

DRAFT

International Policy Fellowship 2004

Topic Area: Scaling Up Microfinance to Increase Access to Financial Services

Hamid Rustamov

BETTER PRACTICES FOR SCALING-UP RURAL MICROFINANCE IN TAJIKISTAN

Final Policy Paper

August 2005

This research has examined the challenges that rural lenders face in designing and operating demand-oriented lending services. These systems should be widely accessible to small farm households and durable. Based on the preliminary guiding principles for rural lending a summary is presented of the main lending strategies. These methods are used to reduce the high costs and risks of lending to small farmers and rural entrepreneurs.

1. COST REDUCTION AND RISK MANAGEMENT STRATEGIES

Cost Reduction

To secure a satisfactory out-reach and sustainability, rural agricultural lending institutions should be actively engaged in adopting cost-effective credit delivery strategies. Further they should develop appropriate loan products and lending technologies. Most of the cost-reduction strategies, outlined below involve heavy initial overhead costs. This means that they do not pay off immediately. In fact, a careful assessment should be made of their long-term cost effectiveness.

Strategies to reduce rural lending costs

- Use a decentralized operational structure and employ mobile loan officers and/or mobile branch offices;
- Delegate loan authority to field staff;
- Recruit staff with a solid background in agronomy, farm management and rural economics;
- Provide adequate staff training and use performance-based staff incentives;
- Simplify lending procedures;
- Screen potential clients and appraise loans by collaborating with local organizations and networks (agricultural extension staff, NGO and communities);
- Install an integrated banking software to produce accurate and timely accounts and constitute an effective management information system;
- Diversify the loan portfolio in order to balance uneven staff work load due to agricultural seasonality.

Selected annotations

- Rural and agricultural lending institutions require an adequate operational structure to meet their client demand. This includes well-trained and motivated staff and appropriate loan products. The effective operation of a decentralized rural branch network depends on the delegation of loan authority to field staff, the existence of proper checks and balances plus the use of an adequate management information system. Performance-based staff incentives enhance the motivation and the productivity of loan officers. Collection of essential market information facilitates the identification of potential clients.
- Classification of farmers by farming systems, description of on farm production inputs and major agricultural commodities helps to define their effective demand for loan products. The high costs of collecting specific information on the creditworthiness and the loan repayment capacity of prospective clients can be reduced significantly by collaborating with local organizations. It is important to set the lending interest rates at market terms to cover the full agricultural lending transaction costs.
- The adoption of integrated banking software for the computerization of an accounting and management information system is highly recommended. Accurate and timely information is indispensable for decision making in a financial institution. With appropriate banking software systems, a comprehensive and consolidated data base may be built from the files of branches. It contains fully integrated information on customers, different types of accounts and a general ledger. Such banking software is able to produce required financial accounts for separate branches as well as a consolidated account for the entire financial institution. Based on the integrated database it is possible to generate a variety of user-defined reports.

Risk Management

Active management on the part of the farmer-borrower and rural entrepreneur-borrower as well as the financial institution is required to reduce the high risks associated with rural agricultural lending. Different factors affect exposure in rural agricultural lending. The kind and severity of risks that face farmers and rural entrepreneurs vary according to the type of farming system, agricultural production, weather conditions and the prevailing economic and agricultural

policies. Rural agricultural lenders are confronted with high covariant rural agricultural credit risks and liquidity risks.

Strategies to reduce agricultural lending risks

Enhance the required information base of rural agricultural lenders by:

- identifying the risks of specific types of agricultural production activities;
- collecting information on the credit history and creditworthiness of potential farmer clients;
- appraising the loan repayment capacity of loan applicants;
- monitoring policies and agricultural commodity markets that are relevant for farmers.
- Start rural agricultural lending in agroecological zones that present low credit risks and expand operations gradually to more risky areas;
- Commence with small and short-term rural agricultural loans and increase the loan size and term with repeat loans;
- Individualize rural agricultural loan products and loan repayment modalities in accordance with the loan repayment capacity and borrowing performance of farmer and rural entrepreneur clients;
- Adjust, in case of group lending, the size and the composition of joint liability farmer groups in accordance with local conditions;
- Reduce rural agricultural credit risks through adequate asset and loan portfolio diversification;
- Manage external credit risks through prudential loan rescheduling; if feasible use commercially viable insurance mechanisms; mobilize, in cases of serious natural disasters, emergency aid to fund rehabilitation grants to affected farmer clients;
- Use staff remuneration incentives to encourage a high lending productivity and to reward good portfolio quality;
- Promote a good credit culture and discipline through client education and moral persuasion;
- Develop mutual trust between lender and borrower by establishing and maintaining close contacts between loan officers and farmers;

- Use appropriate loan collateral substitutes and provide borrowers with incentives that encourage good loan repayment behavior.

