PN-ABM-153

AGENCY FOR INTERNATIONAL DEVELOPMENT
PPC/CDIE/DI REPORT PROCESSING FORM

ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT

1. Project/Subproject Number	2. Contract/Grant Number	3. Publication Date
936-5450	DHR-5450-A-00-9084-00	

4. Document Title/Translated Title

5. Author(s)
1.
2.
3.

6. Contributing Organization(s)

7. Pagination	8. Report Number	9. Sponsoring A.I.D. Office
	ESO #	R&D/EID

10. Abstract (optional - 250 word limit)

11. Subject Keywords (optional)

1.	4.
2.	5.
3.	6.

12. Supplementary Notes

13. Submitting Official	14. Telephone Number	15. Today's Date
M. Brinkerhoff, R&D/EID	(703) 875-4491	9/15/92

DO NOT write below this line

16. DOCID	17. Document Disposition
	DOCRD [ ] INV [ ] DUPLICATE [ ]

AID 590-7 (10/88)

PN-ABM-153
ISN 79118

Economics and Sociology
Occasional Paper No. 1958

SUMMARY OF LESSONS LEARNED AND RESEARCH AGENDA FOR THE FUTURE

by

Douglas H. Graham

May 1992

Presented at the
International Seminar on Finance an
Rural Development in West Africa
October 21-25, 1991
Ouagadougou, Burkina Faso

Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099

Abstract

Research on formal and informal financial markets in the Sahel can be seen and interpreted through two conceptual frameworks: the project focus and the institutional focus. After several decades a consensus is emerging on the appropriate institutional and policy stance in addressing the problems of Sahelian finance. This consensus, along with an agenda for future research, is offered in these closing comments.

SUMMARY OF LESSONS LEARNED AND RESEARCH AGENDA FOR THE FUTURE

by

Douglas H. Graham

This summary of conference proceedings falls into three sections: (i) the contrasting conceptual frameworks that have influenced work on finance in the Sahel region; (ii) the emerging consensus on the recent experience in promoting rural finance in the Sahel; and (iii) a research agenda for future work in the region.

1. Contrasting Conceptual Framework

Two contrasting frameworks stand out in work on the Sahel. As set forth in figure 1 the project focused initiatives exclusively emphasized credit, and more specifically agricultural credit. This credit was targeted for a specific clientele with subsidized interest rates in specialized institutions (usually agricultural development banks) that were "borrower dominated." In short, all the procedures and practices within the institution in the project were directed to facilitate quick and easy disbursement of loans to borrowers with little attention given to loan recovery procedures. Credit needs were emphasized rather than creditworthiness or the debt repaying capacity of the borrower.

Not surprisingly, these specialized credit disbursement institutions (or projects) were not sustainable. They were not financially viable due to high overhead or transaction costs (i.e. high non-interest operational costs to carry out estimates of credit needs, identify and document targeted clientele, engage in loan supervision, and absorb cumbersome reporting requirements) and low loan recovery efforts. The transaction costs of administering these projects/institutions were greatly underestimated.

A contrast to these more traditional project efforts were those that emphasized institutional viability (see figure 1). This institutional focus was concerned with the supply of a complete range of financial services in rural areas (i.e. savings deposits as well as loans). Hence these programs used the word "finance" rather than the more narrowly focused term of credit. Borrower domination was displaced by a more neutral concern that also accepted the fiduciary responsibility of protecting savers' interests (i.e., making credit-worthy loans). Hence the strategic role of loan recovery stands out in evaluating institutional viability along with realistic interest rates to reward savers and to cover the administrative costs of lending and recovering loans. Finally, loan targeting is eliminated in the institutional approach with loans being granted for any creditworthy activity in rural areas. This highlights the legitimate role of non-agricultural trading and artisan activity and, at the same time, allows for long run institutional viability by reducing risk through portfolio diversification into these non-agricultural activities in rural areas.

2. *An Emerging Consensus*

The second diagram (figure 2) sets forth an emerging consensus on what we have learned from the last two decades' experience with numerous financial programs and projects. There may be some disagreement on the relative importance of each of these lessons but the main focus is clear.

First, there should be much less targeting of credit. Indeed, some would argue for no targeting whatsoever. Targeting usually cannot be effectively carried out, and, in addition, incurs high transaction costs. Savings mobilization should be encouraged as an important element in developing financial markets and financial institutions serving those markets. This service reaches a much larger proportion of the rural poor than loan services and helps them smooth out their seasonal consumption needs. Deposit and savings mobilization creates a new constituency within financial institutions that is concerned with creditworthy borrowers who will repay their loans. Hence financial institutions become less "borrower dominated." In short, sustained financial intermediation (between savers and borrowers) should be the goal of financial programs and projects and not the mere creation of financial vehicles acting as conduits for credit.

At the same time, there is a need for more autonomy and decentralization in the supply of financial services at a branch level of banks or within village based savings and loan associations. This decentralization should be associated with multiple financial services being transacted between the lender and borrower through frequent contact and discussion. The autonomy implies that the lender has the right to say no to a risky loan request. An additional consensus has emerged that non-agricultural loans should be incorporated into the portfolio of rural lenders to diversify risk and facilitate rural development.

