value in FY2001. Latin America and the Caribbean remain in the middle of the range at 14% in number of FY2001 projects and 12% by value.
38. About half of RMF components are now incorporated in a wide variety of sectors, rather than mainly in traditional agricultural or rural development operations (Figure 3.2). The relative share of agriculture in total operations with RMF components has declined steadily from 65 percent during FY92-FY94 to 27 percent in FY01. This reflects two main trends:

- Poor performance of credit lines and development banks and the restrictive conditions of the Bank’s 1992 Operational Directive 8.30 have restrained financial intermediary lending for agriculture.
- Other sectors have increasingly adopted microfinance and credit or revolving fund schemes as instruments to achieve their sectoral objectives.

39. Stand-alone financial operations to strengthen RMFIs and their environment have taken a steadily growing share (from nil before FY95 to 23 percent in FY01). This trend represents increased mainstreaming of micro and rural finance as part of financial sector development, consistent with strategies articulated by the World Bank and CGAP. Social protection has jumped from less than a quarter of RMF operations during the 1990s to 40 percent in FY01. The increasing importance of RMF in projects oriented toward social and poverty objectives raises the risk that a focus on direct resource transfer may undermine achievement of longer-run objectives for expansion of access of the poor to sustainable financial services.

40. Indeed, there has been a substantial increase in the share of RMF components that specifically target women (to 50 percent in FY01, from 22 percent or less in previous years; Table 3.1) and the very poor (to 23 percent in FY01, from 12 percent or less in previous years). This trend indicates a shift in focus from building the capacity of microfinance institutions and systems generally to transferring resources to particular vulnerable groups targeted by social programs. While expanded access to microfinancial services is an important part of overall poverty reduction strategies, credit programs are being introduced in a variety of situations where debt may not, in fact, be the most appropriate instrument for the intended beneficiaries (e.g., for HIV/AIDS victims [e.g., Chad] and in devastated post-conflict economies [e.g., East Timor, Eritrea]).
3.3. RURAL FINANCE PORTFOLIO REVIEW

41. As a basis for updating the Bank’s approach to implementing its rural finance (RF) strategy, a study was undertaken of RF operations approved during FY94–FY99 (Yaron and Charitonenko 2000b). The study found that the emphasis had shifted substantially toward supporting RMFIs that provide small loans and saving services, away from the focus on agricultural credit to large farms and agribusinesses in prior decades. This shift in emphasis reflects both reorientation of the Bank’s mission to reduce poverty as well as the application of new microfinance methodologies to extend outreach of financial services to low-income clients while more effectively pursuing institutional self-sustainability and subsidy independence. Descriptive statistics and a few key indicators of RF portfolio performance are summarized below.

Descriptive Statistics

42. The Bank committed US$ 4.1 billion in 101 RF projects (including RMF components that constituted at least half of other types of rural projects, as well as stand-alone RF operations) during the period FY94-FY99, with an average annual commitment of about $688 million in 17 projects per year (Figure 3.3 and Annex 2). About 10 percent of these projects were jointly funded by IBRD and IDA, with the rest evenly split 45 percent IBRD and 45 percent IDA. Both the number and value of projects with RF components rose during the period from 14 in 1997 (and per annum over FY94-FY96) to 24 in FY99 (with total RMF component value of $993 million).

43. Many of the new projects were implemented in countries characterized by poorly developed rural financial systems. This situation often required the establishment of new institutions and institutional arrangements, requiring investments in technical assistance and capacity building. Among RF stand-alone projects and loans with RF components exceeding 50 percent of the total loan amount, Adaptable Program Loans (APLs) and Learning and Innovation Loans (LILs) accounted for 5 out of 20 new projects in FY98 and 8 out of 24 in FY99, reflecting piloting of innovative RF activities, mainly in the AFR and ECA Regions (Box 3.1). These instruments are especially suitable for economies in transition and where the institutional framework is developing but still weak. As a result of the focus on technical assistance rather than large lines of credit and the use of APLs and LILs, the average size of Bank RF loans in these regions have become extremely low, about $10 million and $3 million in ECA and AFR, respectively.

8. Due to the fragmented nature of the Bank’s information on RMF operations, the number and amount of RMF projects presented here should be considered a lower bound. There is no systematic way to obtain information on Bank RMF projects, whose number and loan values have been identified by such diverse sector codes as “Agricultural Credit,” or “Population, Health, and Nutrition Adjustment.” The RMF project database on which this presentation is based therefore drew on a number of internal data sources, including the Bank’s MIS, the ESSD core database, the RMF/SME database, the CGAP microfinance database, Project Concept Documents, Project Appraisal Documents, Project Status Reports, and interviews with Regional Sector Leaders and Task Team Leaders.

9. The total volume of Bank RMF lending is constrained by the absence of borrowing by three of the traditionally largest Bank borrowers for agricultural credit, which did not have RMF projects during FY94–FY99. In the 1980s, Brazil, India, and Mexico accounted for about half of the Bank’s total RMF lending. Much of the Bank lending that reached these three countries in the 1980s incorporated, however, the ill-advised features of subsidized interest rates, debt forgiveness, lack of financial discipline, and over-reliance on state support that entailed substantial subsidy dependence of the domestic participating financial institutions (PFIs) and increased domestic inflation. None of these three traditionally large borrowers had a stand-alone RMF project in the reported period, largely because the policy environment was not conducive to efficient rural financial intermediation.
Box 3.1 New investment instruments: learning and innovation loans (LILs) and adaptable program loans (APLs) – Moldova and Madagascar

In recognition of the changing needs of borrowers and the changing nature of development, in 1997 the Bank introduced two new investment instruments to speed up the response to borrowers’ development needs and increase the flexibility to adapt projects over time. LILs were introduced as a mechanism for experimentation and piloting of unproven solutions to development problems to determine the appropriateness of subsequent larger-scale intervention. They may be used in a variety of situations, such as to test and build up the capacity of institutions prior to a larger intervention, to test promising and innovative solutions to development problems, or to pilot potentially good development efforts. By their nature, LILs are modest in size, and should not exceed US$5 million.

APLs were conceived to respond to the recognition that many development processes, such as institutional capacity building, cannot be addressed by a single investment operation, and may take many years to resolve. Furthermore, as the process unfolds, priorities and specific activities may need to change. APLs provide funding for long-term development programs where there is a clearly defined goal, allowing for activities to evolve as the program proceeds, so long as they are consistent with the overall objective. They also can be multi-sectoral and used as a vehicle for coordinating donor activities.

A LIL: Moldova Rural Finance Project

A small pilot project in Moldova created 11 functioning rural Savings and Credit Associations (SCAs) which increased the access of rural communities to financial services. Based on the promising results of this small pilot, a LIL was approved to expand the pilot and test the institutional viability of the SCAs and the wider financial system. Implemented in 1998 and 1999, the LIL was used to finance a project that demonstrated that SCAs could successfully increase access to institutional finance for small-scale farmers and rural entrepreneurs, and, by the end of 1999, 179 SCAs had been established. A larger scale investment, the Rural Investment and Services Project (RISP), became effective in August 2002 and builds on the experience gained from the LIL and includes further development and financing of the SCA system.

An APL: Madagascar Microfinance Project

To support the wishes of the Government of Madagascar for a long-term commitment to the development of rural financial services, an APL became effective in 1999 to implement a 15-year technical assistance program. The program aims to build institutions that will ensure the long-term viability of savings and loan associations.
Box 3.1 New investment instruments: learning and innovation loans (LILs) and adaptable program loans (APLs) – Moldova and Madagascar

(SLAs) that serve lower income clients. The program will be implemented through three five-year phases, each with clear objectives, though with flexibility in the specific activities to be undertaken. Phase I supports the development of the appropriate legal, regulatory, and supervisory framework and the establishment of SLAs, and subsequent phases will consolidate and expand coverage of SLAs depending on needs. While the APL will be restricted to institution-building and not directly financing credit, partner development agencies (EU, UNCDF, and bilateral donors) will support the program through the provision of credit lines.

Sources: World Bank Internal project appraisal and supervision documents.

Indicators of RMF Project Performance

44. Based on the two primary assessment criteria of outreach and self-sustainability, several key performance indicators were used to assess the Bank’s RF project portfolio in terms of the RMFIs they supported. These included: (a) adequacy of on-lending interest rates; (b) loan portfolio quality; and (c) deposit mobilization. Main findings from related studies are also highlighted throughout, as appropriate, and are summarized below.\(^{10}\)

45. Adequacy of On-Lending Interest Rates. RF projects approved in the 1990s overwhelmingly (87 percent) included on-lending interest rates that were positive in real terms – an increase over comparable data (67 percent) for RF projects approved during the period FY82-FY88 (Table 3.2).

Table 3.2 Comparison of RMFI on-lending interest rates over time in bank rural finance projects

<table>
<thead>
<tr>
<th>Period</th>
<th>RMF projects with available on-lending interest rate information</th>
<th>Positive on-lending real interest rates charged to ultimate borrowers</th>
<th>Positive on-lending real interest rate charged to ultimate borrowers (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>FY82 - FY88(^1)</td>
<td>24</td>
<td>16</td>
<td>8</td>
</tr>
<tr>
<td>FY94 - FY99</td>
<td>30(^2)</td>
<td>26</td>
<td>4</td>
</tr>
</tbody>
</table>

1 Bank Lending for Agricultural Credit (Yaron and Siegel, 1988).
2 Of the applicable 43 projects, 13 projects (for which the on-lending interest rates to ultimate borrowers were described as “market determined” or “variable” with no figures given) are excluded.

46. Loan Portfolio Quality. In those projects that provided information, loan repayment rates ranged from a poor 67 percent to a sustainable 97 percent collection rate. Some 60 percent of these projects stated that the participating RMFIs had procedures to enhance loan repayment, including client loss of future borrowing eligibility, foreclosure or repossession of pledged collateral, and penalty interest rates. These RMFIs typically wrote off as non-collectible any loan delinquent for more than 12 months. However, such a policy was not universal, and some RMFIs may distort arrears data by rescheduling loans or failing to report losses that are written off. Furthermore, the failure of some Bank appraisal and

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10. Indicators of general RF project portfolio quality are based on analysis of stock data. The study analyzed only projects that were either stand-alone RF projects or had an RMF component that exceeded half of the total loan amount. Of the 101 new Bank RF projects approved during FY94-FY99, 57 were reviewed in depth with respect to the selected indicators. The total RF amount accounted for by the 57 projects reviewed was $2,657 million or 65 percent of the total new Bank RMF projects approved during the FY94–FY99 period, with an approximately equal representation of the Regions.
supervision reports to report portfolio performance data for prospective or participating RMFIs makes it
difficult to evaluate systematically the success of Bank projects that support them.

47. Savings Mobilization. The portfolio analysis indicated some shift away from the past overemphasis
on credit to greater inclusion of savings mobilization in RF operations, reflecting growing recognition of
the importance of access to liquid and safe saving facilities for the rural poor and of savings as a
sustainable source of funds for RMFIs (see Section IV.C.2). Over half of the RF projects approved
during FY94-FY99 promoted savings, as against only 13 percent of those approved during FY82-FY88,
and the proportion of participating RMFIs that offered savings services was proportionately higher (63
percent as against 42 percent, respectively (Table 3.3). Annex 3 provides further discussion of the
changing thinking about savings and credit and the myth that the poor are unable to save.

Table 3.3 Trends in inclusion of savings mobilization in rural finance projects

<table>
<thead>
<tr>
<th>Period</th>
<th>Projects reviewed</th>
<th>Projects that promoted savings</th>
<th>Share of participating RMFIs that offer savings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>FY82 – FY88(^1)</td>
<td>24</td>
<td>3</td>
<td>21</td>
</tr>
<tr>
<td>FY94 – FY99</td>
<td>57</td>
<td>29</td>
<td>28</td>
</tr>
</tbody>
</table>

\(^1\) Source: Yaron and Siegel 1988.

3.4. Emerging Issues

48. In the course of these portfolio reviews, several issues have emerged as important considerations for
RMF project design and implementation. These include how to use RMF methodologies to support
agricultural production, as well as off-farm activities; the extent to which RMF can be “commercialized”
as part of the financial system; whether grant-based approaches may undermine, or can complement the
development of rural financial systems; the appropriate use of subsidies; the role of RMF in conflict/post-
conflict situations; and the impact of HIV/AIDS on RMFIs and clients. An internal issue concerns the
collection of adequate data to monitor RMF portfolio performance. Each of these issues is discussed
below.

Enhancing Agricultural Production

49. Formal Financial Intermediaries. A key sectoral issue is how to expand access to financing needed
to achieve agricultural and other rural development objectives in ways that are consistent with Bank
policies and good practices. While directed agricultural credit and agricultural development banks have
generally failed to yield efficient, sustainable financial intermediation, they have not yet been replaced by
more viable mechanisms that are widely available to farming households. Agriculture remains the
cornerstone of rural economies and the livelihoods of the poor, and most client governments of the Bank
continue to focus on access to agricultural credit to boost productivity, for example through the adoption
of more advanced technologies. But with little to no access to financial products, especially term credit
for agricultural production, potential clients in less densely populated rural areas have to rely on their own
savings – primarily in kind, in the absence of suitable financial savings instruments.

50. Section II.B identified high financial costs and risks, unsuitable policy and institutional frameworks,
and weak capacity of RMFIs as explanations for the relative lack of financial services in rural areas. In
many of the poorest countries, an additional constraint is the relatively low return in agriculture itself and
the high risk related to weather and disease. To help manage the systemic risks that inhibit term finance for agriculture, the development of new crop insurance products based on weather (rainfall) and commodity prices could be an important enabling condition. Additional financial products are needed that can solve the problem of the lack of collateral needed for conventional commercial loans. These are discussed further in Chapter 4.

51. Although much innovation has taken place in microfinance that is useful for rural finance operations, the majority of microfinance institutions (MFIs) operate either in urban and peri-urban areas or in densely populated rural areas with a strong non-agricultural economy. While microfinance has received a great deal of attention over the last decade, it remains at best a partial solution to the problems raised by the failure of agricultural development banks and lines of credit (Klein and others 1999; Wampfler, Poursat, and Doligez 2002). There are, however, some well-documented examples of MFIs working in rural areas and offering loans for agricultural purposes, such as PRODEM and Caja los Andes in Bolivia, Financiera Calpia in El Salvador, Credit Municipales de Ahorro y Credito (CMACs) in Peru, and the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand (Box 3.2). A study of MFIs in seven African countries found that an average of 27% of MFI credit went for agriculture (Lapenu-Cerise 2001; see also Box 4.5). The experience of BAAC and the CMACs demonstrate the importance of demand-driven financial product design, cost-effective operations, and risk management (Klein and others 1999). Where agricultural potential offers returns sufficient to justify investments in improved seasonal inputs or productivity-raising assets, the challenge remains to apply available methodologies to reach these clients, whether by extending the outreach of commercial financial intermediaries or by strengthening or introducing specialized RMFIs.

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**Box 3.2 Agricultural lending by microfinance institutions: Caja los Andes and Financiera Calpia**

Standard microcredit methodologies tend to rely on financing non-farm activities with regular income profiles that match weekly or monthly repayment schedules, such as trade. Many microfinance institutions have encountered serious challenges when attempting to expand their lending into more difficult or remote rural areas, or into seasonal crop production or livestock. Lower-risk non-farm activities in areas of higher population density are simply more attractive. However, as competition between microfinance providers for this type of business increases in some countries, MFIs have looked to rural areas and to agriculture as a source of continued institutional growth.

Caja los Andes in Bolivia (which is a highly competitive microfinance environment) is a relatively successful example of an urban-based institution that began expanding into rural and agricultural lending in 1998. Lending for agricultural production required the development of new loan products designed specifically to fit the distinct cash flows from seasonal production cycles. The agricultural lending methodology is based on assessing borrowing households’ cash flows on a case-by-case basis, including all sources of agricultural and non-agricultural income, and taking into account sector-level and household-specific risks. Loan terms and conditions are tailored to individual household needs. Disbursements can be made in installments or lump sum, and there is considerable flexibility in the repayment schedule to fit with household income streams.