Selected annotations

- The basis for good risk management is quality information. For instance, rural agricultural lenders should collect information on the incidence of drought, flood, plant and animal diseases and other risks that affect farm production. Lenders should know what risk-reducing mechanisms are available such as irrigation and insurance. They need to collect data on markets and prices of relevant farm inputs and agricultural commodities. They should monitor current economic and agricultural policies as well as policy changes. On the other hand, lenders have to build up specific client information on the creditworthiness and the loan repayment capacity of prospective farmer-borrowers. The lending operations and conditions of other financial intermediaries and the current and past experiences of agricultural credit programs should be monitored.
- Once lenders have a rough idea of the effective demand for rural agricultural loans and the lending risks, they should choose the loan products and lending technologies to serve specific types of farmer-borrowers. It is recommended to set fairly standardized lending conditions and loan terms. Flexibility can be increased as the lender learns more about new small farmer clients. First-time borrowers should be granted small loans, even though the per unit costs of these loans are high. Similarly, interest rates should be kept simple and uniform for borrowers at the outset. Later differential rates can be set by type and size of loans. The frequency of loan repayment installments depends on the loan repayment capacity of the farmer-borrower. Overdue loans should be dealt with promptly. Both individual and group lending technologies can be utilized. They differ with regard to their method of client screening, loan appraisal, loan collateral requirements, loan monitoring and loan recovery. In general, lenders should be willing and able to adjust their lending technologies over time.
- Diversification of the loan portfolio serves to protect agricultural lenders against a concentration of covariant risks among farmer-borrowers. It is attained by granting loans to different types of farmers for distinct lending purposes at different loan terms. In addition, farmers in various agroecological zones should be served. Still, lenders need to

set ceilings on the volume and the share of agricultural loans. Limits should be defined by zone and in their overall loan portfolio, to restrict the incidence of concentrated risks due to unfavorable weather conditions, pests, diseases and natural disasters.

- Often rural agricultural lending institutions are faced with a subsidy mentality on the part of small farmer-borrowers who were accustomed to receive agricultural loans at concessional terms from state-owned agricultural development banks, donor agencies, and NGOs. For this reason, rural financial institutions need to emphasize client education by informing prospective borrowers on loan application procedures and lending conditions. In particular, farmers have to be reminded of their loan repayment obligations and the various loan repayment enforcement mechanisms. Specific incentives that reward good loan repayment behavior should also be explained to them. The overall aim of client education is to promote a positive credit culture in which mutual trust and respect is built up between the lender and the borrower.

2. REMAINING CHALLENGES IN RURAL AGRICULTURAL LENDING

The granting of loans to small farm households and rural entrepreneurs remains a tricky business. Costs and risks are high and diverse. The dispersed location of rural clients, the difficulties and high costs of transportation and communication, the heterogeneity in farming activities and management skills make small farm lending a costly endeavor. The high agricultural production risks further complicated by the sensitive political nature of agriculture and domestic food production, explain why lending to agriculture is risky. There is limited availability of risk-mitigating mechanisms. Many challenges still remain to constitute an agenda for future research.

Need for an Adequate Agricultural Finance Policy Framework

Structural Adjustment Programs have been successful in generating a more favorable macroeconomic environment in developing countries.

Still ongoing market reform and privatization have not yet produced appreciable improvements in the provision of agricultural support services. Nor have they increased farming profitability. If anything, small farmers often have less access to rural banking and institutional agricultural lending facilities than before. A major reason is the absence of an adequate rural and agricultural

finance policy framework. The generation of agricultural finance policies is also complicated because agriculture is a politically sensitive sector. Rural people and farmers are affected by three different policy-making areas: macroeconomic policy, financial sector policy and agricultural sector policy. The essence of a successful agricultural finance policy is skillfully integrating these three policy areas. The regulation must capture the views of all stakeholders involved in policy formulation, delivery, monitoring and feedback.

