



**Paving the Way Forward for Rural Finance
An International Conference on Best Practices**

Case Study

Rural Finance Expansion: Experience in Commercialization

**Expanding Commercial Microfinance in Rural Areas:
Constraints and Opportunities**

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I. Introduction

The microfinance field has come a long way toward identifying best practices based on the successes of a few microfinance institutions (MFIs) in simultaneously expanding outreach and improving financial self-sufficiency.² Many of these best practices are embodied in the increasing application of commercial principles in microfinance. While commercial MFIs have been successful in substantially penetrating urban and highly densely populated peri-urban areas, only in a few cases has substantial rural penetration been achieved. As a result, only 11% of the world's 240 million poorest families currently are served by MFIs (Daley-Harris, 2002).

The main challenge currently facing the microfinance field is to increase microfinance outreach for a significant number of unserved or underserved microentrepreneurs and poor households, many of whom live in rural areas. This paper analyzes constraints and opportunities to expand the provision of microfinance in less densely populated, rural areas and suggests that commercial microfinance may hold the most promise for sustainably expanding the microfinance frontier.

Section I reviews past lessons in rural lending and offers an analytical framework for considering issues surrounding commercial microfinance and its implications for expanding rural outreach. Section II elaborates the challenges of sustainably increasing rural microfinance (RMF), including credit and savings. Section III highlights practical approaches to the successful expansion of RMF by commercially-oriented MFIs. The paper concludes with a discussion of roles for governments and donors in expanding commercial microfinance in rural areas.

A. Lessons from the Past

Many microfinance providers have avoided rural and especially agricultural finance, in part because of the negative past experiences in rural lending, especially directed agricultural credit programs. In the past, government and donors supported many subsidized lending programs to spur economic growth and agricultural development. 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 rather than by the targeted smallholders. Experience has shown that reliable access to credit is more important to small farmers and other rural microentrepreneurs than the interest rate for production and investment decisions. In addition, a significant proportion of the rural community has proved to be willing and able to save, as deposit mobilization is increasingly used as a tool for expanding outreach and achieving financial self-sufficiency. Table 1 outlines these and other primary features of the old paradigm of agricultural credit and the new financial systems approach.

The success enjoyed by a few MFIs during the 1980s in simultaneously expanding outreach and improving sustainability helped governments, donors, and practitioners share a view that microfinance was a critical tool for promoting economic development and reducing poverty. During the 1990s, greater consensus than ever before emerged about what was needed to make microfinance sustainable and these became known as industry "best practices." The revolution

² Microfinance is defined here as the provision of a broad range of financial services such as deposits, loans, payments services, money transfers, and insurance to the poor and low-income households and their farm or non-farm microenterprises. An MFI is defined as a single organization (for example, an NGO providing microfinance) or a unit whose primary business is microfinance within a diversified institution (for example, a microfinance unit within a commercial bank).

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 a select few benefited from the limited number of subsidized loans that could be delivered. Today, the emphasis is on building commercial approaches to microfinance that can increase both scale and outreach to the urban and/or rural 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.

Table 1: Primary Features of the Old and New Paradigms in Rural Finance		
Features	Old: Directed, Subsidized Ag. Credit	New: Financial Systems
1. Chief aims	Boost agricultural production Reduce poverty	Reduce market imperfections and transaction costs for income expansion and poverty reduction
2. Role of financial markets	Help the poor Stimulate production	Intermediate efficiently
3. View of users	Beneficiaries: borrowers	Clients: borrowers and depositors
4. Subsidies	Heavily subsidy dependent	Increasingly independent of subsidies
5. Sources of funds	Vertical: governments and donors	Horizontal: primarily voluntary deposits
6. Associated information systems	Dense, fragmented and vertical – assessing whether targets were met.	Less dense and mainly horizontal – management information
7. Sustainability	Largely ignored	Major concern
8. Outreach	Short-term focus	Long-term concern
9. Evaluations	Credit impact on beneficiaries – mainly primary data	Performance of financial institutions – mostly secondary information

Source: Adapted from Vogel and Adams, 1997; and Yaron, Benjamin, and Piprek, 1997.