Loans are individual, and for loans under US$7,500 the borrower must either provide property documents as collateral or have personal guarantors who have property. This applies to the majority of agricultural loans, which average US$600, reflecting the size of farms that households own – generally only between 0.5 and 2 hectares. Capable loan officers, who are agricultural as well as financial specialists, are key to the success of the approach. To minimize risks from crop failure, borrowers must not depend solely on crop production and must raise livestock or have other non-farm income sources.

Caja focuses on those rural areas with greater development potential and access to markets. By 2002, eight of Caja’s twenty-seven offices were located in rural areas. Agriculture is still a small proportion of Caja los Andes’ overall portfolio, although it is a relatively new activity. As of December 2002, it represented 6 percent (US$3.9 million) of the active portfolio and 11 percent (5,813) of total bank borrowers. The portfolio at risk for greater than 30 days was 8.3% at end 2002, higher than the 4.8% for Caja’s overall portfolio. Despite this, agricultural lending appears to be sustainable and profit making, though the yields are lower than for other lending products.
Box 3.2  Agricultural lending by microfinance institutions: Caja los Andes and Financiera Calpia

Financiera Calpia in El Salvador has extended its urban operations to rural areas to achieve high levels of outreach (in terms of both credit and savings mobilization), portfolio performance, and profitability. Over 90 percent of its rural loans are allocated to agricultural lending, with loan write-offs of less than 0.7 percent (as of 1997; Klein and others 1999). Key features of Financiera Calpia’s continued success include:

- treating the farm household as a financial unit integrating a variety of economic activities, and basing lending decisions on repayment capacity rather than how funds are utilized;
- managing systematic risk in agriculture by three levels of diversification: (i) across rural and urban branches; (ii) across both agricultural and non-agricultural activities in rural branches; and (iii) across diverse household economic activities;
- long term relationships to lower transaction costs for both lender and borrowers;
- using various types of collateral, including non-traditional collateral from poorer households;
- delegated and decentralized decision making by well-trained loan officers;
- regular monitoring of clients to ensure that repayment capacity is not jeopardized, opportunities are realized, and the borrower-lender relationship is strengthened; and
- an effective management and information system (MIS) and a commitment to high loan recovery (including seizure of collateral where necessary as a signal to other clients).

Sources: CGAP - Agricultural Microfinance Profile: Caja los Andes (draft); Navajas and Gonzalez-Vega 2000.

52. One issue is whether publicly-owned banks have a role to play, especially when private financial institutions fall short of politically important objectives of serving agriculture and rural areas. Well-known examples such as BRI and BAAC demonstrate that well-designed and – managed microfinance programs are possible in state banks (Seibel 2000; Dressen, Dyer, and Northrup 2002). Important conditions for success include independence of decision-making and a high level of accountability for financial performance. State-owned development banks have generally not performed well in the past nor even met their stated objectives, and care should be taken to avoid repeating past mistakes. Furthermore, privatization of agricultural development banks (and commercial banks) can be managed in such a way as to maintain services to rural areas. In Tanzania, a National Microfinance Bank was created out of the rural branches of the former National Bank of Commerce in order to retain access to savings (and, eventually, credit) services in rural areas when the more profitable urban branches were sold to a private buyer (Box 3.3).

Box 3.3  Reforming state-owned banks for rural markets: Mongolia and Tanzania

State-owned agricultural development banks were initially established primarily to channel credit to agricultural producers, often with subsidized interest rates. They have often performed poorly, with high administrative costs, low recovery rates and weak management and supervision. As a result many have closed or become technically bankrupt. However, successful reform of agricultural state banks has occurred, demonstrating that existing infrastructure can form the basis for developing viable and sustainable formal financial institutions with significant outreach in rural areas. BRI in Indonesia and BAAC in Thailand are two well-known examples (Seibel 2000).

Although state bank reform may not always be appropriate, it has worked in instances where there is a clear unmet demand for rural financial services, genuine political commitment to financial sector reform, and adequate available funds for capital improvements and technical assistance. In the cases of the Agricultural Bank of Mongolia and the National Microfinance Bank of Tanzania (summarized below), external management (provided by Development Alternatives, Inc.) has been contracted to turn around these institutions. In these cases, success has been achieved by applying the following approach:

- thoroughly assessing of the bank’s balance sheet, as a basis for negotiation with the government to raise the capital base to at least zero;
- resisting the temptation to cut costs without a clear understanding of the potential of existing products and
Box 3.3 Reforming state-owned banks for rural markets: Mongolia and Tanzania

services (through analysis of the bank’s operations);

- installing an experienced management team on the ground, with the authority to make and implement decisions quickly;
- identifying key market opportunities and introducing a range of responsive financial products;
- improving public image and creating a staff culture to reinforce institutional values; and
- striving for balanced growth with expansion in portfolio matched with improvements in management systems, as opposed to rapid, uncontrolled (and unsustainable) growth.

The Agricultural Bank of Mongolia (AgBank)

In 1999, after years of losses, bail-outs and a failed privatization, the AgBank was in danger of being liquidated. However, the Government of Mongolia recognized its vital importance in serving the large percentage of the country’s population in rural areas, including the transfer of money and payment of salaries and pensions, and brought in an external management team to turn it around, facilitated by the World Bank with USAID funding. Four years later AgBank is being privatized and sold for $6.8 million, double the asking price. This turnaround was achieved by applying the above lessons. Instead of scaling back, management invested in 83 new branches and an additional 500 staff, and introduced a range of new financial products. It is now the third largest bank in Mongolia and, as of May 2002, had disbursed over 200,000 loans, opened 160,000 new current accounts, and increased savings deposits by 200 percent (with 500,000 deposit customers). At the same time Bank assets have grown 270 percent it has been profitable since 2001, with a Return on Assets of 5.3 percent and a Return on Equity of 55.9 percent.

The National Microfinance Bank in Tanzania (NMB)

Tanzania’s National Microfinance Bank (NMB) was created to retain the rural branch network of the National Bank of Commerce (NBC) when it was privatized in 1997. However no buyers were found for the NMB, which was making losses and in need of substantial investment and restructuring. With World Bank support, the Government of Tanzania contracted external management to make the Bank more attractive to investors. The key to making it commercially viable has been rigorous control of costs through drastic simplification of the business model and tight managerial oversight combined with correct pricing of products, particularly payments and remittance services, which had traditionally been cross-subsidized by other product lines. A key initiative has been the development and rolling out of microfinance products, mainly small (average US$400) individual loans. As of June 2002, 10,000 loans had been disbursed through 36 of the bank’s 104 branches, with a level of arrears below 2 percent. As with the Mongolian AgBank, the NMB has become profitable without closure of rural branches.


53. Nevertheless, high rural population density and high average loan sizes in many of the more successful programs make it difficult to apply these models to smaller-scale and more dispersed loans, especially for subsistence crop production in less densely populated countries. In areas with low agricultural potential, the returns may be too low and the risks too high to make seasonal borrowing and lending viable. In such circumstances, the appropriate emphasis is likely to be, first, on improving the underlying profitability of agriculture and non-farm activities and building up the community’s social and economic assets in order to raise income potential and, second, on local and informal financial mechanisms.

54. Cooperatives. Savings and credit cooperatives (SACCOs) and traditional informal savings and credit associations can facilitate agricultural development through pooling and management of financial resources within the local community, in the absence of – or as a means of mobilizing – financing from external institutions. Interest is growing in building up SACCOs and linking them to other financial intermediaries (see Box 4.2 and Section IV.C.2). In principle, a strength of these member-based
organizations is that they are based on members’ savings, giving members strong incentive for active involvement in governance. In practice, in many countries, cooperatives have been politicized or captured by local elites and have generally been registered under the government agency responsible for cooperatives, which may emphasize non-financial objectives and be incapable of providing needed external financial supervision. Establishing a suitable policy, regulatory, and governance framework for SACCOs remains an important challenge for extending financial services deeper into rural areas.

55. Trade Finance and Informal Financial Mechanisms. The reality in many countries is that the bulk of agricultural financing comes, first, from farmers’ own savings and, second, from traders, input suppliers’ credit, and other informal mechanisms. Rather than attempting to replace or circumvent such mechanisms, a comprehensive approach to rural finance needs to develop a better understanding of how to increase the flow of financing through such channels in order to increase the range of options available (e.g., warehouse receipts, agency relationships, contract farming, linking self-help groups to RMFIs).

Commercializing Rural and Microfinance

56. The financial systems approach implies a focus on “commercializing” RMF in order to reach ever-larger numbers of poor clients with limited (and declining dependence on) subsidies. Questions arise both as to how deeply this approach can penetrate to the very poor and to the degree of emphasis to place on three different levels at which the term “commercializing” can be understood:

- **RMFIs**: progressing toward operational and financial self-sufficiency and adopting a for-profit orientation (see Figure 3.4);
- **Commercial banks and non-bank financial institutions**: adopting the methodologies and products of microfinance to move down-market to reach smaller, poorer clients;
- **Environment**: establishing policies, legal and regulatory framework, and access to commercial sources of funds that are conducive to RMF methodologies (see Sec. IV.B).

Figure 3.4 Progress toward commercialization

57. Achieving outreach objectives along with sustainability means that strengthening the rural client base is an essential complement to a commercialization strategy. Thus, application of commercial principles on the financial side does not exclude continued subsidization of training and technical assistance to inculcate a business culture and develop self-help groups and cooperatives at the community level.
Role of Grant-Based (Income Transfer) Approaches

58. The preceding discussion and the experience cited in section II.D suggest that the suitability of financial and grant-based instruments may differ according to three categories of the poor (see CGAP 2001a):

- The “entrepreneurial poor” who are already engaged in viable but low-productivity economic activities or who have good investment opportunities and are constrained principally by lack of access to financing;

- The very poor who have reasonable economic opportunities but are handicapped by low skills, poor basic economic infrastructure, lack of social capital, and/or remote location, as well as absence of financial institutions;

- The extreme poor or destitute and areas with very low economic potential.

59. With respect to the latter two categories, financial mechanisms alone are unlikely to be sufficient, and indeed long-term financial systems development can be undermined by inappropriate use of credit for other objectives in such situations. A growing number of Bank operations for social investment funds and community-based rural development (CBRD) are attempting to support income-generating activities in areas with low economic potential and among the very poor. Credit or revolving fund schemes in such operations have generally performed poorly in terms of repayment and sustainability, whether because clients are unable to generate sufficient revenues or unwilling to repay funds that come from government or donor agencies, or because the institutions involved fail to implement effective financial discipline. A more appropriate approach is to raise the economic potential of these communities and individuals and their ability to utilize finance (discussed further in section IV.D).

60. Grant-based approaches are clearly more appropriate than credit for the third category, when the clients cannot readily bear a debt burden and where prospects are poor for sustainable microfinance. With respect to the second category, the issue is whether poverty-focused grant-based instruments can be designed to strengthen the conditions for sustainable RMFIs (perhaps supported through complementary financial operations) serving clients with viable economic activities. Such instruments may include public investments in infrastructure (e.g., irrigation), technology, and market development for crop production; or interventions to raise the ability of individuals to manage businesses and finances and of communities to form cohesive groups that can intermediate between members and external sources of finance (section IV.D).

Use of Subsidies

61. One reason for a drop in lines of credit specifically designated for rural, micro, and small enterprise finance during the 1990s was the establishment of rigorous conditions for targeted lending in Operational Directive 8.30 (1992). Nevertheless, targeted components emerged in non-financial projects, giving rise to inconsistent approaches to subsidized credit across different sectors. The revised Operational Policy (O.P.) 8.30 (World Bank 1998c) clarifies the Bank’s policy by stating the conditions under which subsidies and directed credits may be acceptable as part of an operation which aims to foster a market-oriented environment that enhances access of the poor and micro and small-sized enterprises to financial services. Targeted subsidies may be warranted if they are transparent, capped, explicitly budgeted, fiscally sustainable, and economically justified. Further, they should not subsidize the ultimate clients but rather be aimed at building the capacity of financial intermediaries or supporting institutions (e.g., supervisory authorities), which may include partial subsidies for operating costs over the medium term if necessary to achieve poverty reduction outreach objectives. In addition, conditions are specified for
acceptable targeted credit that fosters a sustainable flow of financial services to underserved groups (such as the poor, women, and microentrepreneurs) and is accompanied by reforms that address problems in institutional infrastructure and financial markets.

62. Similar principles apply to the use of subsidies for training and other business development services (BDS) to build the capacity of RMFIs or to support their clients’ enterprises (discussed further in Chapter 4).

63. Subsidies may be justified in the short term as an investment in the development of BDS markets (e.g., through development of new products and models). However, even temporary subsidies can create distortions, and are justified only if their market development impacts outweigh their distortionary effects. Therefore, donors must exercise care in the application and duration of subsidies:

- **Specificity:** Subsidies…should be designed to achieve specific market development objectives.

- **Duration:** Subsidies…should be time-bound with specific criteria for their reduction and elimination as market development objectives are achieved—in other words, donors and facilitators must have a clear exit strategy for subsidized interventions.

- **Point of application:** Subsidies applied at the level of the BDS transaction (i.e., direct subsidies to reduce the cost or price of services) are likely to be more distortionary… than pre- and post-transactional subsidies. ¹¹ (Committee of Donor Agencies 2001).

SMEs in Rural Infrastructure and Off-farm Employment

64. Infrastructure projects are a burgeoning source of demand for support for SMEs in rural (as well as urban) areas, with 36 percent of such operations in FY2001 (as against none before FY98). This reflects several trends toward greater private participation in the delivery of infrastructural services, including central government contracting out services, decentralized responsibility to the community level, and recognition that private investment must be leveraged to complement constrained public funds. These trends represent a desirable focus on rural poverty, but there are substantial risks in the weak capacities of local administration and private sector suppliers. A major challenge is to develop appropriate financing mechanisms, incentives, and business support systems for private investors and contractors (largely SMEs) to respond to increasing reliance on them to achieve objectives for expansion of rural infrastructural and social services.

65. The lack of term finance is a particular problem for private investment in rural infrastructure and in other enterprises that can provide diversified, growing incomes and employment in rural areas (as well as for agricultural investment). Even though commercial banking systems often have excess liquidity, term financing to SMEs is limited by the short-term nature of banks’ liabilities, the collateral required, and the lack of suitable mechanisms to assess and manage risk. Innovative approaches that are being included or considered in new projects include “smart subsidies” to reduce the cost of private capital investment in rural facilities (e.g., Uganda Energy for Rural Transformation Project) and risk capital funds that would combine private venture capital with concessional loans to provide a package of equity, debt, and quasi-equity financing that is well-adapted to the needs of SMEs.

¹¹ Pre-transactional subsidies include, for example, those used for R&D and the development of service products, test marketing and product adaptation, capacity building, and raising awareness. Post-transactional subsidies could be used for monitoring and evaluation of the impact of interventions on BDS market development or social/economic development.
66. Community-based infrastructure projects that rely on the services of SMEs often find that they lack the financial and managerial skills for such contracts. Special efforts are often needed to strengthen the business skills and support services for SME contractors (e.g., Ghana Community Water and Sanitation Project PPIAF grant), preferably through demand-driven mechanisms such as vouchers and matching grants that can stimulate the market for private business development services appropriate for SMEs (Committee of Donor Agencies 2001).

Rural and Micro Finance in Post Conflict Situations

67. Designing and operating RMFIs in post-conflict countries is an emerging issue with recent Bank projects in environments as diverse as Afghanistan, Bosnia, East Timor, and the West Bank and Gaza Strip. The Bank is developing means to bridge humanitarian efforts with longer-term development efforts in many post-conflict situations, with RMF being an important consideration in many of them. More is becoming known about the necessary conditions for utilizing credit as an instrument during or after conflict, including: ensuring adequate donor coordination; a policy environment that permits interest rates consistent with sustainability; and starting RMFIs small and allowing sufficient time to reach operational self-sufficiency with demand-driven products based on market research (Nagarajan 1997). External funding for credit is needed in these situations, as it is too risky to promote voluntary deposit mobilization and intermediation until the country has stabilized and an appropriate legal framework with adequate supervision is in place. Grant-based approaches are also appropriate, both to get targeted groups of affected persons or communities back on their feet quickly and for capacity building and (re)capitalization of NGOs that provide financial services, provided that pre-defined, quantifiable performance indicators are met and maintained over time.