Heterogeneity of Farming

The variety in farming activities and farm management poses challenges and opportunities to agricultural and rural lenders. As the use of standardized agricultural lending products and lending conditions is unrealistic, the design of individualized loan products will increase the transaction costs of the lender. The availability of viable farm and non-farm investment provides opportunities to meet the effective demand of farmers and rural clients for a wide range of loan products and other financial services. This diversifies the loan portfolio and thus reduces the concentration of agricultural lending risks. Lenders need to be willing and able to develop new loan products. They need to adopt lending technologies that respond to the demand and the loan repayment capacity of potential farmer-borrowers. To attain this, lenders must have good knowledge of farming systems, agricultural commodity markets, and rural and farm household economy. Initially, those farmer clients should be served who present low risks.

Loan Appraisal and Loan Follow-up

An innovative use of loan appraisal techniques and close loan follow-up can contribute to reduce agricultural lending risks. Yet, the problem of high agricultural lending costs persists. This is due to a dispersed rural client location, high transportation costs, high overhead costs to startup a decentralized rural branch network, and high information costs. Collaboration with local organizations can be extremely useful to reduce client information costs. Farmer-borrowers can be provided with essential non-financial support services such as agricultural extension, and business and financial management training.

Lending Technologies

The choice between the options of individual or group lending is closely related with the type of clients that will be served, the operational structure and outreach of the financial institution and

the relative importance of cost or risk-reducing strategies. For instance, agricultural lenders which work with joint liability groups should be aware that group size and group homogeneity have a direct impact on the effectiveness of peer group member solidarity and pressure. In general, rural borrower groups need to be smaller than urban ones. There are high potential costs for group formation, organization, intra-group information and loan monitoring by fellow group members. High covariant risks of farm and rural incomes suggest that heterogeneous rural groups may be more effective in reducing lending risks. However, too much group heterogeneity can give rise to the problem of demand for different loan products, loan sizes and loan terms between group members. In any case, lenders must be willing to change their lending technologies over time. Individual borrower graduation should be made possible for group members who progress more rapidly than others and who are capable of servicing larger loans.

Potential for the Use of Electronic Banking Products

New information technologies provide significant scope for the adoption of innovations in bank automation, electronic data processing and development of new agricultural loan products. For instance, launch a credit card scheme in rural areas. Farmers who are credit card clients may get advances up to a certain limit per acre of land without additional formalities. Another example is the use of smart cards that allow farmers to draw loans on retailers of fertilizers and other agricultural inputs. For the lender, significant cost efficiency can be effected by using this form of loan disbursement.

Term Lending Facilities

Agricultural loans are required for relatively long terms, which makes matching of assets (loans) and liabilities (sources of funds) a key issue to be addressed. The difficulty of mobilizing sufficient longer-term loanable resources at reasonable financial conditions limits the capacity of agricultural and rural lenders to meet demand for medium- and long-term loans. Ways of securing longer-term loanable funds are the increase of equity of a financial institution by retaining earnings, the negotiation of long-term borrowings from development organizations and multilateral development finance institutions. This may also happen through the issuing of medium and long-term debentures or bonds and the creation of a subsidiary merchant bank

Liquidity Management

Mismatching the term of loan assets and liabilities exposes a financial institution to high liquidity risks. Good liquidity management requires priority attention in agricultural lending. The liquidity position of agricultural lenders is affected, in particular, by agricultural seasonality. Careful liquidity management is also needed in the event of large changes in agricultural commodity prices, or natural disasters. Under these circumstances withdrawals of rural savings and new loan demand of farmers occur at the same time. Agricultural lenders need reliable information on the timing of required loan disbursements and scheduled loan repayments to properly plan and manage their cash requirements. Sufficient funds should be available at the beginning of the planting season, while the high costs of keeping loanable funds idle should be minimized as much as possible.

Interlinked Agricultural Credit Arrangements

Today, with the breakdown or restructuring of agricultural development banks and the withdrawal of the state and donor and development agencies from agricultural and rural finance, interlinked credit arrangements provided by non-financial institutions often offer the only way to finance the on-farm production of small farmers in developing countries. For instance, both traditional trade finance as well as more sophisticated forms of agribusiness arrangements like outgrower schemes and contract farming have (re-) emerged recently in many countries. Interlinking the supply of agricultural inputs with credit and output marketing, presents farmers with the advantage of market orientation and better outlets for farm products. Small farmers, with weak bargaining positions, may be paid unfair low prices for their produce. Essential support services will be required in developing appropriate market intelligence systems and providing farmers with better market information and business advisory services. At the same time, they may be assisted in proper farmer organization. Much more research on this subject is needed.