It is now recognized that transactions costs are important in financial markets. Borrowers as well as lenders incur non-interest transactions costs in trying to secure or supply financial services. Frequently these can be more burdensome than interest rates, especially to small borrowers trying to secure a loan. Realistic interest rates are now widely recognized as necessary to cover the costs and risks of lending. Subsidized interest rates lead to financial insolvency and invariably worsen the distribution of income by being captured only by those fortunate enough to secure a loan and with larger loans securing a larger advantage than smaller loans.

It has also become apparent that group finance administered through non-government organizations (NGOs) can represent a risk reducing and transaction cost reducing innovation in the supply of financial services to a rural clientele. NGOs can function alone or as an intermediary between a bank and a low income clientele. Savings and credit cooperatives have proven successful as non-bank financial intermediaries servicing a relatively marginal rural clientele in Africa. At the same time, small group orientated initiatives, in part emulating the Grameen Bank model, have been launched with some apparent initial success in selected African countries. These current successes build upon the positive virtues of informal finance in drawing upon collateral substitutes such as joint liability, close friendship and trust, and the potential of peer group sanctions to promote cooperative behavior (i.e., loan repayment). Such experiences highlight the importance of the role and presence of informal finance in rural areas as an ongoing activity that deserves more study for those concerned with financial innovations in rural areas. This experience has also recognized the positive gains associated with the dynamic interaction between formal and informal financial markets.

Finally, there is agreement on a continuing impasse in rural financial markets in Africa, i.e., the inability of any financial institution to service <u>long term</u> loans without effective collateral institutionalized with secure property rights. On the one hand, the lender should protect the interests of its short term depositors by not lending too long into the future. Term transformation of short term liabilities into longer term assets must be kept within bounds. Furthermore, the lender should periodically alter its long term loan rate to correct for the effects of inflation eroding its real interest income. In the end, long term lending is highly risky in an environment of frequently changing commodity prices, exchange rates, and interest rates. It is not wise for a lender to have a portfolio too heavily locked into by term loans in light of these changing circumstances affecting the financial viability of a lending institution.

3. Research Agenda for the Future

The third diagram outlines a research agenda for the future for studying African rural financial markets. First, traders and enterprise finance should be researched more thoroughly in Africa. There is a strong likelihood that these larger enterprises and wholesalers are net borrowers from the formal financial system (i.e., they borrow more from banks than they put back in deposits). However, through the consignment of goods or sales on credit they transfer down through their network of micro-enterprises and retailers the liquidity they were able to secure initially from banks. This linkage between formal and informal finance plays a valuable role in extending short term working capital down to smaller economic units than banks could ever hope to reach directly. In short, these informal enterprise intermediaries are net creditors in the informal financial markets as they enjoy informational economies and low transaction costs in extending credit through their network of retail buyers.

It is relevant to document the terms and conditions of these contractual arrangements between wholesalers and retailers and between retailers and their final customers. Once this is accomplished it will be possible to undertake the second research task of determining the degree of segmentation and integration of formal and informal finance and the properties of the contracts that characterize these markets. This can be done through a comparison of the range of interest rates, term length, collateral, and transactions costs that exist for formal and informal lenders and borrowers. To the extent that fragmentation prevails, policy initiatives can be considered to reduce the barriers to promote greater integration of financial markets.

A third research task should be directed towards documenting the importance of deposit services to small business, groups, and households. These units are invariably net borrowers (or debtors) from the informal systems, but net creditors to the formal system (i.e., they have more deposits in banks than the loans they receive from banks). Therefore the expansion of branches and deposit agencies (including mobil deposit taking services) will directly benefit these more marginal groups in society through improved access to deposit services.

A fourth research objective should focus on determining the nature of the collateral substitutes operating in the informal lending world of Africa. This research should try to distinguish between joint liability arrangements that are successful in generating responsible loan repayments and those that provoke free rider problems (i.e., non-cooperative behavior leading to poor loan recovery on the part of members in a group). Also, the specific features of collateral substitutes for private traders should be investigated to learn more about how they manage the risk of arrears in their private trading networks.

The final research objective should focus on the set of issues affecting the restructuring of formal financial systems in Africa, particularly as they pertain to institutions serving a rural clientele. The profile of a viable financial institution should be established highlighting portfolio diversification, managerial autonomy and accountability, and asset and liability management practices to reduce the risks of lending. Then the transition path an institution must traverse to move from insolvency to solvency should be investigated. The need for an early warning system to track loan repayment by loan type and borrower characteristics is essential for bank managers to remain in control of their portfolios. The establishment of this tracking system should be a high priority for research, especially for institutions engaged in making long term loans where the early profile of installment payments should be related to the installment amount owed. This early warning tracking device will allow the institution to detect problem loans quickly before these term loans have matured into uncorrectable defaults.