Impact of HIV/AIDS

68. The HIV/AIDS epidemic has become a major challenge for microfinance, both because of its impact on the clients of RMFIs and hence on portfolio performance and because many agencies are looking to microfinance as one means of assisting those who are affected. HIV/AIDS is now the leading cause of death in Sub-Saharan Africa and the fourth biggest killer worldwide (UNAIDS 2001), and over 12 million African children are estimated to be orphaned as a result.

69. RMFIs are affected directly by HIV/AIDS in multiple ways. First, clients who are sick or caring for those with or affected by HIV/AIDS (orphans) may be unable to attend required borrower group meetings and may more frequently miss scheduled repayments. Increased client illness translates into higher RMFI exit rates and rising operational costs, including greater loan loss provisioning and a higher percentage of costlier new clients. RMFI staff themselves may also be affected directly, raising turnover and training costs for the RMFI.

70. These implications of HIV/AIDS have prompted RMFIs to innovate in terms of financial products (especially savings and insurance), use of groups (loan insurance), and service design and delivery (flexibility in group meetings and payment schedules). Such innovations are quite consistent with goals of the microfinance industry: demand-driven new product development, greater service efficiencies, greater flexibility in methodologies employed, and greater outreach. In some cases, RMF is part of a larger response package, where financial intermediation is combined with social intermediation measures ranging from group formation to skills development to health information and services (Parker 2000). One issue is how to manage the financial risks involved when RMFIs are asked to direct their services to particular groups regardless of skills, business experience, and repayment capacity. Box 3.4 presents a range of innovations undertaken by Opportunity International in its RMF operations across Africa; one
lesson is the desirability of offering complementary social and financial services but delivering them separately through specialized agencies with the requisite skills.

**Box 3.4 RMFI innovative responses to HIV/AIDS**

Opportunity International (OI) has been involved in microfinance in Africa since 1992 and currently serves more than 30,000 clients throughout the continent. OI has observed the effects of HIV/AIDS on both clients and its partner institutions. In response, it has initiated several financial and non-financial services to address the health concerns of its urban and rural microfinance clients:

- **Mandatory loan insurance**: In one program that serves as a model for others, OI charges clients a one-time fee of approximately $0.30 to cover loans outstanding in the case of client death. This “credit insurance” mitigates the impact of client death both on the affected household and on the MFI’s portfolio, since the insurance fund covers the remaining balance.
- **Emergency loans**: OI is considering loan products for emergencies, both health-related and otherwise.
- **Education trust for minors**: OI is examining ways to establish an education trust, so that clients could make payments that could be accessed as an annuity at a later date for educational purposes.
- **HIV/AIDS prevention**: In 1999, OI initiated efforts to disseminate AIDS prevention information to its clients through partnerships with several community groups throughout Africa that provide health education through peer education at weekly meetings that clients are required to attend.
- **Outsourcing social service provision to local partners**: OI has opted to concentrate on the provision of financial services, where its experience lies, and rely on other NGOs that are experienced in providing health education and social services, rather than trying to use loan officers to develop this kind of specialized knowledge.
- **Legal services**: OI works with organizations that provide legal advice on issues, such as wills and inheritance laws for women, to ensure that women and children will have full legal protection after a husband/father dies.

Source: Adapted from UNAIDS 2000, p. 5.

**Monitoring Bank Operations in RMF**

71. The portfolio reviews summarized in sections III.B and III.C encountered considerable difficulty identifying operations that contained RMF components and obtaining information on performance of the RMFIs being assisted. Given the wide range of sectoral operations in which RMF components are found and the lack of any systematic way of identifying them, maintaining a separate database on the RMF portfolio is essential. To simplify identification of relevant projects, not only for the database but also to provide assistance in conforming to Bank policies and best practices, it is strongly recommended that the Project Concept Document include a question on whether the project intends to provide any funds (directly, or indirectly through other institutions) for lending to individuals, groups, or enterprises, or to strengthen the capacity of RMFIs to provide such funds. When more than half of project funds are allocated to such uses, the Project Appraisal Document should be mandated to provide baseline data on key indicators of outreach, sustainability, and efficiency, which should also be tracked as a part of Project Supervision Reports or at least mid-term review and Project Completion Reports.12

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12. Key indicators (discussed in more detail in Annex 1) would include: Outreach: numbers of savers and borrowers; percentage who are women; penetration below poverty line and into rural areas; Sustainability: operational and financial sustainability; Subsidy Dependence Index; Adjusted Return on Assets; Portfolio At Risk; and real interest rates on savings and loans.
Furthermore, involvement of specialist rural/micro finance staff in project design, or at least review by financial sector staff, is mandated by Bank Procedure 8.30 on Financial Intermediary Lending. Efficiency indicators such as operating costs as a percentage of average loan portfolio and number of clients per loan officer are important to ensure that raising interest rates to cover costs is balanced by efforts to reduce costs.
4. Strengthening Implementation

72. The Bank’s rural finance strategy is based on developing efficient financial markets in rural areas with sustainable RMFIs capable of providing well-adapted savings, credit, insurance, payments, and other services with significant penetration to reach the rural poor. Implementation at the country level requires initial assessment of the extent to which conditions are favorable for enhancing market mechanisms or whether alternative measures are needed first (or in parallel) to improve the underlying conditions and the client base. This section sets forth the options that are available for effective implementation of the strategy, consistent with the Bank’s policies for financial intermediation, good practices in RMF, and the process of consultation in project design and implementation.

4.1. Options and Issues

73. Analysis of the options should be grounded in a poverty assessment that characterizes the rural poor, the binding constraints on their ability to generate sustainable livelihoods and to increase productivity, and their demand for an available supply of financial services (informal as well as formal). A consultative process (e.g., in developing a Poverty Reduction Strategy) based on data from the poverty assessment can then be used to evaluate the policy options and, in particular, the extent to which market-oriented measures are sufficient to reduce poverty. Figure 4.1 illustrates this process and the major options available. In reality, each country is likely to select some combination of market-enhancing mechanisms and alternative interventions to establish the conditions for market development, particularly with respect to the skills, assets, and debt capacity of the rural poor and their ability to smooth consumption and manage vulnerability.

74. Redressing market imperfections that discourage financial intermediaries from entering rural markets and prevent the poor and microenterprises from accessing commercial finance is a key rationale for intervention, and indeed is required by O.P. 8.30 on Financial Intermediary Lending as a corollary to directed lending. When the primary objective is increasing access to financial services for the poor, the Bank Group strategy focuses on:

- **Fundamentals of the external operational environment**: basic macroeconomic stability; the policy, legal, and regulatory frameworks that allow innovative financial institutions and instruments to develop and supervise their soundness; elimination of direct state interventions that undermine the sustainability of microfinance; risk management mechanisms such as deposit insurance and microinsurance products; industry standards and systems for collecting and disseminating information; and other institutions that help markets to function.

- **Internal institutional capacity of RMFIs to enhance viability and outreach**: exposure to and training in best practices that banks and microfinance institutions need to expand their outreach and develop sustainable operations, along with performance-based support for capacity building (e.g., MIS systems, internal controls, governance, risk management, new product development) and measures to promote linkages to commercial sources of funds (see Committee of Donor Agencies, 1995).

75. Stand-alone operations, preferably in the financial sector, or a major component in a financial, rural, or private sector operation, are the appropriate vehicle when development of RMFIs to extend the reach of financial services to the poor is the primary objective. Given the long time frames required to achieve
Figure 4.1 Options for rural finance for poverty reduction

Poverty Assessment
Characterize the rural poor and the binding constraints they face, including demand for and supply of financial services

Evaluate policy options

Are market-oriented measures sufficient to reduce poverty?

Yes

Financial Systems Development:
Enhance the efficiency and completeness of rural financial markets to support broad-based growth and manage risks

Complementary Investments in social and economic infrastructure to improve well-being, reduce vulnerability, and raise skills, assets and debt capacity of target groups

No

Micro

Build Capacity of RMFIs
- Training
- Performance-based grants for internal controls, MIS, TA, new products, governance, etc.
- Savings mobilization
- Link to commercial funds
- Product development

Ability to Demand Rural Finance
- Social mobilization
- Business development services (microenterprise management, training, marketing, etc.)
- Start-up subsidies for community-based savings and credit associations

Alternative Interventions
- Investment in rural infrastructure
- Matching grants for productive assets
- Employment generation via public works programs, food-for-work

1. Fundamentals: Enabling Environment

Macro

Create Awareness and a Favorable Policy Environment
- Sustain macro stability
- Remove urban-biased policies and constraints on agricultural production and marketing
- Promote financial liberalization (especially interest rates)
- Eliminate state subsidized credit schemes

Improve the Legal and Regulatory Framework
- Special licensing and regulations adapted to RMFIs
- Deregulate lending by non-deposit-taking institutions
- Improve land titling and registration
- Reform laws for secured transactions
- Improve judicial contract enforcement

Meso

Develop Market Institutions
- Develop industry standards and reporting/information systems
- Default registry, credit bureau
- Industry associations/networks
- Insurance and risk management mechanisms
- Incentives for new products and linkages to RMFIs

Source: Adapted from Yaron, Benjamin, and Piprek 1997.
77. and implement legal and regulatory reforms and to build the capacity of RMFIs, instruments such as Adjustable Program Lending or joint programming with other development agencies should be considered to ensure adequate long-term commitment of resources. Following the recommendations of O.P. 8.30, the primary assessment criteria of outreach and sustainability are now regularly utilized in the design and implementation of financial intermediary loans (FILs) and other operations that focus on improving access to financial services. These primary assessment criteria serve as a guide for reforming the operating policies and procedures of RMFIs and provide time-bound, quantifiable benchmarks against which the impact of Bank efforts to build the capacity of RMFIs can be assessed.

78. This emphasis on integration of rural and microfinance within financial sector development, however, may not succeed without complementary investments to ensure a conducive social, economic, and infrastructural base, including clients with adequate skills and social capital necessary for microfinance methodologies based on non-traditional collateral. Such investments are likely to be the appropriate starting-point in remote areas or in crisis situations. A potential conflict arises when Bank operations turn to microcredit as an instrument to address some of these underlying problems if the conditions for developing sound rural microfinance systems do not exist. Alternative investments using grant-based approaches may be more appropriate. At the level of individual projects, the challenge is to address these poverty reduction objectives in ways that also support the longer-term development of viable rural financial markets accessible to the poor and to avoid using microfinance intermediaries as channels for resource transfer.

4.2. FUNDAMENTALS AND AWARENESS AT THE MACRO LEVEL

79. Measures that improve efficiency in rural financial markets are particularly beneficial to those who have the least access to financial services, such as the rural poor, and simultaneously foster income expansion and poverty reduction. Market imperfections can result from distorted macroeconomic and sectoral policies, a weak legal and regulatory framework, and poorly functioning institutions and information systems. These areas can be pursued comprehensively or sequentially, depending on each country’s circumstances; even when the policy environment is not yet favorable, progress on the legal and institutional underpinnings of financial markets can lay the groundwork for subsequent more rapid development.

Creating an Enabling Policy Environment

80. For RMF development to succeed, experience has shown that a stable macroeconomy and a liberalized financial environment are essential. Policy reforms that have been implemented as part of RMF projects in many countries include liberalizing interest rates, relaxing controls on RMFIs, privatizing banking services, and enhancing bank competition. In some countries, however, policy issues may still need to be addressed at the levels of macroeconomic management, financial sector, and sectoral policies. Besides exchange rate stability and low inflation, fiscal and monetary management should avoid overvalued exchange rates, which bias economic incentives against domestic agricultural production, and high interest rates on government securities, which discourage commercial financial institutions from entering relatively risky rural markets. In addition to deregulating interest rates, financial sector reforms

13. Nevertheless, the relatively small size of such capacity-building operations makes it difficult to secure a place in the lending program over an extended period.

should remove lending targets and administrative directives, promote consistent rediscount rates across subsectors, and facilitate entry into and exit from the rural financial system. Other sectoral policies that may need reform to reduce bias against rural production and finance include agricultural price and marketing controls, high taxation of agricultural exports, high effective rates of protection for domestic industry, and budgetary biases toward urban infrastructure and social services.

81. Even where liberalization has occurred on the books, politicians (and even some donors) may remain reluctant to accept interest rates to poor clients significantly above commercial bank rates and may promote special schemes or funds to channel loans to the poor at subsidized rates. This is often the legacy of past emphasis on “affordable rates” and subsidized interventions and of insufficient exposure to the lessons of experience, which demonstrate that: (i) such approaches fail to achieve their intended impact (the poor are less likely to receive subsidized allocations than the more politically powerful); (ii) the poor place greater importance on sustained access to financing rather than interest rates per se; and (iii) repayment rates in government- and donor-directed credit schemes are invariably low, with dangerous spillover effect on the regular portfolios of RMFIs.

82. In such cases, the priority is to raise awareness of experience and principles of RMF, showing that economic opportunities in capital-starved low-income communities enable them to profit from short-term loans even at relatively high rates and that the sustainability and outreach of RMFIs depend on charging enough to cover not only operating costs but a margin for expansion. Proponents of this approach argue that the interest rates needed to cover the costs of sustainable microfinance are well below the much higher interest rates from informal moneylenders (the only alternative available), even though they may seem high relative to commercial bank interest rates (to large borrowers with collateral). At the same time, legitimate concerns about excessive costs of rural and microfinance need to be addressed through competition and capacity-building measures to increase efficiency and lower costs in RMFIs. Discussion among government officials, politicians, RMFIs, grassroots organizations, donors, and other stakeholders is essential to build consensus on what approaches are most appropriate to serve different objectives.

**Improving the Legal and Regulatory Framework**

83. Establishing an appropriate legal, regulatory and supervisory framework for RMFIs involves striking a balance between (i) encouraging relatively unfettered development of innovative methodologies for reaching the poor; (ii) providing a legal niche for RMFIs that want to mobilize and intermediate savings from the public; (iii) and protecting depositors and the financial system from unsound practices and institutions. While there is a broad consensus that the long-run future of RMF with significant outreach lies in licensed institutions that can mobilize and intermediate savings, views differ on whether:

- Early establishment of a legal and regulatory framework enhances investment and expansion of RMFIs by creating a more predictable operating environment;

- A “rush to regulate” is likely to be counterproductive by constraining innovation and natural maturation in a nascent industry and imposing regulatory burdens that central banks (or delegated authorities) are ill-equipped to handle (Christen and Rosenberg 2000);

- Small, unregulated NGOs and self-help groups (SHGs) have a long-run role to play in providing financial services to the very poor and remote rural areas, either through linkages to more commercial RMFIs or as channels for targeted support.

84. A consensus is emerging that a suitable framework consists of different tiers, allowing for licensing of specialized RMFIs with lower minimum capital (but perhaps stricter prudential) requirements than commercial banks, while defining minimum criteria that trigger regulatory requirements and leaving
small, less formal organizations outside the regulatory regime (Van Greuning, Gallardo, and Randhawa 1999). Since protection of depositors is usually viewed as the principal rationale for licensing restrictions, the benefits of regulation generally appear unlikely to warrant the substantial costs of overseeing the large majority of RMFIs (NGOs and SHGs) that do not take voluntary deposits from the public. To facilitate the existence of small organizations using their own (or donated) funds to reach underserved clients and to act as financial agents, financial legislation needs to be complemented by other regulations and procedures that permit their voluntary formalization and legal operation.