B. Definition of Commercial Microfinance

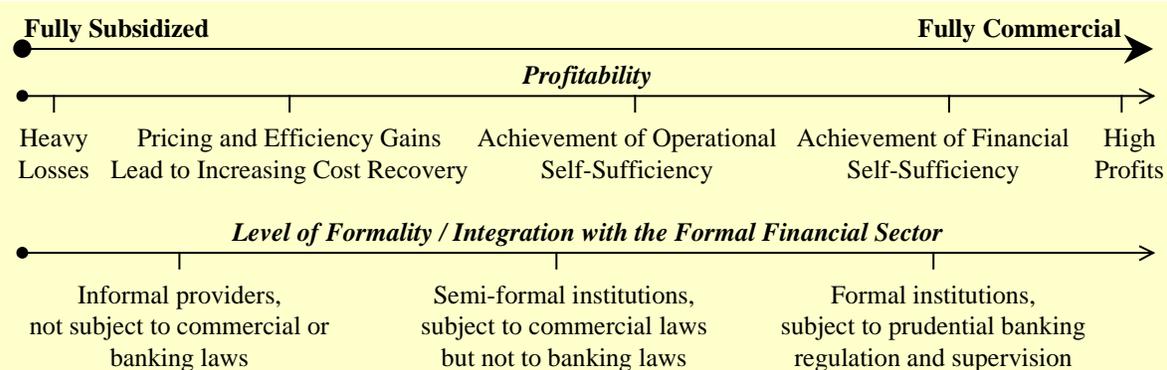
International microfinance professionals are increasingly considering the commercialization of microfinance to be “the application of market-based principles to microfinance” or “the expansion of profit-driven microfinance operations.”³ There is a growing realization in the international arena that commercialization allows MFIs greater opportunity to fulfill their social objectives of expanding access of the poor to an array of demand-driven microfinance products and services on a sustainable basis. This paper adopts a comprehensive view of what constitutes commercial microfinance. It takes into account commercialization at two levels, proposing that it involves both institutional factors (MFI commercialization) and attributes of the environment within which MFIs operate (commercialization of the microfinance industry).

At the **micro level**, MFI commercialization can be considered as progress along a continuum, which is described below and depicted in Figure 1.

³ See for example, Poyo and Young 1999 and Christen 2000.

- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified, demand-driven microfinance products and services and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and efficiency, as well as expanding outreach.
- Use of commercial sources of funds; for example, non-subsidized loans from apex organizations (wholesale lending institutions) or commercial banks, voluntary savings, investor equity or other market-based funding sources.
- Operation as a for-profit, formal financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

Figure 1: Key Stages in Commercialization of an MFI



At the **macro level**, the extent of commercialization of the microfinance industry depends on several factors, including the degree to which the policy environment and the legal and regulatory framework are conducive to the development and growth of commercial MFIs, the availability and access of commercial MFIs to market-based sources of funds, and the existence of key industry support institutions, such as credit information bureaus, microfinance trade associations, microfinance technical training centers and providers of business development services.

C. How Commercial Microfinance Expands Outreach

MFI commercialization is usually hastened by a strategic decision of an MFI's owners/managers to adopt a for-profit orientation accompanied by a business plan to operationalize the strategy to reach full financial self-sufficiency and to increasingly leverage its funds to achieve greater levels of outreach. The recognition that the key to achieving substantial levels of outreach is building a sound financial institution essentially means that the MFI needs to charge cost-covering interest rates and continually strive for increasing operational efficiency. As an MFI's interest and fee revenue covers first its operating costs and then the cost of its loanable funds, it may be considered to be increasingly operating on a commercial basis. To balance outreach considerations with achieving financial self-sufficiency, pricing decisions are key as are streamlining operating systems to improve productivity and increase client volume to reach economies of scale. MFI profitability enables expansion of operations out of retained earnings or access to market-based sources of funds. As profitability improves, so does the ability of the institution to leverage commercial sources of funds to achieve increasing levels of outreach.

Operating as a for-profit, formal financial institution may be the most complete hallmark of MFI commercialization because this implies subjectivity to prudential regulation and supervision and that the MFI has become fully integrated into the formal financial system.

The process of commercialization has led to increased competition as existing MFIs have expanded their outreach over time. In addition, the profitability that commercial MFIs have demonstrated has attracted some new entrants to the market and, to a more limited extent, downscaling by a few commercial banks. In some countries where this process has been occurring for some time, such as Bolivia, the microfinance market is approaching saturation with heated competition in virtually all urban and peri-urban areas. However, many other countries have localized competition that is intensifying as MFIs vie for similar target clientele in densely populated areas.

D. How Commercial MFIs Enhance Access to Demand-Driven RMF

In most developing countries, the poor and poorest are largely located in less densely populated, rural areas. The extent to which commercial MFIs target rural areas for market expansion depends on two main issues: i) the degree of focus on the poor (or more specifically, the rural poor) in a commercial MFI's mission statement; and ii) the extent of competitive pressures in the environment. For commercial MFIs that start out with a rural focus or maintain a more general but strong social orientation toward serving the poor, expanding their outreach over time to less densely populated, rural areas can be expected to proceed in accordance with the MFI's capacity in terms of expertise and funding to expand its rural operations.