Finally, it is important to underscore the distinction between bad and good regulation of formal financial markets in any restructuring of financial systems. Bad or counterproductive regulations refers to interest rates ceiling, and selective credit policies that attempt to control the pricing and the allocation of credit. These non-market rationing schemes lend themselves to political intrusion and institutional insolvency. Good and proper regulation refers to bank examination and supervisory procedures that investigate the quality of the assets in a bank's portfolio. This fiduciary or prudential regulation, protecting depository interests and systemic stability becomes more and more important as programs of structural adjustment remove interest rate ceilings and selective credit allocations in a spirit of financial liberalization. Once banks are given the freedom to lend widely without interference, government authorities must be trained and prepared to supervise and monitor the risks this freedom may introduce into the financial system.

Figure 1

PROJECT FOCUS: CREDIT		**INSTITUTIONAL FOCUS: FINANCE**
1. The borrower	vs.	1. The Depositor-saver
2. Targeted credit	vs.	2. Open, untargeted loans
3. Output, income, employment, technology adoption goals	vs.	3. Long run institutional viability
4. Credit needs	vs.	4. Creditworthiness or debt capacity
5. Quick disbursement as dominant goal with little interest in effective loan recovery	vs.	5. Strategic role of loan recovery in evaluating institutional performance
6. Subsidized interest rates	vs.	6. Realistic interest rates
7. Transaction costs ignored	vs.	7. Importance of transaction costs (non-interest rate operational costs)

Figure 2

AN EMERGING CONSENSUS

1. Less to no targeting of loans

2. Importance of savings mobilization

3. Financial intermediation not mere conduits of credit

4. Frequent contact, multiple services

5. Need for decentralization - more local autonomy in the supply of financial services

6. Inclusion of rural non-agricultural activities diversifying the portfolio

7. Realistic interest rates

8. Transaction costs important - simple procedures important

9. Groups can represent positive innovations with NGO support

10. Continuing impasse in servicing long term loans without institutional role for collateral - prudential protection of depositor-savers

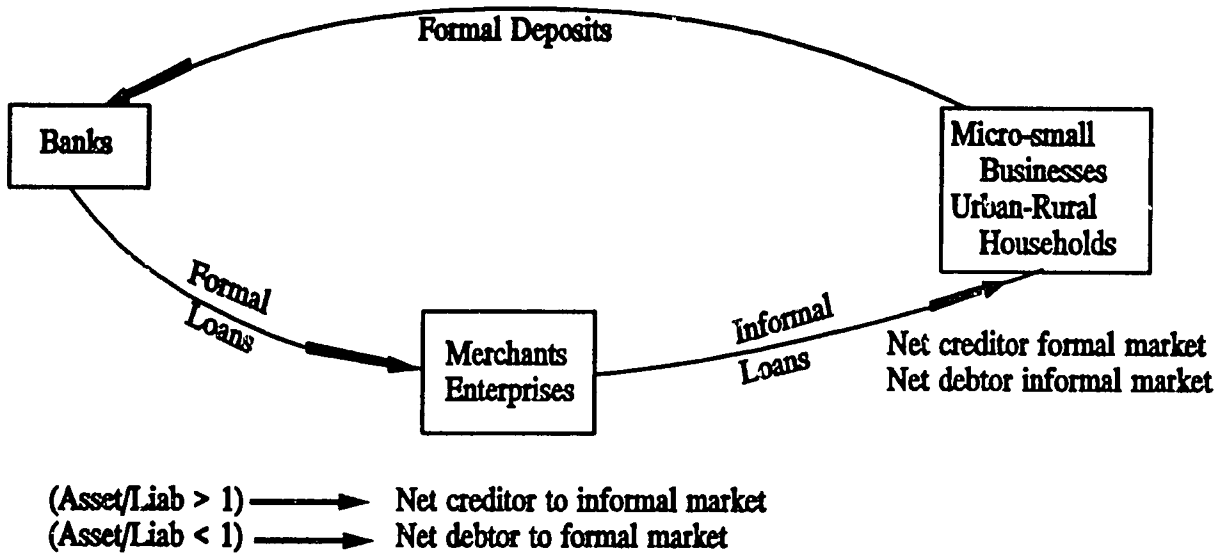
11. Informal finance important role and presence

12. Greater recognition of positive gains associated with linkages between formal and informal financial networks

Figure 3

RESEARCH THEMES FOR THE FUTURE

1. Document Formal-Informal financial linkage network



2. Document financial integration-segmentation formal-informal sectors

3. Document importance of deposit services to households, groups, small businesses

4. Determine terms and conditions and "collateral substitutes". Contractual features restricting, or enhancing:

   (a) joint liability in groups vs. free rider problem
   (b) contracts in informal chain of finance
   (c) bonded warehouses
   (d) innovations substituting for lack of futures markets or insurance markets

5. Research agenda for restructuring formal financial system

   (a) Profile of a viable institution
   (b) Transition path
   (c) Early warning system to track loans
   (d) Good regulation vs. bad regulation