85. For those RMFIs that do accept deposits, and even for microfinance portfolios of commercial banks, a tailored set of prudential and supervision guidelines is increasingly viewed as desirable – though experience remains limited as to the optimum quantitative requirements, which may vary according to the size, type, and ownership structure of the institution, as well as the capabilities of the supervisory authorities. The requirements for different tiers and financial products should be designed to minimize the scope for seeking a competitive advantage by registering in a less-regulated tier while competing directly with more tightly regulated institutions. Legislation should be introduced only after careful preparation to avoid both an excessively restrictive approach that inhibits innovation and entry and overly easy entry that can overwhelm the capacity of the supervisory authorities (which should be built up as the legislation is being prepared). A related issue is the extent to which supervision can effectively be delegated to bodies other than the central bank, such as credit union associations. For non-regulated institutions, a system to gather performance indicators is highly desirable in order to monitor the growth and health of the industry, and many associations of RMFIs are engaged in developing performance monitoring systems.

86. Improving land titling is especially important to give rural landholders greater access to financing. Creation of recognized security interest in land, together with a system for registering claims, can have significant impact by enabling the rural poor to leverage their biggest asset, land rights, as collateral for financing (Yaron, Benjamin, and Piprek 1997).

87. Similarly, the absence of a strong framework for secured transactions – creation (legal definition), perfection (registration), and repossession – is a clear constraint on rural entrepreneurs’ access to finance, including indirectly through the wholesale and retail marketing system. Establishing a comprehensive legal framework and modern registries can facilitate supplier credit and linked transactions secured by inventory and accounts receivable, as well as bank lending for moveable property (e.g., in Peru and Romania). Key measures include: (i) establishing or implementing laws for loan recovery and contract enforcement (e.g., expediting debt recovery, permitting non-judicial foreclosure of collateral to lower costs, offering legal protection against defaults, permitting establishment of licensed debt collection agencies); and (ii) removing regulatory impediments to broadening the range of collateral that can be used to access credit, particularly non-traditional collateral substitutes that the poor have to offer such as movable property, commodity, livestock, accounts receivable, personal or group guarantees, credit history and good past repayment records.

Developing Market Institutions

88. Improving the information base for lenders can facilitate market development by reducing risks and transaction costs. RMF projects can support measures to provide accurate and timely information regarding collateral, including: (i) expansion, modernization, and unification of public registries, particularly for land; (ii) improvement and modernization of titling and registration procedures; and (iii) promotion of default registries, credit bureaus, credit scoring, and rating services, particularly to provide better information about potential institutional borrowers such as NGOs and SHGs. In these areas, government may have a role in fostering and regulating the development of information bases to be
utilized by the private sector for establishing credit history, insurance, and other risk management mechanisms.

89. Industry associations and networks play an important role in setting standards and improving the availability of information by establishing systems for collecting, benchmarking, and reporting data on performance of RMFIs. They also are critical in representing the RMFI industry in effective policy dialogue with governments and donors and in developing and implementing national microfinance strategies. Given the public goods nature of much of the information and services typically provided by such associations and the need for political independence, they are appropriate avenues for external support, which nevertheless should be linked to performance in providing services to members and partial cost recovery.

90. Improving risk management is essential for development of rural financial markets. Measures to reduce the underlying risks in rural, agriculture-based economies – a major reason for the lack of commercial financial services (see section II.B) – include improving farmers’ access to information and to less risky technologies, diversification, and risk-pooling mechanisms (Anderson 2001). While traditional crop insurance methods have not had much success in developing countries, emerging methods for insurance based on readily measurable indicators such as rainfall and commodity prices offer some promise for stabilizing farm income in some regions (Box 4.1). Nevertheless, it must be recognized that the cost of such insurance may limit it to commercially-oriented farmers, while social and relief programs may be more suitable for the poorest and subsistence-oriented farmers (Varangis, Larson, and Anderson 2002). There is also growing experimentation with “micro-insurance” products that can help the poor cope better with sudden expenses due to ill health, funerals, and loss of income-generating assets (Siegel, Alwang, and Canagarajah 2001; Gallardo, Kalavakonda, and Randhawa 2002). Many RMFIs, credit unions in particular, are introducing credit insurance as part of their financing package to protect both their loan portfolio and the borrower’s family by paying off outstanding loan balance in case of death.

**Box 4.1 Innovative approach to weather risk management for agriculture**

Weather risk markets are among the newest and most innovative of markets for transferring financial risks. The underlying index for weather risk management contracts is a measurement of some weather phenomenon, by an objective third party, at a given location over a specified period of time. Participants in weather risk markets are drawn from a broad range of economic sectors such as energy, insurance, banking, agriculture, leisure, construction, and entertainment. To date, the US and European energy sectors have been responsible for most activity in weather risk markets, but new applications are emerging, including for agriculture.

Rainfall risk management contracts could be considered as alternatives to traditional crop yield insurance programs, which have typical difficulties due to moral hazard and adverse selection problems and high

15. The World Bank Africa Region managed a program of Action Research on Sustainable Microfinance Institutions in Africa from 1995 through 2000, with funding from Swiss Development Cooperation and DANIDA to support documentation and networks of RMFIs in six countries (Cameroon, Ethiopia, Ghana, Kenya, Mozambique, and Zambia), with additional assistance to networks in Malawi and Uganda. Local workshops held to discuss case studies quickly led to the formation of national networks, which have proved effective as lateral learning mechanisms to disseminate best practices and to build consensus on policy and institutional development issues. Current programs to support the development of national microfinance associations are sponsored by the Small Enterprise Education and Promotion network (with CGAP support) and by UNDP, GTZ, and Women’s World Banking, which have assisted the creation of the Africa Microfinance Network in Abidjan (Bruentrup and Gross, forthcoming). These programs have facilitated the registration of networks as professional associations, giving practitioners a more formal role in the policy dialogue. Many are playing an increasingly active role in development of the RMF industry, for example through advocacy, training programs, and developing standards and indicators of industry performance.

16. Crop insurance schemes have failed by attempting to cover essentially uninsurable risks, because premiums were not set adequately (requiring recurrent subsidies and bailouts), and because of problems of moral hazard, adverse selection, and political interference (Yaron, Benjamin, and Piprek 1997; Empel and Sluijs 2001).
Box 4.1 Innovative approach to weather risk management for agriculture

administrative costs. Rainfall Indexed Contracts (RICs) could enable farmers and others to manage their risks against the significant risk of drought or flooding. A RIC is a contingent claims contract that can be sold as simple certificates in low denominations at dispersed points of sale. In return for a specified premium, the ‘writer’ of the contract agrees to pay the ‘holder’ an amount that depends on the rainfall measured at a specified weather station over a designated period of time. In years with normal rainfall, the contract pays nothing. In drought or flood year, however, the RIC pays an amount that rises with the severity of the event. Besides farmers or groups of farmers, others such as traders, processors, and input suppliers may be affected can purchase RICs. Recent experience shows that such indexed ‘derivative’ contracts can attract large pools of capital, helping to transfer local risk to other insurance and capital market participants who wish to hold a diversified portfolio of risks – especially as rainfall in a particular country is not correlated with other financial risks or natural disasters.

Potential benefits include: (i) smoothing income and consumption patterns to minimize the expenditure shocks of excess or insufficient rainfall; (ii) enabling risk-averse producers to shift from lower-yield production patterns to more specialized outputs and technologies; (iii) improving the volume and terms of loans to agriculture and rural enterprises; (iv) explicitly pricing rainfall risks, thereby creating incentives to reduce the probability that a rainfall-related disaster would occur; (v) providing insurance against systemic weather risks to mutual insurance groups at the farm or village level; and (vi) reducing Government costs and uncertain fiscal pressures of flood and drought relief programs and reconstruction.

Challenges in establishing a market for rainfall risk contracts include: making them economically appealing to both insurers and buyers; availability of good historic weather data; installing a credible rainfall measurement system; and establishing transparent regulatory guidelines for risk hedge sales and exchange. The design of a rainfall risk management project should seek to introduce purely private coverage of the majority of rainfall outcomes and to make explicit the Government’s commitment to act as a reinsurer of last resort in the event of a highly improbable rainfall catastrophe.

The agricultural sector has thus far made only limited use of weather risk markets. In the Canadian provinces of Ontario and Alberta, weather risk instruments have been used to hedge forage production risk. AGROASEMEX, the state agricultural re-insurance company in Mexico, used weather derivatives to reinsure part of its weather-related crop insurance risk. Other countries with plans to launch weather risk contracts include Argentina, India, Morocco, and South Africa. In many developed countries highly subsidized agricultural insurance schemes crowd out the demand for agricultural weather risk instruments. Developing countries, on the other hand, typically have no government-subsidized agricultural insurance. They are, however, highly susceptible to weather risks and often highly dependent on agriculture. Thus, developing countries would seem to be a potential growth market for weather risk instruments.

Source: Lisa Taber and Panos Varangis.

91. Collateralizing commodities can be an effective means of overcoming the lack of acceptable collateral due to problems associated with land ownership and titling. Wider use and acceptance of warehouse receipts, inventories, and accounts receivables can greatly enhance the ability to secure commercial finance on the part not only of farmers and their associations, but also input suppliers, feedlot operators, grain silo operators, processing plants, and other actors in the supply chain. Many Latin American countries now license warehouses that issue endorsable receipts, which the producers can use to obtain financing based on inventories deposited in the warehouse. Farmers’ groups may be able to operate their own inventory credit schemes, with limited initial assistance (Box 4.2). Nevertheless, introduction of such instruments may depend on prior reform of legal and judicial systems for securitizing assets and enforcing contracts.

92. Improved systems for effecting payments and making transfers to and from rural areas are particularly valuable in reducing the costs of financial transactions. Application of technology through automatic teller and “smart” cards also has the potential to facilitate commercializing microfinance by lowering and decentralizing transaction costs.
### Box 4.2 Inventory credit scheme

The international NGO, Technoserve, has developed an inventory credit scheme in Ghana that enables farmers’ groups to obtain higher value for their crops by

- providing post-harvest credit by linking with a rural financial institution,
- using individual savings (in the form of stored crop) with credit; and
- through cooperative group management by farmers producing maize, oil palm, and cashews.

Instead of selling all of their crop at harvest – when prices are lowest – in order to meet cash needs, small-scale farmers in the scheme store their crop in a cooperatively-managed warehouse and receive a loan representing a percentage of the value of the stored crop, which serves as collateral. This loan permits them to clear their accumulated debts and satisfy immediate cash requirements.

Subsequently, when prices have risen in the off-season, the farmers either sell the stored crop or redeem it for home consumption. Even after deducting a storage fee and a margin for the cooperative, farmers typically realize significant profits by waiting for the higher prices to sell (or by avoiding having to buy at off-season prices for home consumption). The success of this “warehouse receipts” model has led several commercial banks to adopt this form of lending.


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93. The role of informal financial agents and intermediaries should be acknowledged as part of a strategy for developing the rural financial sector. Traders, wholesalers, input suppliers, savings and credit associations, moneylenders, savings collectors, and transfers or loans from relatives and friends are especially important in the absence of a conducive legal framework and efficient formal intermediaries. Experience shows that these institutions may serve as a basis for scaling up and commercializing services as the enabling environment becomes more favorable, and in any case continue to play an important role in filling many gaps in the availability of financial services to different market segments and types of clients. While the scope may be limited for direct assistance to strengthen informal institutions, at least care should be taken to avoid undermining their ability to function.

### 4.3. Building Capacity of RMFIs to Deliver Appropriate Financial Services

94. At the micro level, the top priority is building efficient, viable RMFIs capable of delivering appropriate products, including savings, insurance, and payment services, as well as credit. Performance-based grants should be accompanied by indicators to monitor RMFIs’ progress in achieving subsidy independence and evaluate whether a continued subsidy is justified, with the ultimate object to get them to be financial self-sustainable and able to access market-based sources of funds. The Bank recognizes that a variety of institutional forms and strategies are needed to match particular environmental constraints. For example, in areas with a predominance of subsistence agriculture and other low-return activities, expansion of small, user-owned, savings-based RMFIs may be the most suitable approach until economic opportunities can be enhanced using grant-based approaches. Alternatively, in areas with profitable agricultural or rural microenterprises, large, privately-owned, full-service RMFIs may be viable.

Institutional Choice and Capacity

95. The focus has shifted dramatically from nurturing subsidized government-run institutions with cheap credit to developing institutional capacity and improving financial performance for a broader range of RMFIs. On the one hand, licensed, supervised commercial financial institutions engaged in rural and micro finance are essential to reach significant scale, especially through mobilization of domestic savings.
On the other hand, NGOs and community-based savings and credit associations and self-help groups may play an important role in reaching certain target groups that remain beyond the reach of formal financial institutions, such as the very poor, remote rural areas, and women. A program of institutional strengthening has to recognize that different institutional choices may serve different, complementary objectives, and address their needs accordingly. Depending on the country context, institution building may include assistance in transforming into a licensed financial intermediary or establishing new, specialized RMFIs; it may also include support for formation, strengthening, and linkage of groups at the community level.

96. Institutional capacity refers to the degree to which commercial operating policies and procedures are embedded in the daily activities of an organization, implemented effectively to achieve increased levels of sustainability and outreach, and managed under a governance structure that assures adequate accountability (especially when savings of members or from the general public are involved). A good management information system (MIS) that can generate timely reports on the performance of the portfolio and staff is particularly essential both for strong internal controls and for reporting to supervisory authorities—especially in RMFIs that mobilize savings deposits. Building this capacity is a continuous process which must be steadily internalized within the institution. This means that assistance to RMFIs, for example in staff training and other business development services such as technical assistance and audits, should be provided through demand-driven mechanisms such as matching grants and vouchers, which stimulate private providers to offer the services at full cost-recovery prices and for which subsidies can be phased out as the market develops. Financial performance depends on close attention to loan recovery, minimizing portfolio at risk, cost recovery through appropriate pricing and cost-reduction measures, and reducing dependence on subsidies (see Appendix 1).

97. Perhaps the most important factor that determines the success of RMFIs is ensuring appropriate governance. The powers and responsibilities of all decision-making entities and individuals must be clearly defined, and the boundaries of roles and responsibilities must be fully understood and consistently enforced. Management must have autonomy and be held accountable for operational decisions, and clients’ interests must be represented. Adopting RMF industry standards is essential to improve transparency of performance and strengthen accountability. Improved organizational, operating, financial, and reporting standards will foster recognition of RMF as a legitimate sector in the financial services industry. Reliable RMF standards reinforce trust and confidence in RMFIs and can be used to enhance operational efficiency and, eventually, to access market-based sources of capital. In a country with a typical diverse range of both licensed and unlicensed RMFIs, institutional strengthening should include both the ability of the central bank to effectively supervise licensed RMFIs using appropriate methodologies and the capacity of an association of RMFIs to set standards and monitor industry performance.

17. There is a growing consensus that training courses should, in principle, charge fees sufficient to cover the costs of offering them so as to assure long-run sustainability, although there is also concern about the affordability to smaller, grassroots RMFIs. The approach of CGAP’s APCAP-CAPAF program is to train local trainers to deliver a set of high-quality core courses aimed at relatively advanced RMFIs who can pay the full costs of delivering the courses. Some countries are attempting to adapt this approach to provide incentives for appropriate but less costly training for smaller, rural RMFIs by shifting (partial) subsidies to the demand side through mechanisms such as a matching grant fund for training. Nevertheless, the predilection of donors and governments to offer training on a highly subsidized basis remains high and can easily undermine the incentive for private providers to enter the market. Hence there is an important need for greater donor coordination and consensus on how best to develop this market, both overall (through CGAP and the Small Enterprise Donor Committee) and with respect to programs in individual countries.
Savings Mobilization as a Service and a Source of Funds

98. Past overemphasis on agricultural credit has failed to develop the range of financial products needed to address the wide diversity of clients, activities, and demands in rural areas. The myth that poor people cannot save has dominated development finance thinking in the past and given rise to the emphasis on credit operations and the underrating of savings promotion, exacerbated by pressures to lend in most international donor institutions. In many cases, however, promoting efficient savings mobilization could more effectively enable the poor to accumulate funds and greatly reduce the demand for credit offered by donors and NGOs.

99. Savings instruments are increasingly recognized as a highly valued financial service that enables the poor to cope with life cycle events and the general mismatch of income flows and consumption expenditures (Hannig and Wisniwski 1999; Hirschland 2002; Robinson 2001; Rutherford 2000; Wright and others 2000). Indeed, RMFIs that offer both savings and loan products on commercial terms consistently reach far more poor clients through savings than through credit.