For MFIs whose commercial missions outweigh their social objectives, exploitation of the lowest cost, most highly profitable market niches will naturally occur first. Some people have expressed concern that increased commercialization will cause MFIs to drift from their missions, in other words, reduce their focus on the poor. While mission drift can happen, this has not been the case for most NGOs transforming to formal, commercial MFIs.⁴ In fact, increasing competition in traditional microfinance markets of more highly populated areas can push the market frontiers in several directions (upmarket to wealthier clients; down market to underserved, poorer clients; or into new geographic locations), including serving harder to reach clients in more sparsely populated rural areas. So, while competitive market pressures can initially deter the second type of MFIs from focusing on rural markets, over time competition can push these MFIs into expanding their rural operations out of a need to identify new markets for expansion.

For both types of commercial MFIs, competition is bringing significant benefits to clients as MFIs become more customer-oriented and interest rates become more attractive. Also, competition brings innovation in products and delivery mechanisms, deeper market penetration, increased efficiency, lower prices and better service. For example, competitive pressures in Bangladesh have prompted one of the leading commercially-oriented microfinance NGOs there, BURO Tangail (BT), to break with traditional products offerings to keep its existing client base and continue growing in the face of a crowded market (Box 1). However, competition can also have negative implications, as in the case of Bolivia in which consumer lenders flooded the microfinance market, resulting in a significant number of clients to become over-indebted and

⁴ See Fernando, 2003 and Campion and White, 1998.

default on their loans. Nonetheless, this period of excess competition forced Bolivian MFIs to become more efficient and customer-oriented, which should bring positive results in the future.

Whether due more to rural focus, social commitment to serving the poor, or competitive pressures, commercial MFIs that expand into rural areas should not only be able to offer more demand-driven products and operate more sustainably. Commercially-driven MFIs, such as the Bank Rakyat Indonesia's Microbusiness Division (BRI Units),⁵ have proven for nearly two decades that providing large-scale financial services can be both economically and socially profitable. It has been amply demonstrated that even in exceptionally severe country and

regional economic crises, MFIs that operate on a commercial basis can continue to serve millions of poor clients while remaining solvent and profitable. Such was the case with the RMF provided by the BRI Units even during the 1997/98 Asian Financial Crisis. The BRI Units earned \$177 million in profits in 1996, before the Asian Financial Crisis hit, and \$121 million in 2000, reflecting recovery after profitability ebbed slightly during the crisis years of 1997 and 1998.

To reach the millions of people who need microloans and other microfinance services, MFIs must transition to commercially viable institutions that can mobilize savings, access commercial finance, and achieve full cost recovery through appropriate interest rates. Their integration into the formal financial sector allows commercial MFIs the flexibility and funding base required to provide RMF on a sustainable basis.

Box 1: Responding to Competitive Pressures with Flexibility – BURO, Tangail (BT) in Bangladesh

Established in 1990, BT's commercial orientation is reflected in its focus on appropriate pricing and efficiency, which has allowed it to achieve FSS of 111% in 2002 and growth in its outstanding microcredit portfolio of 135% over the last five years.

BT achieved this high performance despite operating in Tangail, one of the most competitive microfinance markets in Bangladesh. The city of Tangail is home to the four largest MFIs and around 100 smaller ones. The competition between MFIs has been increasing over the last few years, and in some villages it is already quite intense.

Mainly in response to rising competitive pressures, BT increased the number of its savings services to three and made each type voluntary (independent of any microloan outstanding) and completely liquid. The results were very positive in that, the deposits and net savings increased substantially and they became a major source of funds. BT's capital consists of 51% equity, 35% members' savings and 14% commercial borrowing. BT also increased the number of its microcredit products to nine and remains committed to providing high quality, flexible financial services adapted to the needs of the poor.

Source: BT 2002 Status Report.

II. Constraints to Expanding Commercial RMF

When considering the constraints to expanding commercial RMF, it is important to consider not only the specificities of the rural sector and the challenges that these present to rural financial intermediation but also, the general constraints present in the financial markets that affect RMF. Table 2 graphically depicts the universe of constraints that impede commercial RMF.

A. General Constraints in Financial Markets

Country-level constraints affecting the financial sector as a whole can prevent rural financial markets from operating efficiently. Examples of these include:

⁵ While BRI is a 100% government-owned limited liability company (state bank), the commercial approach applied by the BRI Units is largely reflected in their application of cost-recovery lending interest rates and maintenance of an interest rate spread sufficient to cover the high costs of servicing small loans and deposits.

- a) unsound macroeconomic policy and management;
- b) restrictive financial policies (particularly interest rate controls);
- c) insufficient institutional capacity within MFIs to achieve high levels of outreach in a sustainable manner;
- d) underdeveloped legal systems, particularly with respect to 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.

B. Additional Challenges of Rural Financial Markets

Rural populations in most developing 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, which increase the transaction costs per monetary unit of financial intermediation.
- Lack of infrastructure (communications, electricity, transportation, etc.), limited 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) affecting client incomes and add to the costs of rural financial intermediation.