100. Furthermore, savings mobilization is an important step away from dependence on donor funds toward becoming a true financial intermediary and represents a major source of funds for most self-sustaining RMFIs (Hannig and Wisniwski 1999). For example, under pressure to become self-sustaining, the Bank Rakyat Indonesia’s Unit Desa program introduce a well-designed and -managed deposit product in 1984 that enabled its savings mobilization to far exceed the volume of its loan portfolio by 1991, despite rapid growth of the latter (Patten and Rosengard 1991).

101. Community-level savings-based approaches may be the most suitable entry point for improving access to financing in low-potential areas that are not likely to attract RMFIs. In the past, savings and credit cooperatives (SACCOs) have often not performed well in countries where they were promoted by governments as part of a cooperative approach to organizing farmers. Nevertheless, a new generation of SACCOs or credit unions has been established successfully over the last 15 years in countries ranging from Madagascar to the Kyrgyz Republic, from Cambodia to Brazil (Box 4.3). Other countries are revisiting the legal and support framework for SACCOs and credit unions to introduce a more commercial orientation, while community-based rural development projects are experimenting with technical assistance to build the capacity of communities to mobilize and manage their own funds on a less formal basis. Similar comments can be made regarding post office savings banks: while they have generally not succeeded in developing countries, they are being revived in some cases as independent, commercially-operated entities that can take advantage both of post office networks and innovations in information and communications technology. Experiences from such efforts are being gathered through studies and donor forums, leading toward greater understanding of successful practices in cooperative approaches to savings mobilization and intermediation.

102. Managing voluntary savings deposits, however, is a different task from managing loan portfolios (and the mandatory savings that are often required as a precondition and security for microcredit) and requires both sound internal controls and effective external supervision. Adaptation of the legal and regulatory framework and strengthening the capacities of the supervisory authorities, as well as RMFIs themselves, are especially important to develop specialized RMFIs that can effectively offer deposit services and prudently utilize savings as a source of funds.

Box 4.3 Savings-based, agriculture-oriented rural credit unions – SICREDI, Brazil

SICREDI is one of the largest savings-based, member-owned credit union systems in Brazil, operating in five states. SICREDI’s common bond of membership, which all credit unions in Brazil must maintain, is agricultural community membership, with the majority of financial services provided for agricultural activities. SICREDI specializes in agricultural lending, primarily for the production of rice, wheat, beef, fodder, fish, and vegetables.
Box 4.3  Savings-based, agriculture-oriented rural credit unions – SICREDI, Brazil

and for agricultural equipment.

**Products**: Short-term loans are financed from deposits and longer-term loans (over one year) from National Development Bank borrowings. Loan approvals are based upon the members’ savings history and credit record, with the size limited to 50 percent of production costs and dependent upon the potential return of crop sale at harvest as well as household income and debt obligations. The borrower makes monthly interest payments and then a balloon payment of the principal at harvest time. In addition, SICREDI participates in the PROAGRO national crop insurance, for which a premium of 3.9 percent is added on the loan rate. PROAGRO pays 100 percent of the loan loss if the crop fails.

**Membership** in SICREDI has expanded rapidly in recent years, increasing from 210,054 members in 1999 to 577,499 in 2002, with a total of 129 credit unions with 767 agencies. As of December 2002, SICREDI had received US$518 million in savings, managed US$121 million in borrowings, and had outstanding loans of US$315 million. SICREDI capital reserves to assets were 10 percent in 2002; net worth stood at 18 percent; and delinquency was 8 percent. Savings financed 81 percent of total assets, and the loan portfolio made up 55 percent of total assets. This expansion and strong performance of SICREDI has been largely driven by: (1) increased public confidence in the credit unions as they adopted and established common standards of financial discipline; (2) an expanded range of products offered by the credit unions; and (3) aggressive marketing and branding programs.

**Success factors** of the SICREDI system include the use of consistent lending practices, system-level management of liquidity risk, and system-wide commitment to uniform standards. In order to use the SICREDI name and logo, credit unions must pass financial and product quality standards and meet specified policy criteria. The financial details of all credit unions are shared among the system to ensure peer enforcement of these standards. The narrow dependency on agricultural lending concentrates risk, and this is managed by limiting the percentage of assets in lending, financing longer-term loans with borrowing, and buying national crop insurance. In the medium term SICREDI will need to diversify its risk further by developing new products and markets for new types of lending.

Source: Brian Branch, World Council of Credit Unions.

**Product Development**

103. Adapting existing financial products and developing new ones is important for RMFIs to reach more rural clients with appropriate services and to remain competitive. To better serve rural clients, RMFIs need to pilot better ways of making and recovering loans for agriculture, whether directly or through community-based organizations, and to adapt to the changing environment and conditions of its clients (Box 4.3). Besides establishing a legal framework that supports secured transactions and contract enforcement, grant assistance for the costs of developing and piloting products such as leasing, factoring, warehouse receipts, housing loans, insurance, smart cards, and payment transfer mechanisms is an appropriate component of capacity-building programs to help RMFIs become more commercial. Nevertheless, while small RMFIs should be responsive to client demand and competition, they should also be wary of expanding into new areas beyond their management capabilities. The range of financial products available can be increased by encouraging the creation of new, specialized institutions, as well as through diversification within existing institutions. Programs to develop rural financial markets should include incentives for RMFIs, commercial banks, and specialized non-bank financial institutions to adapt and introduce these instruments to meet the cost and risk characteristics of rural markets.

104. For example, the highly competitive microfinance market in Bangladesh has induced RMFIs there to introduce equipment leasing to meet clients’ demands for equipment financing while managing some of the risks inherent in term finance. They have also developed a range of insurance products to accompany loans and leases (Gallardo, Kalavakonda, and Randhawa 2002). Credit life insurance that pays off loan balances in case of the death of a client is a suitable insurance product that RMFIs can build
into the cost of lending, as it benefits both clients and the RMFI by avoiding problems of collecting from the families of deceased clients. However, for other types of insurance (such as health insurance and life insurance that pays out), RMFIs are generally better off acting as agents for insurance companies or clinics that develop suitable projects and take the risks.

Commercial Sources of Funds

105. RMFIs (especially NGOs) often rely on donor grants and concessional credit lines in building up their loan portfolios in the early stages. But such funding is limited in amount and uncertain over time, and excessive availability of easy money can delay the transition of RMFIs to a more commercial, sustainable basis (CGAP, 2002). To move toward sustainability and greater scale, RMFIs need to build access to and the capacity to absorb commercial funds. Linking RMFIs to commercial sources of credit and equity is an important part of building up their long-run capacity to survive and grow.

106. Conditions for Credit Lines. The importance of shifting RMFIs from reliance on grant funds to sourcing commercial funds from financial intermediaries means that specially targeted credit lines are generally not preferred as a primary instrument in Bank operations, for several reasons:

- Directed credit (especially when highly subsidized) tends to distort financial markets and create perverse incentives that undermine long-run sustainability.

- Lack of liquidity in the financial system must be demonstrated to be the binding constraint (rather than weak retail delivery capacity, which is often the limiting factor in low-income countries and very poor, remote areas).

- Where funds for on-lending are available from other donor agencies on a grant or concessional basis, World Bank Group credit lines are relatively unattractive and tend not to disburse (they must be passed on at wholesale rates that do not distort financial markets).

107. Thus, credit lines should be incorporated only when assessment of RMFIs in the country shows that they have the capability to reach the targeted groups but lack liquidity and that their cost structures enable them to pay wholesale rates for such funds so as not to distort financial markets, as required by O.P. 8.30. In countries where a growing number of RMFIs are reaching maturity but have limited access to commercial funds, suitable approaches may include “linkage banking” mechanisms (AFRACA/GTZ 1997) and establishment of an apex facility to mobilize funds and make them available on a performance-based basis (Box 4.4). When targeted lines of credit can be justified, O.P. 8.30 states that they should be accompanied by reforms to rectify underlying market imperfections and that (micro-) financial sector staff and the Financial Sector Board should be involved in the design and review of the operation. Otherwise, the focus should be on strengthening the capabilities of RMFIs themselves, and/or on “social intermediation” to build social capital and the skills of potential clients (see below). This indirectly supports income-generating activities by raising both the capacity of the poor to manage businesses and qualify for financing and the capacity of RMFIs to meet that demand.

18. “Bank-supported Financial Intermediation Loans (FILs) also aim to remove or substantially reduce the use of directed credits, which are akin to interest rate subsidies, as they lead to resource allocation outside market mechanisms. In many borrowing countries, increasing access to credit by specific sectors (e.g., microfinance institutions or the rural sector) is a major policy objective of the government, and some use directed credit to pursue this objective. A Bank FIL may support directed credit programs to promote sustained financing for such sectors, provided the programs are accompanied by reforms to address the underlying institutional infrastructure problems and any market imperfections that inhibit the market-based flow of credit to these sectors. Such reforms include measures to (a) address obstacles that impede the flow of funds to the credit recipients, or (b) enhance the creditworthiness of the intended beneficiaries through appropriate approaches such as mutual group guarantees” (World Bank 1998c).
Box 4.4 Apex mechanisms

Apex organizations are essentially wholesale mechanisms for channeling funds to retail microfinance institutions. In providing second-tier financing to retail MFIs, apexes can support the expansion of financial service provision in rural areas, with the important caveat that the institutional capacity of retail MFIs has to be sufficient to absorb and on-lend the apex funds. MFIs that are not licensed to take deposits, such as microcredit NGOs or finance companies, are limited in the sources of funds they can access, and an apex can be a valuable source of funds for them. Apexes can offer governments and development agencies a means of dispersing large volumes of money into microfinance and thus are attractive to donors struggling to effectively channel funds to individual MFIs.

However, this potential is rarely fully realized, as apexes have tended to suffer from the following design flaws:

- Insufficient TA to build the institutional capacity of the recipient MFIs to absorb and recover the funds available for on-lending;
- Over-complicated or lengthy selection procedures for recipient MFIs;
- Apex staff lack the capacity to effectively and flexibly deal with MFIs;
- Apex design determined by disbursement pressure, rather than adapted to the type and level of funding needed by the microfinance sector and based on performance criteria; and
- Government control or influence leading to the selection of inappropriate MFIs.

Apexes can be well positioned to provide technical assistance for capacity building, coordinating development agencies, and monitoring and supervision services, yet too often they lack the capacity to do so or have insufficient grant and TA funding. Capacity of MFIs and not liquidity is usually the binding constraint on expansion of MFI services. Apexes that have succeeded in expanding outreach typically combine access to funds with considerable technical assistance and the provision of information and management systems. Apexes that provide subsidized long-term access to funds on a substantial scale can also crowd out private sector sources of financing, such as banks and investors that are needed to ensure long-term MFI sustainability and the integration of MFIs into the wider financial sector.

In Bosnia, the Local Initiative Department, an apex-type facility, was set up by the Bank to provide technical assistance and funds for on-lending to microfinance providers, with building a sustainable microfinance sector as one of its goals. The microfinance institutions supported by the apex facility had disbursed over $80 million in micro-loans by 2002, with an extremely high repayment rate. Loans have targeted disadvantaged groups: women make up half of the clients, and other recipients include displaced persons, returning refugees, and demobilized soldiers. The facility has played a leading role in shaping the emerging microfinance sector by providing technical assistance, institution-building grants, and legal protection and monitoring while banking and microfinance law and supervisory capacity were developed. Furthermore, the facility has been successful in leveraging funds from other donors. Key lessons include:

- Initial and ongoing access to funding was dependent on performance indicators agreed with each MFI.
- Comprehensive technical assistance was provided, with the continual involvement of a microfinance expert able to sub-contract technical assistance inputs as appropriate.
- Institution-building grants were provided in addition to funds for on-lending.
- The facility promoted good practice microfinance performance and reporting standards that were accepted by both MFIs and other donors (many of which channeled their funding through the facility).
- LID was sufficiently ‘arms length’ from government to (mostly) be able to resist political pressures to work with certain MFIs in certain regions, often associated with ethnic priorities, and to select MFIs based on their capacity to grow and provide microfinance on a large scale to the poor in the long-term.

Sources: (Pearce, 2002).

108. The Bank continues to face the challenge of operationalizing O.P. 8.30 such that all lending operations are in line with Bank policy. As discussed above, RMF projects and components are found in
a wide range of sectors other than the financial sector, and it is essential to modify project concept and supervision documentation to identify relevant projects, as well as to improve internal coordination to provide technical expertise in the design and implementation of operations that are not specifically designated as financial intermediary lending.

109. **Conditions for Guarantees.** Guarantees may be suitable to facilitate access of RMFIs to credit from commercial financial intermediaries. They are likely to be more effective in building up a viable wholesaling arrangement through RMFIs than in getting commercial financial institutions to lend directly to smaller, poorer clients. Guarantees are sometimes used to try to persuade commercial banks to lend directly to SMEs and microenterprises. The rationale is that such guarantees reduce the risk of serving smaller and rural clients and enable them to establish a credit history and subsequently to move into the category of regular clients. The new clients are also provided a chance to interact with the bank and learn how to comply with standards.

110. The rationale against such guarantees is that, in and of themselves, they do not provide the methodology and capacity to financial institutions to deliver RMF. They are often misused as a political instrument by allocating a certain percentage of the portfolio to rural or SME clients based on political rather than economic concerns. They may also be misused to reduce losses on the bank’s existing portfolio of problem loans, or conversely, to increase profits for the bank by applying them to clients that the bank would have qualified for loans in the first place. By reducing the expected loan write-off, guarantees may reduce the incentive of clients to repay (moral hazard) and of banks to undertake vigorous collection efforts. When guarantees in fact induce financial institutions to engage in high-risk lending, either the resulting claims bankrupt the guarantee fund or its failure to cover losses undermines its credibility with the institutions.

111. Worldwide experience shows that such guarantee schemes for direct lending will not work without a strong policy and institutional framework and unless the lenders are committed to developing the techniques necessary to make RMF operations profitable. They work best when they increase financial institutions’ comfort level with taking on additional rural clients who meet most lending criteria except track record or collateral, not to underwrite a large portfolio of risky loans that the institution is ill-equipped to appraise and collect.

112. On the other hand, in cases where strong, profitable RMFIs have emerged and are seeking commercial funds for expansion, guarantees may facilitate their access to wholesale funds from commercial banks by mitigating risk and securing the loan. This approach works best when commercial banks have excess liquidity and are looking for reliable outlets, and in particular to demonstrate that they are assisting smaller, poorer clients, even if only indirectly through retail institutions with suitable methodologies. Ideally, such guarantees should be on a fully commercial basis, with the RMFI paying a fee in order to obtain initial access to financing, until such time as its track record warrants lending without such a guarantee. Nevertheless, the IFC’s experience indicates that the costs and small loan sizes involved may require some subsidization of the costs of establishing and operating guarantee funds as a means of leveraging locally-mobilized commercial funds (Box 4.5).

**Box 4.5  Commercial guarantees for credit to MFIs in West Africa**

The IFC enabled three West African microfinance institutions (MFIs) to raise financing from local banks for up to CFAF2.4 billion (about US$3 million equivalent) by providing local currency guarantees. This commercial approach allowed the MFIs to meet the strong demand for medium-term credits from their clients by raising medium-term funding for the first time from local banks. The three leading MFIs in West Africa target entrepreneurs and poor people who have no access to the formal financial banking sector, including urban and rural clientele ranging from market women to small cotton-growing farmers in Mali. Average loans range from US$100 to US$2,500.
Box 4.5 Commercial guarantees for credit to MFIs in West Africa

Because the leading MFIs had reached the point where they needed to cooperate more strongly with the banking sector to meet their funding needs, the partial guarantee approach was designed to pave the way for future bank lending without an IFC guarantee, as well as to ensure supervision of the institutions by the local lending banks. This would give the lending banks a direct exposure, which would ensure on-going interest and a chance to build a long-term relationship. The guarantee was structured to leverage additional non-guaranteed funding alongside the guaranteed financing by making reference in the legal agreements to a guaranteed and a non-guaranteed loan, thus de facto creating a partial guarantee, and providing the lending bank with enough comfort that the guarantee is easily manageable and callable at first demand. The indemnity was denominated in CFA Francs, thus avoiding any foreign exchange rate risk for the microfinance institutions. Legal agreements were designed to be well understood by the Boards or Directors of the microfinance institutions, many with little sophistication in finance.

Three key elements were critical for the success of the operation:

- Mature microfinance institutions ready to pay the price for commercial funding and to move away from dependence on donor funding.
- Banks willing to finance MFIs with medium-term funds at a rate that allows sufficient spread for the MFIs to cover their costs. The mix of IFC’s credit risk with that of the MFIs is perceived to generate a better overall interest rate than in the case where the bank would have to price a 100% IFC guarantee.
- Leveraging the institutions’ negotiating position vis-à-vis the banks by emphasizing the institutions’ financial strengths. A well-managed MFI with a capital adequacy ratio ranging from 15% to 30% and very low loan portfolio at risk is often far more conservatively leveraged than the banks they seek funding from. In addition, most MFIs keep considerable liquid positions with banks, as required by the West African regulatory framework, often without using them as a negotiating argument.

Source: Peer Stein, IFC.

113. Equity. Obtaining equity funds is essential for RMFIs to become commercial and sustainable, both as a less expensive source than commercial credit for financing loan portfolios and to meet minimum capital requirements for licensing as a formal financial institution in order to take savings deposits from the public. A growing number of equity funds involving both private and “socially responsible” investors are seeking opportunities to invest in RMFIs that are transforming into licensed institutions. Although donors often wish to assist in this process, the important role of direct equity shareholders in assuring that their funds are well managed must be recognized, and donor funds may better be used to cover the costs of transformation than for equity per se.

114. Nevertheless, grants that help non-licensed RMFIs build up an equity base can be an appropriate part of donor programs, if they are designed to catalyze mobilization of commercial funds and to boost performance in terms of outreach and sustainability:

Grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks… to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale. (Committee of Donor Agencies 1995)

19. CGAP (2001b) identifies at least 25 such potential investors, which are nevertheless having difficulty finding suitable RMFIs interested in such funding.
4.4. **Investments in Social and Economic Infrastructure at Community and Client Levels**

**Improving the Ability to Demand and Utilize Rural Finance**

115. *Non-financial Interventions*. Financial institutions are only as strong as their clients. Besides strengthening RMFIs directly, their ability to reach the poor can be enhanced by improving the abilities of households to manage their economic and financial activities and of rural communities to work cooperatively, whether for group-based microfinance methodologies or to manage their own savings and credit associations (SCAs). Social funds, for example, can help improve the capacity of the rural poor to utilize credit and mobilize savings through grant-based “social intermediation” programs that build social capital and skills, for example through:

- **Social Mobilization**: Covering the costs of outreach and providing information to targeted groups and communities by RMFIs, including training in establishing and managing SACCOs and “village banks”; development of local organizations that can facilitate storage, marketing, and partnership with private firms (such as input suppliers, traders buying products).

- **Client Capabilities**: Grassroots management training, including household management and business and financial skills, that 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 often linked with literacy and health programs (Dell, undated; Heney 2000).

- **Business Development Services**: Providing incentives for adaptation of business support and development services to the needs and ability to pay of small rural enterprises, including marketing, communications, training, information, technology, accounting, and advice. For long-term availability of such services, emphasis should be placed on developing a sustainable market, for example through demand-side incentives such as vouchers and matching grants (Committee of Donor Agencies 2001).

116. An emerging strategy is to reorient microfinance components within social funds or other poverty-oriented projects toward training and preparing clientele for local savings mobilization and obtaining future loans, rather than disbursing funds to clients through institutions that may not have adequate knowledge of financial intermediation. First, this strategy builds on the experience of successful savings-led approaches, for example in West Africa, where existing indigenous savings and credit associations have been strengthened through networks that link them and provide capacity-building services. Second, it recognizes that a significant constraint on increased outreach to the poor by RMFIs is the high cost of educating them on what is involved in savings and credit services, training them in specific methodologies (such as group formation and management), ensuring adequate financial and business management skills, and intensive monitoring while they are establishing a track record as financial clients. These non-financial activities to build social capital and skills are termed “social intermediation” – as distinct from “financial intermediation,” which refers to the process of mobilizing funds (directly or indirectly) from savers and making them available to borrowers.

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20. As noted in Section IV.C.2, however, savings-led approaches require strong management and supervision and may be susceptible to diversion by pressures to disburse credit. Despite initial success of FECECAM (Fédération des caisses d’épargne et de crédit agricole mutuel) in Benin in increasing deposits by as much as 34 percent a year (Fruman 1997), excessive expansion based on external credit (rather than member-based savings) and inadequate capability to manage such growth subsequently resulted in financial distress for the network and some constituent members, requiring restructuring.
117. The FY98 Benin Social Fund (IDA) exemplifies the approach of linking the targeted groups to existing institutions that specialize in microfinancial services. It makes grant funds available for FECECAM and other RMFIs that wish to deepen their outreach (in particular, to poor women in rural villages). These funds can be used to engage NGOs or other community development and training institutions to provide education, training, and technical assistance to the targeted groups to prepare them to access the financial services offered by the RMFIs. The FY00 Ethiopian Women’s Development Initiative Project focuses on building the skills of very poor rural women through the World Bank Institute’s Grassroots Management Training program.

118. Nevertheless, it should be recognized that non-financial interventions can be costly and that clear evidence is lacking in how cost-effectively they can generate sustainable results in terms of increased ability to manage finance, higher productivity, access to financing, and business success. Such programs should be keyed to clearly defined targets, indicators, and time periods.

119. Supporting Community-based Savings and Credit Associations. In some cases, it may be appropriate for non-financial operations to support the establishment of community-based financial organizations, e.g., through grants for initial costs (training, basic furniture and equipment, bookkeeping materials, and operating costs for a limited time) of establishing SCAs, “village banks,” or equity-based “financial service associations” or credit unions. This approach is especially suitable in areas where regular RMFIs are absent, to help community associations effectively mobilize and lend their own savings, thereby building a basis for subsequent relations with RMFIs (Box 4.6). Nevertheless, such interventions should focus on situations where these organizations have reasonable prospects to become financially self-sufficient, move to a more formal status, or become clients of RMFIs, and they should include an exit strategy, so as to avoid creating local organizations that remain dependent on external funds. In such situations, effective community-based savings and credit associations and self-help groups can provide a basis for greater outreach of the financial system through measures to link them with more formal financial intermediaries (Kropp and others 1989; Seibel 1989).

Box 4.6 Supporting community-based savings and credit associations – CVECAs, Mali

Caisse villageoises d’épargne et de crédit autogérées (CVECAs) are village-based savings and credit organizations, prevalent in parts of West Africa. In the Dogon region of Mali, CVECAs have successfully shown that sustainable microfinance organizations can reach and serve remote rural communities, even where the agricultural production conditions are marginal. The project was launched in 1986, and by 2001 a network of 51 CVECAs were operating, grouped into 3 unions. The CVECAs complement local institutions that have evolved to counter and manage the risks in village economies. They operate with three main guiding principles: financial self-sustainability; self-management; and integration into the institutional environment of the village. Financial self-sustainability is pursued through a “savings-first” approach, though deposits are generally insufficient to meet credit demands, and these funds are supplemented through a refinancing mechanism in which the Banque Nationale de Développement Agricole (BNDA) lends to the CVECA unions, which on-lend and guarantee loans to CVECAs, dependent upon the CVECA meeting a set of standards. The size of these loans depends on the amount of savings mobilized by the CVECA.

The financial system is highly decentralized. The CVECAs are highly integrated into village institutions, with villagers having considerable ownership, village chiefs playing an important role in dispute settlement, and villagers electing a village management committee. A common facility provides training and financial auditing services and conducts feasibility studies for new CVECAs. The CVECAs are approved and regulated under a law drafted and enacted by the Central Bank of Western African States, which came into force in Mali in 1996.

Products include:

- Savings: A number of deposit products are available for members, with a range of terms, which meet villagers’ requirements for convenience, safety, and remuneration. In 2001 the CVECAs in Pays Dogon had a total of 9,416 depositors, with total deposits of CFAFr 872 million (US$1.2 million).
Box 4.6 Supporting community-based savings and credit associations – CVECAs, Mali

- Loans are granted mainly to individuals, with terms and conditions depending on a number of factors, including the value of collateral offered. Village farmers associations provide technical information on the situation of each farmer prior to the approval of loans (70 percent of loans are used for crop production) and play a vital role in the finance and marketing systems. The loan conditions fit the seasonal cycles of agricultural production and marketing. In 2001, there were 9,108 active borrowers, a total outstanding portfolio of CFAfr 1,365 million (US$1.9 million), and an average loan size of CFAfr 143,123 (US$195). The PAR greater than 90 days was only 2.8 percent in 2001.

A note of caution with such community-level financial service institutions is that the duration, cost, and intensity of second-tier monitoring and technical assistance to these institutions are often underestimated. The capacity and quality of management, governance, and systems are limited by the human and financial resources available within small rural communities, which can in some cases lead to problems of fraud and mismanagement if there is insufficient technical support and monitoring. In the case of the CVECAs, donor support was needed for more than ten years. Donors supporting a similar model in East Africa, Financial Service Associations, have found that emerging portfolio and governance problems have required a strengthened and longer-term focus on developing ongoing support and monitoring mechanisms than was initially envisaged.

Sources: Chao-Beroff, R. 1999; Nguyen, Ouattara, and Gonzalez-Vega 1999.

Alternative Interventions for Poverty Reduction

120. Where economic opportunities are lacking and financial flows sporadic, such as in very poor, remote communities, prospects are generally poor for the success of credit-based instruments and development of sustainable RMFIs. The appropriate response is likely to be through grant-based approaches that build economic opportunity and potential client debt capacity through investment in basic economic and social infrastructure that raises income-earning potential in the community. In some cases, as part of a program of targeted poverty reduction, grants may be in order to help individuals as well as communities acquire the assets needed to raise their long-term income potential. Nevertheless, support for “income-generating activities” can be a thorny area where it is essential that grant-based mechanisms are well designed to foster, rather than undermine sustainable financial institutions – a particular concern for programs intended to respond to the consequences of conflict or HIV/AIDS. Even in relief-oriented programs, there may be scope to design grant assistance in a way that promotes a transition toward sustainable RMF.

121. Investment in Rural Infrastructure Services. The importance of empowering communities to develop infrastructural and social services adapted to their needs is increasingly recognized through government measures to decentralize responsibility and through supportive programs such as community-based rural development and social investment funds, which are important instruments of World Bank assistance. Basic investment in water, transport, energy, education, and health is needed to lay a basic foundation for local economic and financial development by lowering the transaction costs and risks of both daily life and operating a business, making it easier to take advantage of available opportunities, and raising the productivity of labor. Since these economic and social infrastructure investments do not in themselves generate income but rather facilitate the carrying out of income-generating activities, they are appropriate for grant funding, with some contribution by the community (in cash and/or in kind). Some types of economic infrastructure can more directly raise income potential, e.g., small-scale irrigation, market facilities, a harbor or cold storage for fishing. In such cases, it may be appropriate to build in a mechanism to capitalize a local savings and credit association that can capture and recycle the increased income flow (discussed further in the next section).

122. Given the inadequacy of public funds to meet the infrastructure needs of rural populations, private investment has an important role to play in the provision of basic needs, especially in the areas of
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water supply and sanitation, energy, and low-cost housing (Varley 1995). Expensive public investments in water supply plants, waste-water treatment, and electricity grids can be replaced by on-site facilities, such as water storage tanks, pit latrines, septic tanks, and photovoltaic cells, which generate personal economic benefits for which the poor are both willing and able to pay, with appropriate financing. At the same time, financing is needed to enable households to undertake lumpy investments. While donors may be willing to provide funds for such programs, the success depends heavily on the existence of local financial and support institutions and their ability to design suitable loan products (including supplier credits) and manage the risks involved (Box 4.7). Otherwise, targeted credit programs in which the intermediary does not bear the risk are likely to foster poor repayment and fail to recycle the funds to sustain the program. Both RMFIs and suppliers of small-scale technologies should be encouraged to develop credit instruments suitable for low-income households (as well as wage earners) to undertake small infrastructure investments, in order to generate best practice lessons and provide an effective vehicle for external funds for infrastructure development.

123. Private enterprises are increasingly involved in the development and delivery of rural infrastructural services. One motivation is financial, to stretch scarce public funds by leveraging complementary private investment. However, weak rural financial systems make it difficult for local entrepreneurs to obtain financing. For major investments that generate a reasonable cash flow (energy, water, markets, warehouses), it may be possible to mobilize external private investment through a build-operate-transfer (BOT) mechanism, in which a private operator supplements public funds by supplying part of the financing in cash and borrowing part from local financial intermediaries. The private firm then operates the investment until the cash generated by sales covers its costs and generates an agreed profit, at which time the investment is transferred back to the public institution (e.g., municipality, district) that initiated the operation.

Box 4.7 Mvula Trust of South Africa

Mvula (Zulu for “rain”) is a national South African water and sanitation infrastructure development NGO based upon the principle that an enabling infrastructure environment is a necessary component of poverty relief at the household level. Government funds, however, are insufficient for infrastructure that provides better than basic water provision. In collaboration with the Financial Services Association (a village bank co-operative), Mvula makes financial services accessible to rural villagers. Villagers are encouraged to save for their own infrastructure – particularly yard water taps – in order to enhance the household’s potential productive capacities. The principle of water as an entry point for economic development underpins this philosophy, and microfinance is an essential tool in achieving this goal.


124. Even where the funding for rural infrastructure is entirely public or through donor-supported programs rather than private investment, opportunities for local private enterprise are expanding rapidly to gain contracts for construction, manufacturing and supply of materials, management, distribution, bill collection, maintenance, and other ancillary services. Decentralization of contracting to local authorities spread through rural areas means that the relevant "private sector" consists mainly of SMEs. Because local SMEs are typically constrained by low skills, poor management capabilities, and lack of access to financing and support services, improving access of the poor to infrastructural and social services, therefore, requires explicit complementary measures to build up the access of SMEs to financial and business development services.

21. BOT techniques are now used extensively in developing countries that do not want to privatize public investments but agree that the private sector should undertake and manage such investments temporarily (e.g., China, Malaysia, Philippines, Turkey, Viet Nam). While most BOTs have been used to finance large urban investments, local BOTs are increasingly being used to finance local infrastructural investments, with public money covering the portions not directly linked to cash-generation (e.g., electrical lines for small power plants or clearing of the land on which a building will be constructed).
125. The implication is that, while investment in rural infrastructure is needed to lay the conditions for expanding rural finance, it also generates demand for – and indeed depends on – improved access of SMEs to financing and BDS. However, this is not an area in which there are simple, quick fixes: the aim should be to help local markets develop by improving information, products, and services and facilitating institutions. This will require consultations with private and financial sector staff at an early stage of project development, as well as a process of studies and consultations with stakeholders at the national level to develop solutions that are workable in the context of each country.

126. *Investment in Productive Assets and Income-Generating Activities.* CBIRD programs and social funds are under increasing pressures to fund productive assets and “income-generating activities.” While grant programs for community social and economic infrastructure generally do not raise problems for financial development, grants for assets and start-up capital raise the question of possible conflict with private and financial sector development objectives and require careful assessment and monitoring to ensure they are indeed a least-cost method of alleviating poverty. Commercially-oriented financing of an investment in which both the entrepreneur and the financier bear risk is preferable in that it creates incentives for careful review of the prospective returns, ensuring that scarce capital funds go to the most productive uses. In contrast, grant financing tends to focus on the eligibility characteristics of the promoter and entails a higher risk of investment in activities whose revenues do not cover the costs involved. Nevertheless, *ex ante* grants may be preferable to poorly designed credit programs that result in *ex post* grants and a culture of non-repayment, and a partial grant for purchase of an asset that leverages the recipient’s savings is preferable to subsidizing the interest rate (and can accomplish the same objective of lowering debt service payments to an affordable level).