The combination of these specificities leads to increased transaction costs and risks for any MFIs wanting to serve rural clients. 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 business financing at a reasonable cost leaves most microentrepreneurs dependent on self-finance or very costly, short-term credit from money lenders, which limits their ability to actively benefit from investment opportunities and contribute to economic 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.

The extent of market penetration of commercial MFIs in rural areas depends on two main factors. First is the presence of economic opportunities for microentrepreneurs in rural areas. Rural enterprises that do not generate sufficient margin to cover the financial costs of a debt obligation are simply not bankable. Fixed and unvarying prices for agricultural outputs and poor

infrastructure significantly elevate production and marketing costs, and export taxes reduce the profit margin of many rural enterprises. Second, the ability of commercial MFIs to develop demand-driven products and services; to implement cost-effective screening, distribution, monitoring and enforcement mechanisms; and to manage covariance⁶ and other risks in the loan portfolio will determine how profitably they can serve rural clients and expand operations over time.

III. Successful Approaches to Commercial RMF

Several commercial MFIs have made inroads in addressing the constraints to rural microfinance over the last several years. Their achievements in developing demand-driven products and services, and using cost-effective delivery mechanisms and technologies are highlighted below.

A. Rural Credit

Rural group lending. In the absence of adequate risk mitigation instruments (e.g., collateral, insurance, futures, etc.) commercial MFIs are forced either to avoid rural areas or to design contracts that indirectly resolve the problems. Use of joint liability contracts or group credit is one popular indirect alternative. Group lending has been successful in settings where regular meetings provide significant ancillary benefits, where a high degree of social cohesion exists, and when the loan size is still within the mutual insurance capacity of the group (IADB, 2001, p. 10). Nevertheless, in some cases group lending imposes high transaction costs on its members, such as their time involved in identifying members, group formation, as well as attending group meetings and any mandatory training. Box 2 presents an example where group lending has worked well.

Box 2: Lending to Rural Women's Groups in Mali

Freedom from Hunger started working with two commercial microfinance credit unions in Mali, Nyèsigiso in 1996 and Kafo Jiginew in 1997, to target rural women through its *Credit with Education* group lending program. As of June 2002, Nyèsigiso had reached 16,200 women and Kafo Jiginew had added 18,260 women through their Credit with Education programs.

Freedom from Hunger's Malian field agents worked with women's groups to develop their capacity to manage their own Credit Association, to which the MFI gives a loan. The group is jointly liable to repay the loan, which is generally over 16 weeks. The members divide the large loan into small loans (initially \$60-\$80) customized to the member's request for investment in her individual microenterprise. If the Credit Association pays its entire loan back to the local organization, on time and with interest, it becomes eligible to immediately receive a new, usually larger loan.

The result of participation in such microfinance programs is that the access to credit enables women to expand and diversify their enterprises and often replaces more costly sources of funding. Participants acquire inputs for their microenterprises in bulk at lower prices and begin to build fixed assets. Also, women's increased profits and their accumulated savings tend to be directly channeled toward their families' needs for food, medicine and school supplies. In addition, as women's incomes increase, so do their self-confidence and status in the community.

Source: Freedom from Hunger, <http://www.ffhtechnical.org>

Rural individual lending. Two commercial MFIs that have successfully tailored their loan products to the demand of rural clients are Financiera Calpiá in El Salvador (Box 3) and Centenary Rural Development Bank of Uganda (CERUDEB). These MFIs offer individual loan products and have even attracted significant farm-based and agriculture-related microenterprises and households. The main reasons clients use CERUDEB's financial services are the low

⁶ Covariance risk is defined here as the sensitivity of an MFI's yield on its loan portfolio to movements in the clients' income.

barriers to entry, including a minimum savings deposit balance of \$6 and a minimum loan amount of \$30. In addition to business loans, CERUDEB has instituted an innovative small-holder agricultural loan product, which is based on projected levels of agricultural production, has a flexible repayment schedule and takes into account off-farm income.

Rural banks offer another commercial model upon which successful RMF has been built (Box 4). The Microenterprise Access to Banking Services (MABS) project in the Philippines has broken new ground by demonstrating that commercial rural banks can profitably serve the microfinance needs of the rural poor (Owens and Campion, 2003). One important hallmark of its successful program is its use of cash flow-based lending in rural areas.