127. Support for income-generating activities is most likely to be justifiable as a cost-effective intervention to reduce poverty in poor communities that have already raised their economic potential through basic economic and social infrastructure investments and capacity building and that have no RMFIs present. In such cases, the following guidelines will help ensure that grants for income-generating investment will help lay a foundation for, rather than undermine the development of, good practice microfinance at the community level:

- Grant assistance should be **targeted** to very poor communities or groups that are beyond the current reach of micro (or other) finance institutions.
- The investments should **not compete directly with private investment** (existing or likely).
- The beneficiaries should **contribute at least partly in cash**, which can serve toward the initial working capital to operate the activity.
- Grants should be **combined with training** and support to establish local savings and credit associations (SCAs) to capture and recycle increased income flows.

128. Grants for community-owned assets (such as a grain mill) are most likely to have public goods aspects that would warrant subsidization. One approach to bridge between a grant-based approach and loan financing is to impose a cost recovery obligation that commits the group to capturing income from the project through its SCA and then granting the proceeds as capitalization for the SCA to use for future individual lending, thereby recirculating the income flows within the community.

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22. Grants for individual assets are particularly contentious in terms of market distortions and equity considerations, and many governments are reluctant to use public funds to subsidize individual assets.
129. When governments wish to target particular groups for subsidized credit for income-generating assets (e.g., small farmers who lack both the equity and the income potential to obtain credit on commercial terms), it is preferable to use a combination of grant and loan. A matching grant that multiplies the beneficiaries’ equity contributions provides positive incentives for savings and reduces the proportion of the investment to be financed through a loan, thus improving both the probability and the affordability of commercial credit. The Ghana Village Infrastructure Project is introducing such a grant scheme to enable poor farmers meeting income eligibility criteria to leverage their savings and access a line of credit being made available through Rural Banks. It is essential for such programs to administer the grant component separately from the credit, which must be on the normal terms and at the discretion of the RMFI in order to avoid the repercussions of a sense of entitlement.

130. **Income Transfer and Microfinance.** Because credit generates a debt burden, it is unsuitable as a safety net instrument for the destitute, unemployed, or people affected by conflict or natural disaster. For the purpose of safety nets and income transfer, grants – which can be in the form of food-for-work as well as cash – are the appropriate instrument (Box 4.8). Displaced persons during or immediately following a conflict or those affected by natural disasters such as earthquakes and floods may be suitable candidates for one-off, targeted compensatory “safety net” grants that enable them to rebuild their livelihoods and replace lost assets. Micro-grants for the hardcore poor or for people affected by HIV/AIDS may constitute a longer-term safety net. These people are unlikely to be in a position to use a loan productively: loans might be used to meet basic consumption or health needs rather than to invest in income-earning activities. Indeed, use of debt-based instruments such as microcredit may further erode their economic position.

**Box 4.8 Grants as a response to rural indebtedness in Afghanistan**

Extended conflict and drought, combined with efforts to clamp down on opium production, have led to severe rural indebtedness in Afghanistan. Over 90% of households in poppy-growing areas were not able to fully repay their outstanding debt in 2000, according to one survey, and if anything the situation appears to have worsened since then. Prior to the 2002 planting season therefore, donors faced disbursement pressure due to an urgent need of rural households for liquidity. One response commonly suggested is microcredit, yet piling new debt onto existing critical levels does not seem to be an immediate answer, and sustainable rural financial service provider structures are largely absent.

One-off grants offer a more appropriate response, as ‘compensation’ to individuals affected by poppy-eradication, conflict and drought. Grants should not be seen as the soft option, though. Grants can be designed and disbursed as selectively and efficiently (or more so) as good practice microlending. Existing NGO networks can be utilized to disburse grants in many areas. At least one donor is linking grants to community works programs in order to also address critical infrastructure constraints. The World Bank is experimenting in Ghana and Nigeria with matching grants to poor farmers to enable them to acquire productivity-raising assets by leveraging their equity contribution to improve their ability to obtain commercial loans for the balance. Easing of individual indebtedness and injection of liquidity will hopefully lead to a more effective demand for financial services and therefore the potential for rural financial sector development.

Source: CGAP.

131. As a means of rationing safety net and income transfer grants and selecting appropriate recipients, the concept of ‘compensation’ can be helpful – for example, for taking care of HIV/AIDS orphans, for suffering caused by a conflict or natural disaster, or for retrenched workers. Micro-grants not only provide a safety net, they can be the first step in a strategy to graduate the poor from vulnerability towards economic self-sufficiency. Grant-based schemes may provide a starting point to bring people to the level where they can make plans and consider investments (Parker and Pearce, 2001).
The Bangladesh Rural Advancement Committee’s (BRAC) Income Generation for Vulnerable Groups Development (IGVGD) Program is an instructive example of how grant-based approaches and financial services can be complementary (Box 4.9). The IGVGD Program is targeted towards destitute rural Bangladeshi women and helps participants move from absolute poverty to economic independence. Over 10 years, nearly a million participants have made that transition.

Box 4.9 From relief to microfinance: BRAC’s IGVGD

IGVGD begins with an 18-month commitment of free food (with the support of the World Food Program and the government) to people at greatest immediate risk. The program engages participants in skills-training programs in income-generating activities such as poultry rearing and silk. The IGVGD program also provides the hardcore poor participants with access to BRAC’s Essential Health Care services, which addresses the link between productivity and health. During this period, BRAC helps participants learn to save, building up an economic “nest egg” for future investment and protection. Most participants then progress to individual income-earning activities within the same sectors. Within two years of starting the process, roughly 80 percent had made the transition—with their small income-earning activities and accumulated savings—into BRAC’s mainstream microfinance program as borrowers. This progression of support services—from grants to training to savings to self-employment—appears to be sufficient to break down the barriers of extreme poverty, social isolation, lack of productive skills, and poor self-confidence that previously kept this population from self-employment.

BRAC’s large scope and scale of operations in relief, RMF, advocacy, and other areas sets it apart from most graduation efforts that might have to be implemented through inter-institutional or inter-program partnerships, with each partner focusing on their respective areas of comparative advantage. The IGVGD Program example makes it clear that successful graduation takes time and so may not be appropriate for shorter-term projects to be partners in graduation initiatives.


4.5. Incorporating a Consultative Approach

Internal Coordination

Ensuring that the Bank takes an internally consistent, systematic approach to RMF requires, first, better monitoring of the portfolio and, second, incorporation into country strategies and sector work as an integral part of financial sector development. Because RMF in Bank operations is most often a component of a larger project, which may be in any of a wide range of sectors, a question is needed at an early stage such as the Project Concept Document to identify projects that intend to provide credit through RMFIs or to strengthen their capacity to lend or mobilize other funds. Financial sector staff should be consulted (as required by B.P. 8.30) to assess the underlying financial market conditions and the applicability of the Bank’s policy (O.P. 8.30) on financial intermediary lending in order to evaluate whether such a component is appropriate without broader financial market development. Non-financial sector operations with a significant RMF component should include adequate financial sector expertise in the review process and design team.

23. Projects that involve financial intermediation should then have to answer a short set of related questions to ensure compliance with O.P. 8.30 and to signal the indicators that should be collected at appraisal and during supervision. The Project Status Report format should also be modified for operations involving credit lines to include basic financial data such as nominal and real interest rate spreads, portfolio at risk, loan loss provisioning (and its adequacy), and SDI, to facilitate both early detection of problems with project intermediaries and assessment of performance of projects in the Bank’s RMF portfolio—which is currently impossible, as supervision reports rarely report relevant data.
134. Enhanced internal linkages are needed to ensure that micro and small-scale enterprise lending and non-lending assistance is client driven, based on a comprehensive strategy for the country as a whole, and consistent with best practices. Addressing these challenges requires difficult cross-sectoral communication and collaboration. The strengthening of Country Teams has provided a forum for a more consistent approach to RMF across different sectors, although there are few trained microfinance specialists in most subsectors and Regions. More systematic discussion is needed (especially in terms of the approach taken in Poverty Reduction Strategy Papers and Country Assistance Strategies, as well as at early stages of project preparation) of the thorny issue of potential conflicting approaches to microfinance as part of sustainable financial sector development and as an instrument of poverty reduction or credit for particular real sector objectives.

135. The Financial Sector Operations and Policy Department and the Rural Private Sector, Markets, Finance, and Infrastructure Thematic Group, together with CGAP, play an important role in developing the Bank’s strategy for RMF, disseminating best practices, developing new approaches to achieve operational objectives, and monitoring performance. Recent innovative approaches include: quality enhancement reviews; holding clinics for social fund project teams with microfinance specialists early in the design phase to brainstorm on alternative good-practice approaches to meeting objectives; and combination of the grant-based approach of social funds with the establishment of community-managed savings and credit associations (as discussed in section IV.D.2).

136. To increase development impact and effectiveness and better leverage respective strengths, the Bank and the International Finance Corporation (IFC) have established several joint departments, including the Small and Medium Enterprise (SME) Department. This represents an effort to better coordinate World Bank Group responses to the challenges of RMF and SME development both by addressing the need for government policy and legal reforms and by developing an array of financing instruments. Urban and rural SMEs and microentrepreneurs can be reached by IFC’s financial sector investments in or through local intermediaries, including RMFIs and leasing companies, with the objective of establishing commercially-oriented RMFIs that are financially self-sustaining and can grow to reach far more poor clients than previous models that rely heavily on donor financing (e.g., in Bosnia, Cambodia, Ghana, and Kosovo).

External Coordination

137. Consultative Group to Assist the Poorest (CGAP). RMF operations have benefited from the Bank’s efforts to coordinate with other development agencies, in particular by initiating and housing CGAP, the secretariat for a consortium of 29 donor agencies that was established to disseminate and develop the tools for implementing best practices in microfinance. Since 1995, CGAP has played an important role in helping to bring Bank staff to the frontier of microfinance by making information

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24. During FY97-00, a series of training seminars was held for Bank Group staff interested in learning microfinance best practice, methodologies, and operational issues, sponsored by the Consultative Group to Assist the Poorest (CGAP), the Rural and Microfinance and Small Enterprise (RMF/SE) Thematic Group, the Financial Sector Development Department, the Private Sector Department, and the World Bank Institute. With nearly 200 people trained in seven sessions, these seminars rapidly built up a core of knowledge and experience among Bank Group staff, supplemented by more intensive training of a few staff at the CGAP Microfinance Training program in Boulder, Colorado. In FY99 and FY00 the training program was tailored to the particular issues facing Eastern and Central Europe (ECA) and Africa (AFR) Region staff and counterparts, and Bank Resident Mission staff were included in the training. Nevertheless, budget cuts for Thematic Groups have limited the amount of training that can be offered, and the number of specialists working primarily in micro and rural finance has begun to decline. Efforts are expected during FY03 to strengthen expertise in RMF within both the financial sector network (in the Anchor unit, in collaboration with CGAP) and the rural development network (through training of key staff at the Boulder Microfinance Training program).
available, advising on the design of operations, emphasizing capacity-building, and linking with other donors and international experience. A significant contribution has been provided through the technical tools developed by CGAP on appraising microfinance institutions, use of performance-based benchmarks, management information systems, audit guidelines, and other business tools. These have been made widely available through Focus Notes and a web site, which provides a gateway to a searchable library of microfinance articles and publications, as well as through the staff training seminars mentioned above. One result has been increasing application to the design of lending operations of CGAP-style performance standards and the principle of setting interest rates to enable both sustainability and increased outreach. For example, application of CGAP methodology to analyze Ethiopia’s RMFIs as part of a Rural Finance Review in 2000 helped to open dialogue on appropriate interest rates and the need for capacity building.

138. CGAP’s review of the World Bank’s Microfinance Portfolio in 1997 was the first attempt to document the full Bank-wide portfolio of operations with microfinance components (which cannot be extracted from project databases), and it helped lead to the on-line Portfolio Database developed by the RMF/SE Thematic Group and now being taken over by the Rural Development Department. It highlighted the basic problem that too many operations were designed under the old paradigm of welfare-oriented credits and continued “to work on a small scale with government ministries and development banks to support targeted lines of subsidized credit.” Many of the training and non-lending activities and the operational innovations described above respond to the strategic and operational recommendations made in this review.

139. Other Development Agencies. The Bank also plays a key role in chairing two donor committees, the Donors’ Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development, which together issued “Guiding Principles for Selecting and Supporting Intermediaries” in 1995 as a common framework for the design of operational support. Following a conference on “The Challenge of SME Financing” in Vienna in October 2000, these donor networks have established a working group to continue developing a consensus on best practices in SME finance. The Committee has also held a series of conferences on BDS, resulting in another set of Guiding Principles in 2001.

140. The Bank participates in meetings of the Partnership for Improved Capacity Building in Rural Finance (CABFIN), formed in 2002 by CARE International, DFID, FAO, GTZ, IFAD and NRI to improve the flow of knowledge and lessons of experience regarding the supply of and demand for capacity building products and processes in rural finance. It also works closely with other international financial institutions, particularly IFAD, FAO, ADB, AsDB and IADB, in sharing strategic approaches as well as in cofinancing operations at the country level.

141. Country Level. The incorporation of as many in-country stakeholders as is feasible in the design of a RMF project is crucial for its successful implementation. The issues and strategic options to address constraints to RMF development should be identified from the outset with a broad range of partners, including the Government (Ministry of Finance, Central Bank, Ministry of Agriculture and other relevant Ministries, as appropriate); RMFI industry and farmer associations; senior managers from major state or donor-sponsored RMFIs; other development organizations with related programs (agricultural, financial, poverty alleviation, rural development); distinguished academics from universities with well-respected Agricultural Economics departments, if any; senior managers of prominent NGOs and other private sector organizations offering microfinance services (commercial banks, insurance companies, large corporate community development programs, etc.); and community leaders, as may be appropriate. Ideally, these stakeholders would have built consensus through development of a national microfinance strategy (which may also be an appropriate initial step toward project preparation). Prior to or as part of any ESW, the above-mentioned internal and in-country partners should be involved or at least made aware of the scope of work, any proposed conferences or trainings, and possible projects. When possible, first-stage
missions should be undertaken jointly to maximize cross-fertilization and coordination of evolving work programs.

142. During the design stage, an assessment should be made of the capacity of the intermediaries that will participate in project execution. Funds should be allocated for technical assistance for institutional development, as necessary, rather than focusing solely on funds for on-lending. When RMFI channels are not in place prior to the Bank loan, the component should be designed first as a pilot and only expanded as experience is gained and relevant lessons drawn from implementation experience. Participation of the RMFIs and the ultimate beneficiaries in project design and during implementation is crucial to the successful outcome of the component. Even if the condition of institutional capacity is not fully met, there can be the option to proceed with an RMF project if the Bank and the government agree on an institutional development plan with a set of time-bound quantifiable indicators as a prerequisite to launching the project and as criteria to be met before the next tranche of project funds is disbursed.

143. An RMF project ought to be well justified with clear, well-defined, and realistic objectives that go beyond the transfer of resources and emphasize establishing a sound enabling environment for and building the capacity of efficient rural financial institutions. Projects may be justified on the grounds of enhancing the supply response of the agricultural sector, promoting institution-building in intermediaries that serve the sector, introducing or strengthening sector-wide reforms, and catalyzing the broadening of financial services accessible to the rural population.

4.6. Critical Issues and Appropriate Responses

144. The wide range of rural finance issues discussed in this paper can be grouped into three critical areas that confront task managers in a variety of sectors in trying to respond to the demands of developing countries for assistance in rural development:

- Achieving real sector objectives in agriculture and rural infrastructure;
- Commercializing microfinance in rural areas; and
- Addressing problems of resource transfer to the very poor, post-conflict situations, and HIV/AIDS.