Another is its zero tolerance of delinquency. Since this USAID-funded program started four years ago, Chemonics MABS' project has worked with 102 rural bank branches and participating banks have disbursed over \$31 million to more than 60,000 microentrepreneurs. As of March 2003, MABS participating banks had 33,587 active loan clients, with a total outstanding loan portfolio of PhP224.7 million (\$4.5 million). In that same time period, microdeposit balances (accounts with balances less than P15,000 or \$287) have increased by PhP162.0 million (\$3.1 million). Total microdepositors served by the participating banks now

Box 3: Innovative RMF by Financiera Calpiá

In El Salvador, Financiera Calpiá's rural microfinance methodology has the following attributes:

- Calpiá communicates to clients its desire to create a long-term relationship, offering a stream of financial services at improving terms and conditions.
- Loans are tailored to individual demand, which allows clients to take advantage of a wider set of productive opportunities and offers the organization opportunity to maximize income from each borrower.
- Loan officers are carefully recruited and trained since they are the most important link (and most of the time the only link) between Calpiá and its borrowers.
- Conducts in-depth analysis and monitoring of the client's use of loan funds to gauge their repayment capacity and to detect changes in risk profiles. Calpiá understands that clients perceive changes in their productive opportunities better than anybody else and encourages them to adjust their decisions to these changes in the environment. This was instrumental, for example, in keeping arrears at very low levels even during El Niño flooding.
- Continual monitoring by loan officers reinforces the borrower-lender relationship and signals the seriousness of Calpiá's intentions.
- Non-traditional assets (with high incentive value, but low resale value) and traditional assets (such as mortgages on houses) are accepted as collateral;

Source: Navajas and Gonzalez-Vega, 2000.

Box 4: MABS Project Helps Rural Banks Provide Microfinance in the Philippines

Rural Banks are ideally suited to the provision of commercial microfinance in that they are formal financial intermediaries, run on a for-profit basis with individual owners that know the local markets. Today, there are over 790 rural banks with more than 1,800 branches that cover 85% of the municipalities in the Philippines. As a whole, the system of rural banks has the widest branch network than any other financial institution in the country. While some rural banks have focused on larger, more traditional collateralized loans, many either independently or with the help of the MABS project are returning to lower-income rural entrepreneurs as a growth market.

Unlike commercial banks where management rotates every two to three years, rural banks are locally managed on a continuing basis with the same staff. This helps to keep information costs low for the rural bank in selecting micro- and small-scale borrowers and to build up trust and confidence among clients who want to deposit their small savings. These relations between customers and the bank, characterized by mutual trust, attract some clients who could deposit with commercial banks (Wehnert 1999, p.11).

Source: Charitonenko 2003.

have increased by more than 135,000 from the time MABS started working with the banks.

B. Rural Savings

The experience of commercial MFIs, and particularly the BRI Units, has shown that satisfying client demand for safe and liquid savings instruments is just as, if not more, important than satisfying their demand for credit (Holloh, 2001). While not all microfinance clients need to borrow at all times, most maintain savings or other types of deposit accounts continuously. Besides the fact that savings mobilization provides a large and stable source of funds for commercial MFIs, savings facilities also provide a valuable service for clients by offering a source of liquidity and expenditure management, as well as a chance for clients to build their debt capacity for future loans. These attributes are taken into consideration when designing demand-driven deposit services and for gauging client creditworthiness.

Many credit unions, such as the ones in West Africa including Kafo Jiginew in Mali and FECECAM in Benin, began with a strong emphasis on mobilizing client savings. By making the commitment to mobilize savings from inception, many credit unions have developed very efficient and successful savings mobilizing operations (Campion, 2001). Kafo Jiginew is a commercial credit union that operates primarily in rural areas of Mali. It offers two types of savings accounts: voluntary, passbook savings and term savings accounts, in addition to its loans to rural individuals village associations. By focusing primarily on rural markets, especially in Mali's cotton-producing zones, Kafo Jiginew has experienced some difficulties having adequate funds for lending prior to planting season. At the end of 2001, however, Kafo Jiginew was funding 75% its loan portfolio with its \$8 million savings portfolio, which reduces its need external finance.

The postal infrastructure has been a vehicle for the mobilization of rural savings and the provision of financial services to low-income populations in many countries. For example, in India, the use of postal infrastructure for savings mobilization accounts for 85% of the country's total savings in financial institutions (Box 5).

<p style="text-align: center;">Box 5: Use of Postal Infrastructure for Savings Mobilization in India</p> <p>India has by far the world's most extensive postal savings network and the oldest one among developing countries. All 154,000 post offices offer financial services even in small and remote villages; overall it is estimated that they serve some 116 million account holders with Rs1,817 billion (\$42 billion).</p> <p>Originally organized during British rule in 1883, since India's independence in 1947 the Post Office Savings Bank (POSB) has offered an extensive array of postal savings schemes and other financial products, albeit acting as an agent of the National Savings Organization (NSO), a division of the Ministry of Finance. Currently, the POSB offers 12 different savings instruments, each crafted to meet the savings requirements of different markets... Since 1947, the NSO has introduced, revised, and/or withdrawn some 230 products in response to market conditions and mobilization objectives. Although many of the same NSO products are also offered by state-owned commercial banks, those by the POSB account for 85% of all household savings in financial institutions in India.</p> <p>Source: Sher, 2001.</p>

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C. Cost-Saving Innovations and Best Practices

To mitigate the costs of serving potential rural clients, MFIs have used a number of methodological and technological innovations, some are for rural finance in general, while others are specific to rural credit or rural savings mobilization.

General rural finance innovations. Innovations with respect to branch size, location and staff allocation are used by commercial MFIs. As population density declines, branch design becomes smaller and less expensive. For example, in some areas of rural Indonesia, where the population density does not support a full branch or even a scaled down four-person BRI Unit, Village Service Points operated by only two people are used to lessen the fixed costs of doing business with a limited client base (Box 6).

Branches or outlets are best placed near dense settlements or markets and kept open only on market days. In the absence of population centers, an alternative is mobile banking, in which agents go out on motorcycles to issue loans and collect deposits from groups or individuals, such as the case of ASA in Bangladesh. However, this approach can put the agent at risk of attack and theft if security measures are not in place.

Box 6: Use of Village Service Points to Reduce Transaction Costs

At the end of 2001, the BRI Units maintained 3,823 Village Units (Units Desa) and 240 Village Service Points (*Pusat Pelayanan Desa*, or PPD). With its national coverage, the BRI Units also serve as Indonesia's financial backbone to support economic activity in the country's rural sector. Despite using a portion of its profits to cross-subsidize 150 unprofitable Units in 2001, the BRI Units locate outlets and allocate personnel in innovative ways to reduce transaction costs.

Staffing of Units is determined by a ratio - for example, one credit officer per 400 borrowers, one teller per 200 daily transactions in automated units, and one teller for 150 daily transactions in non-automated units. The operational structure of each unit is kept simple. PPDs are operated by two people while Units are staffed by at least four persons and at most 11. PPDs are opened in locations warranting a physical presence by not having enough business to support a Unit. PPDs may be open from one to six days a week depending on the volume of business. If the business of a Unit expands beyond the maximum staff limit, the Unit is split, thus keeping the operation small and focused.

Source: Charitonenko et. al. 1998, p. 39.

Best practices in rural credit. Several commercial MFIs have managed to mitigate covariance and repayment risks in their loan portfolios while engaging in rural micro-credit. Given the fluidity of funds between the household and the firm, best practice in individual lending is for lenders to evaluate the risk not of a single activity listed by the borrower on the loan application but rather of all the diverse cash flows of all household members (Schreiner, 2001, p. 8). To cope with the heterogeneity, seasonality, and the risk of agriculture, the best rural microlenders tailor loans to the production cycles of each borrower and check that the household can repay with non-farm income even if crops fail or if livestock die. Through time and repeated contact, loan officers grow to know the character and cash flows of borrowers and so can judge their risk better.

Other effective approaches employed to reduce risk and strengthen the repayment potential associated with rural lending include: i) keeping microloan terms flexible, based on the cash flow of the rural household; and repayments based on frequent, small installments; ii) using chattel mortgages on equipment, livestock and household goods that can threaten the borrower's reputation as a way to deter defaults as the salvage value is often less than the cost of seizure and sale (Navajas, 1999; Churchill, 1999); iii) using stepped lending, gradually increasing the size of loans for individuals who repay debt on time; and iv) selecting loan officers carefully with a knowledge of local farming practices and non-farm economic activities, preferably from rural areas (Schreiner, 2001, p. 9). Charging interest higher rates to compensate for the higher risk is

also possible, but has a limit as it can induce adverse selection wherein only risky clients demand credit (IADB, 2001, p. 10).

Time is money for both client and MFI. Therefore, borrower evaluation procedures should be kept short and simple. In addition, microcredit decisions should be able to be taken in a decentralized manner in the field by the credit officer, preferably on the basis of one visit. In some cases, credit officers' evaluations are assisted with portable computers, personal digital assistants (PDAs) or smart cards. For example, Swayam Krishi Sangam (SKS), a microfinance NGO in India, replaced its manual systems for recording transactions with a smart card-based system. SKS provided small hand-held computers to each loan officer and smart cards to each customer to record transactions, which greatly reduced meeting times and increased loan officer productivity. With the increased efficiency provided by this technology, SKS loan officers can now service three to four rural groups per day, or 120 to 200 customers (depending on the size of the village). Before, the loan officer could only service two groups per day, so the new technology has doubled loan officer capacity (Campion and Halpern, 2001).

Best practices in rural savings mobilization.