145. These are difficult issues on the frontiers of rural finance, where there are no simple solutions and often relatively little relevant experience to draw on. This paper is intended to chart a course that will be illuminated through subsequent more detailed operational notes and guidelines on particular issues, drawing on lessons of experience. Key constraints in these areas and promising approaches to addressing them are summarized below, by way of guidance toward the way forward.

Real Sector Objectives – Agriculture and Rural Infrastructure

Key Constraints

- Low returns in agriculture, lack of collateral;
- Lack of risk management mechanisms;
- Absence of effective intermediaries and instruments;
- Lack of entrepreneurs, service providers;
- Lack of term finance.
Appropriate Responses

- Develop and support a wider range of rural financial products:
  - Microfinance;
  - Weather- and price-based insurance;
  - Supply chain finance (warehouse receipts, traders, processors)
  - Savings and credit cooperatives.

- Pilot innovative products (“smart subsidies”; term and equity finance);
- Secure marketable land rights (collateral);
- Partial guarantees to leverage liquidity in banks;
- Complementary investment in infrastructure, skills;
- Market-based development of business development services to support rural enterprises.

Commercializing Micro Finance in Rural Areas

Key Constraints

- High costs of reaching remote areas, the very poor, and other vulnerable target groups;
- Unadapted skills and requirements of commercial banks (which control the bulk of available funds);
- Low capacity and self-sustainability of RMFIs (which must be profitable in order to become licensed).

Appropriate Responses

- Develop local savings and credit associations or cooperatives;
- Work on fundamentals (policy, legal, regulatory);
- Emphasize capacity-building of RMFIs before expanding loan funds;
- Link RMFIs to local commercial sources of financing.

Resource Transfer to the Extreme Poor and for Post-Conflict and HIV/AIDS

Key Constraints

- Economic opportunities under these conditions are often extremely limited;
- Microfinance techniques work best with the “entrepreneurial poor” with good opportunities;
- Credit for resource transfer objectives imposes a heavy debt burden on recipients and undermines sustainable RMF.
**Appropriate Responses**

- Use grant-based interventions when credit (debt) is inappropriate (e.g., infrastructure; basic management and financial training);

- Matching grants to complement savings if need be to raise equity contributions of target groups;

- Facilitate savings-based approaches (informal, savings and credit associations).
Appendix   Minimum Performance Indicators for Rural and Micro Finance

Experience has shown that funding agencies’ microfinance interventions produce better results when design, reporting, and monitoring focus explicitly on key measures of performance. Unfortunately, many projects fail to include such measurement. This Annex offers basic tools in four core areas to measure performance of rural and micro finance institutions (MFIs), whose objectives may include serving the poor, and explains the calculation and interpretation of the minimum indicators suggested for each:

Outreach — how many clients are being served?
• Number of active clients or accounts.

Client poverty level— how poor are the clients?
• Average outstanding balance per client or account

Collection performance — how well is the MFI collecting its loans?
• Portfolio at Risk (PAR) or Loans at Risk (LAR) or
• Current Recovery Rate (CRR) together with Annual Loan-loss Rate (ALR).

Financial sustainability — is the MFI profitable enough to maintain and expand its services without continued injections of subsidies or donor funds?
• For commercial institutions:
  • Return on Assets (ROA) or
  • Return on Equity (ROE).
• For subsidized institutions:
  • --Financial Self-Sufficiency (FSS) or
  • --Adjusted Return on Assets (AROA) or
  • --Subsidy Dependence Index (SDI).

The indicators suggested here do not capture all relevant aspects of MFI performance. Some funders, and certainly all MFI managers, will want to monitor a longer list of indicators. And there are important dimensions, such as governance quality, that simply cannot be quantified. The four performance areas discussed here represent a minimum that should be:

- included in all appraisals of existing institutions;
- treated in all project designs; and
- reported and monitored during implementation.

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25 Applicable if poverty reduction is an explicit objective of the institution.
This list has been kept short, and the treatment of indicators basic, in order to make this Annex useful to a non-specialist audience. At the end of the Annex are references – all of them available on the internet – for readers who want more detail.

### A1.1 Outreach

**Indicator**: The best measurement of outreach is straightforward:

The number of clients or accounts that are active at a given point in time

This indicator is more useful than the cumulative number of loans made or clients served during a period. Among other distortions, cumulative numbers makes an MFI offering short-term loans look better than one providing longer-term loans. The recommended measure counts active clients rather than “members” in order to reflect actual service delivery: members may be inactive for long periods of time, especially in financial cooperatives.

**Interpretation**: Expanding the number of clients being served is an ultimate goal of almost all microfinance interventions. But rapid expansion sometimes proves to be unsustainable, especially during an MFI’s early years when it needs to design its products and build its systems. It has very seldom been useful for funders to pressure MFIs for rapid expansion.

### A1.2 Client Poverty Level

**Indicator**: Many, though not all, microfinance projects are expected to reach poor clients. There are various techniques for measuring client poverty levels, some quite expensive and others simpler, but as yet there is no widespread agreement on any one of them. If the project does not use a more sophisticated indicator, it should at a minimum report the following rough proxy for the poverty level of loan or savings services at a point in time:

\[
\text{Average Outstanding Balance} = \frac{\text{Gross amount of loans or savings outstanding}}{\text{Number of clients or accounts}}
\]

This point-of-time number should not be confused with total amounts loaned or deposited during the reporting period, or with the average initial amount of loans in the portfolio. The Average Outstanding Balance includes only loan amounts that clients have not yet repaid, or savings that the clients have not withdrawn. For comparison purposes, it is useful to express this indicator as a percentage of the host country’s per capita GDP. An average outstanding loan balance below 20% of per capita GDP or US$150 is regarded by some as a rough indication that clients are very poor.

**Interpretation**: Average Outstanding Balance is related to client poverty, because better-off clients tend to be uninterested in smaller loans. But the correlation between loan balances and poverty is far from precise. Low loan sizes do not guarantee a poor clientele. Likewise, growth in average loan size does not necessarily mean that a MFI is suffering “mission drift.” As an MFI matures and growth slows, a lower percentage of its clients are first-time borrowers, and average loan sizes will rise even if there has been no shift in the market it is serving.
Funders who want to reach very poor clients should usually look for MFIs that are already committed to a low-end clientele, rather than trying to encourage higher-end MFIs to change their market. Most MFIs that focus on the very poor use formal tools to screen potential clients by income level.

### A1.3 Collection performance

Reporting of loan collection is a minefield. Some indicators camouflage rather than clarify the true situation. Moreover, terminology and calculation methods are not always consistent. Therefore, whenever any measure of loan repayment, delinquency, default, or loss is reported, the numerator and denominator of the ratio should be explained precisely.

MFIs’ self-reported collection performance often understates the extent of problems, usually because of information system weaknesses rather than intent to deceive. Collection reporting should be regarded as reliable only if it is verified by a competent independent party.

**Indicators:** The standard international measure of portfolio quality in banking is *Portfolio at Risk (PAR)* beyond a specified number of days:

\[
\text{PAR (x days)} = \frac{\text{Outstanding principal balance of all loans past due more than x days}}{\text{Outstanding principal balance of all loans}}
\]

The number of days (x) used for this measurement varies. In microfinance, 30 days is a common breakpoint. If the repayment schedule is other than monthly, then one repayment period (week, fortnight, quarter) could be used as an alternative.

Many MFIs don’t yet have loan tracking systems strong enough to produce a PAR figure. Most of them should be able to calculate *Loans at Risk (LAR)*, a simpler indicator that counts the number of loans instead of their amounts. As long as repayment is roughly the same for large loans and small loans, LAR will not differ much from PAR.

\[
\text{LAR(x days)} = \frac{\text{number of loans more than x days late}}{\text{total number of outstanding loans}}
\]

An alternative measure, the *Current Recovery Rate (CRR)*, can be computed by most MFIs, and gives a good picture of repayment performance—but only if it is interpreted very carefully.

\[
\text{CRR} = \frac{\text{cash collected during the period from borrowers}}{\text{cash falling due for the first time during the period under the terms of the original loan contract}}
\]

This ratio can be calculated using principal payments only, or principal plus interest.

CRR and variants of it are often misunderstood. It is tempting, but badly mistaken, to think of the CRR as a complement of an annual loan loss rate. For instance, if the MFI reports a 95% collection rate, one might assume that its annual loan losses are 5% of its portfolio. In fact, if an MFI making 3-month loans
with weekly payments has a 95% collection rate, it will lose well over a third of its portfolio every year. Thus, the CRR indicator should never be used without translating it into an Annual Loan-loss Rate (ALR). Here is a simplified formula:

\[
ALR = \frac{1 - CRR}{T} \times 2
\]

where \( T \) is average loan term expressed in years.

Variations in late payments and prepayments cause the Current Recovery Rate to jump around over short periods, often registering above 100%. Thus, it must be applied to a period long enough to smooth out random or seasonal variations—typically a year.

**Interpretation:** Repayment of an MFI’s loans is a crucial indicator of performance. Poor collection of microloans is almost always traceable to management and systems weaknesses.

The strongest repayment incentive for uncollateralized microloans is not peer pressure, but rather the client’s desire to preserve her future access to a loan service she finds very useful to her and her family: thus, healthy repayment rates are a strong signal that the loans are of real value to the clients. Finally, high delinquency makes financial sustainability impossible. As a rough rule of thumb, Portfolio or Loans at Risk (30 days) above 10%, or Annual Loan-Loss Rates above 5%, must be reduced quickly or they will spin out of control.

### A1.4 Financial Sustainability (Profitability)

**Indicators:** In banks and other commercial institutions, the most common measures of profitability are Return on Equity (ROE), which measures the returns produced for the owners, and Return on Assets (ROA), which reflects that organization’s ability to use its assets productively.

\[
ROE = \frac{\text{After-tax profits}}{\text{Starting (or period-average) equity}}
\]

\[
ROA = \frac{\text{After-tax profits}}{\text{Starting (or period-average) assets}}
\]

These are appropriate indicators for unsubsidized institutions. But World Bank interventions more typically deal with institutions that receive substantial subsidies, most often in the form of grants. In such cases, the critical question is whether the institution will be able to maintain itself and grow when continuing subsidies are no longer available. To determine this, normal financial information must be “adjusted” to reflect the impact of the present subsidies. Three subsidy-adjusted indicators are in common use: Financial Self-sufficiency (FSS), Adjusted Return on Assets (AROA), and the Subsidy Dependence

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26 See the CGAP paper on delinquency measurement cited at the end of this Annex for an explanation of this surprising result, and for calculation refinements.
Index (SDI). These measures are more complex than the indicators discussed previously, and there are slight variations in the ways of calculating each of them, so use of the references cited at the end of this Annex is especially encouraged.

FSS and AROA use similar adjustments. An Inflation Adjustment (IA) reflects the loss of real value of an MFI’s net monetary assets due to inflation:

\[
IA = \frac{(\text{Assets that are denominated in currency amounts} - \text{Liabilities that are denominated in currency amounts})}{\text{times The inflation rate for the period.}}
\]

This adjustment is usually based on net asset values at the beginning of the period, but using period averages may be appropriate for MFIs that receive large grants, or other infusions of equity capital during the period.

A subsidized-Cost-of-Funds Adjustment (CFA) calculates the effect of soft loans to the MFI:

\[
CFA = \frac{\text{Period-average borrowings by the MFI}}{\text{times “Market” interest rate}} \times \left( \text{minus Actual amount of interest paid by the MFI during the period} \right)
\]

A common benchmark for a market interest rate is the rate that commercial banks pay on 90-day fixed deposits. Arguably a more appropriate rate is a few points above the “prime” rate that banks charge on loans to their best customers, because few MFIs could actually borrow at a lower rate.\(^{28}\)

The In-kind Subsidy Adjustment (ISA) quantifies the benefit an MFI gets when it receives goods or services without paying a market price for them (computers or free services of a manager are common examples).

\[
ISA = \frac{\text{Market price an unsubsidized MFI would pay for a good or service}}{\text{minus Actual price paid by the MFI}}
\]

Financial Self-Sufficiency (FSS) is a subsidy-adjusted indicator often used by donor-funded microfinance NGOs. It measures the extent to which an MFI’s business revenue—mainly interest received—covers the MFI’s adjusted costs. If the FSS is below 100%, then the MFI has not yet achieved financial break-even.

\[
FSS = \frac{\text{Business revenue (excluding grants)}}{\text{Total expenses + IA + CFA + ISA}}
\]

\(^{27}\) For instance cash, investments, or loans; but not buildings or equipment

\(^{28}\) A more sophisticated benchmark would be based on the probable cost (including interest, administrative expense, and reserve requirements) of the specific form(s) of commercial funding the MFIs is likely to be raising when it moves beyond soft funding sources.
Adjusted Return on Assets measures an MFI’s net profit or loss (including adjustments) in relation to the MFI’s total assets.

\[
AROA = \frac{\text{Accounting profit/loss (excluding grants) – IA – CFA – ISA}}{\text{Period-average total assets}}
\]

The Subsidy Dependence Index (SDI) measures how much an MFI would have to increase its lending interest rate in order to cover all of its costs including adjustments. An SDI above zero means that the MFI still needs subsidy to operate—i.e., it has not achieved financial sustainability. A two-stage calculation produces first the amount of annual subsidy and then the index.

\[
S = A (m - c) + [(E \cdot m) - P] + K
\]

where:
- \(S\) = Annual subsidy received by the MFI;
- \(A\) = MFI concessional borrowed funds outstanding (annual average);
- \(m\) = Interest rate the RFI would be assumed to pay for borrowed funds if access to borrowed concessional funds were eliminated;
- \(c\) = Weighted average annual concessional rate of interest actually paid by the RFI on its average annual concessional borrowed funds outstanding;
- \(E\) = Average annual equity;
- \(P\) = Reported annual before-tax profit (adjusted, when necessary, for loan loss provisions, inflation, and so on);
- \(K\) = The sum of all other annual subsidies received by the RFI (such as partial or complete coverage of the RFI’s operational costs by the state).

\[
SDI = \frac{S}{LP \cdot i}
\]

where:
- \(SDI\) = Index of subsidy dependence of MFI;
- \(S\) = Annual subsidy received by the MFI (see above);
- \(LP\) = Average annual outstanding loan portfolio of the MFI;
- \(i\) = Weighted average interest yield earned on the MFI’s loan portfolio.

**Interpretation:** According to OP 8.30, the World Bank “supports programs involving subsidies only if they are (a) transparent, targeted and capped; (b) are funded explicitly through the government budget or other sources subject to effective control and regular review; (c) are fiscally sustainable; (d) do not give unfair advantage to some FIs vis-à-vis other qualified and directly competing institutions; and (e) are economically justified, or can be shown to be the least-cost way of achieving poverty reduction objectives.” Measurement of financial intermediaries’ financial sustainability is crucial to understanding whether or not a project receiving subsidies is meeting these criteria.

It takes some sophistication to judge whether an MFI’s sustainability is improving fast enough. The fact that an MFI’s sustainability indicator improves over a period of years does not necessarily mean that the MFI will reach financial sustainability. Sustainability indicators for MFIs will improve almost

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29 The SDI is framed in terms of increases in an MFI’s interest rate on loans, but this is not meant to suggest that raising interest rates is the only path to sustainability. Cutting costs is at least as important.
automatically in the early years; but the majority of MFIs never become fully sustainable, and thus can never expand beyond the limits of scarce subsidized funding. Most MFIs that have become profitable have taken 3-5 years to get there. Some MFIs working in areas of very low population density have taken up to 10 years. One important factor is the pace of growth: rapid growth will temporarily depress an MFI’s profitability because such growth requires new investments in staff and facilities that take a period of time to become fully productive.

### A1.5 Useful References

**General:**


**Client Poverty:**


**Collection Performance:**


**Sustainability:**


**Notes:**

- The three references listed above under “General” all have sections on sustainability/profitability.
- All CGAP publications can be accessed through [www.microfinancegateway.org](http://www.microfinancegateway.org).
- SEEP publications can be accessed through [www.seepnetwork.org](http://www.seepnetwork.org).
References


Otero, Maria, and Elisabeth Rhyne, eds. 1994. The New World of Microenterprise Finance, Hartford, CT: KumarianPress.


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