Technological development necessary to reduce transaction costs has been slower for deposits than for loans (Schreiner, 2001, p. 8). The chief advance has been to recognize that the poor do save and that they value safety, liquidity, and convenience more than returns, particularly in countries where in-kind savings predominate and are not easily liquidated to meet short-term emergency cash needs (Robinson, 1994). Interest paid on savings is of less importance for rural savers. As a result, many MFIs that offer rural savings pay little to no interest on liquid savings.

Other advances include efforts to revive post-office savings in Africa, raffles for depositors, and the use of roving savings collectors (Rutherford, 1998). For example, the MABS project in the Philippines introduced a savings box that functions as a "piggy bank" for its savings clients who can bring the box to a branch to be unlocked and the savings deposited. Box 7 presents a more modern technological innovation in savings mobilization, Banco ADEMI's use of debit cards.

Box 7: Banco ADEMI Debit Cards Facilitate Rural Savings

In 1998, Banco ADEMI introduced its debit card, ADEMI+. Banco ADEMI's rural savings clients like the debit card because it facilitates access to cash through a broad ATM network and can be used to make purchases, thereby reducing their transaction costs. The cash used in debit card transactions is withdrawn directly from the customer's savings account. Banco ADEMI saw the debit card technology as a vehicle for developing its savings portfolio and facilitating loan repayments. In addition, as customers use the ATMs more, they will require less time with a human teller, which reduces Banco ADEMI's transaction costs.

Banco ADEMI launched the debit card in conjunction with a new loan product, "Préstamo con ahorro" (loan with savings). When a customer applies for a loan up to RD\$200,000 (or \$12,500), she agrees to deposit 10 percent of the loan value into a Banco ADEMI savings account and to allow the bank to automatically withdraw future loan payments from that account. In exchange for this agreement, Banco ADEMI authorizes loan amounts 10 percent higher than it would otherwise authorize. The additional loan funds are then placed in savings at the time of the loan disbursement. These funds are not specified as a loan guaranty because the customer can withdraw them at any time. However, the customer must keep the savings account open throughout the loan cycle, which implies maintaining sufficient funds to cover loan payments and a minimum balance of RD\$100 (or \$6.25). The more clients store savings in their account, the less need Banco ADEMI has for external financing for its loan portfolio.

Source: Campion and Halpern, 2001

IV. Roles for Governments and the Donor Community

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. Governments may play an active role in establishing a favorable or “enabling” policy environment 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 commercial MFIs can legally provide a variety of financial services, not just credit, to low-income households and their microenterprises; and
- Building the capacity of commercial MFIs to deliver demand-driven credit, savings and insurance services in a self-sustaining manner.

Accomplishing these priorities requires governments and the donor community to focus on three main tasks: i) providing an enabling environment; ii) improving institutional capacity; and iii) supporting innovation and linkage development.

A. Providing an Enabling Environment

First, efforts are needed to create a policy environment conducive for rural microfinancial intermediation. Macroeconomic stability is key – inflation needs to be kept low and stable and the government needs to maintain a stable currency that is not overvalued. Most important is the government’s maintenance of a supportive policy regime that is committed to financial sector liberalization, including elimination of interest rate controls, and cessation of retailing subsidized, directed microcredit and the privatization of development banks. More specifically, steps must be taken to improve the profitability of rural activities, such as by developing national competitiveness strategies for key growth and export markets. In addition, governments should reduce macro and sectoral risks, improve information flows, and reduce legal impediments to efficient and low-cost intermediation (review minimum initial capitalization requirements for new MFIs, for example) and improve contract enforcement. The framework for security interest in many cases needs to be strengthened and a registry for all kinds of movable goods should be established. Comprehensive credit information bureaus can be of great assistance to the industry, especially as competition emerges.

Donors can help to demonstrate the role that rural finance can play in reducing poverty by supporting empirical studies that determine the correlation between various approaches to rural finance and their impact on poverty alleviation. By broadly disseminating such findings, donors can support the development of an enabling environment for rural microfinance.

B. Improving Institutional Capacity

Second, efforts are needed to improve retail capacity, namely by rewarding the best performers with advanced technical assistance and training, forging links between formal and informal financial institutions, and strengthening existing formal and semi-formal institutions. The

strengthening of financial retail capacity is a clear and fundamental need. Specific areas of concern are governance incentives, quality of business management and development of sound and transparent risk management, internal control and management information systems for financial institutions. No particular institutional type has been dominant in terms of performance in the development finance literature. Therefore institution-building interventions should continue to be multi-pronged and guided largely by country context, the quality of available leadership and commitment to achieving financial self-sufficiency.

To build the supply of financial services, the emphasis of donor intervention is on building the capacity of commercial MFIs 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 commercial MFIs 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 MFIs to reduce dependence on donor funds.

C. Supporting Innovation and Linkages

Third, to reach different segments of diverse rural financial markets, institution-building should also include efforts to encourage the introduction and diffusion of other financial services besides credit, such as deposits, crop insurance, commodity collateralized finance (e.g. warehouse receipts), hedging instruments, and microleasing (IADB, 2001, p. 13). These products hold the potential to assist in risk and liquidity management as well as lowering transaction costs. However, as IADB 2001 points out, newer instruments such as commodity collateralized finance and hedging instruments, must be preceded by strong investments in cash-based agricultural marketing systems and improvements in the legal and regulatory framework.

Institution-building efforts should also support linkages to commercial sources of funds so that MFIs can expand to rural markets in response to demand (e.g., through equity funds for transformation into licensed financial intermediaries and through commercial guarantees for wholesale credit from banks to commercial MFIs). A particularly successful use of loan guarantees supported by USAID's Development Credit Authority (DCA) is detailed in Box 8.

Box 8: Successful Use of Loan Guarantees to expand RMF in Mexico

USAID's Development Credit Authority (DCA) facilitates direct loans and partial loan guarantees to private lenders in order to stimulate new markets and achieve economic development objectives. DCA is a low-cost tool, based on private risk-sharing, to introduce private lenders and investors to creditworthy but underserved markets.

Chemonics' USAID/Mexico Microenterprise Strategy project assisted in the design and implementation of two DCA agreements to expand microfinance in rural as well as urban areas of Mexico. Chemonics assisted USAID with its economic and financial viability analyses of two credit unions, *FinComún* and *Unión de Credito Progreso*, and demonstrated that both were financially self-sufficient and merited investment to expand their operations. The analysis helped to convince USAID to offer 50 percent DCA guarantees to *FinComún* (for a portfolio up to \$2.5 million) and to Wells Fargo Bank Texas to lend \$1 million to the *Unión de Credito Progreso*.

The two DCA agreements were signed in February 2001. Both credit unions have used the guarantees to promote the safety of their institutions to expand their long-term deposit base. *Unión de Credito Progreso* has already placed 668 loans for \$984,000 and has captured an additional \$5.7 million in savings. To offset the exchange risk, it has set aside nine percent of interest received from DCA loans as a reserve fund.

Source: Chemonics International, 2003.

Nevertheless, implementation of the financial systems (or commercial) approach faces special challenges in situations of extreme poverty or crisis where economic opportunities and the conditions for financial systems are lacking. Effective demand for rural financial services is often constrained by poor business skills and services, lack of social capital, and inadequate infrastructure. 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 can help build demand for and ability to utilize rural finance, 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. In remote areas beyond the reach of commercial MFIs, 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 off of indigenous savings systems⁷ and laying a foundation for subsequent relations with commercial MFIs.

V. Conclusion

While some commercial MFIs have managed to overcome some of the constraints to providing rural microfinance, many more barriers must be overcome to significantly expand commercial microfinance in rural areas. Although the challenges of expanding RMF provision by commercial MFIs are formidable, they are not insurmountable. Microfinance practitioners should continue to build on the achievements made to date by those MFIs that have had encouraging results in developing innovative products and delivery methodologies (Table 3).

As these approaches are adapted to other areas and new innovations are developed and tested, the emerging best practices presented here undoubtedly will need to be revised and updated. Continued and expanded government and donor support of commercial MFIs along the lines suggested in this paper will hasten the learning process and help to achieve the goal of broadly serving the financial needs of the world's rural poor.

⁷ Including rotating savings and credit associations (ROSCAS), tontines, susus, chit funds, etc.

Table 3: Emerging Best Practices in Commercial Rural Microfinance

Microcredit Product Design and Delivery

- Full-cost pricing (i.e. higher interest rates for riskier clients)
- Credit decisions taken on the basis of household cashflows and repayment schedules reflect client income cycles
- Use of chattel mortgages on equipment, livestock and household goods
- Use of stepped lending, gradually increasing the size of loans for individuals who repay debt on time
- Use of partial interest rebates have proved to be popular and effective
- Use of technology (e.g. PDAs, smart cards, etc.)

Microsavings Product Design and Delivery

- Recognize savings mobilization as beneficial for the clients (rural poor can and do save) and for the MFI in terms of providing it with a potentially large, stable source of funds
- Design takes into account that clients prefer security, liquidity, and convenience over returns
- Distribute savings boxes to rural savers; lotteries are also popular in rural areas
- Use existing infrastructure where possible to help keep down costs (post offices, ATMs, etc.)
- Use of technology (e.g. debit cards, PDAs, etc.)

General Cost-Saving Innovations

- Branch/outlet location and size (in terms of personnel) dependent on population density/volume of business
- Reduced days/hours and mobile banking employed in areas without sufficient business to merit a full time presence
- Loan officers are carefully chosen from rural areas (with pre-existing knowledge of local farm and non-farm microenterprises) and trained well
- MFI field agents travel to clients or clients travel to the MFI on foot, bus or motorbike

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