

DFID

The purpose of these *Key Sheets* is to provide DFID Natural Resource Advisers with an easy and up-to-date point of reference on issues relating to development in the natural environment.

The sheets are designed for those who are managing change and who are concerned to make well-informed implementation decisions. They aim to distil theoretical debate and field experience so that it becomes easily accessible and useful across a range of situations. Their purpose is to assist in the process of decision-making rather than to provide definitive answers.

The sheets address three broad sets of issues:

- Service Delivery
- Resource Management
- Policy Planning and Implementation

A list of contact details for organisations is provided for each sub-series.



Overview of the debate

Over the past 5 years, the debate about rural finance has focused on:

- Revisiting the notion of credit: it is now viewed as one of a range of financial services to which people should have access, rather than a mechanism to kick-start rural enterprise.
- The importance of providing savings facilities as well as credit to enable people to manage their financial flows better.
- The extent to which the provision of rural finance can reduce poverty, improve food security and empower recipients.
- How to ensure the sustainability of rural financial institutions (including discussion of short- or long-term subsidies to such institutions).
- Whether the provision of financial services should be part of a broader rural development package or a stand-alone intervention.
- Finding ways to reduce the transactions costs of lending to small borrowers while at the same time increasing repayment rates.

Key issues in decision-making

Credit schemes, particularly when integrated into a broader financial services 'package', can materially improve the livelihoods of the poor. However, many credit schemes have failed. To guard against failure it is critical to understand existing financial systems and the debt-bearing capacity of local people. Provision should then be adapted accordingly.

- Are people already accessing credit through the informal sector, traders or savings and credit associations? How successful have these mechanisms been?
- Can target beneficiaries be reached by supporting these or must new systems be introduced?

This will provide initial information. Schemes must then be designed to capture further information on individual debt capacity. A number of mechanisms for doing this have already been established, including working through local agents (who are offered an incentive to share information they already have from other sources or who benefit in other ways from providing credit, in the case of traders who help finance their suppliers) and working with groups whose members provide mutual guarantees.

- Are there individuals within the community who are both well-connected and who have some (semi-)official authority who can act as agents?
- Is the formation of stable groups a viable prospect in the area?

Groups have a number of additional benefits: transactions costs for lenders are reduced and transparency in lending decision-making is increased. However there are costs associated with group formation; these are higher in some societies than others, depending upon underlying social relations (which influence the ease/difficulty of group formation) and the distances people must travel to participate in group activities.

There is no universal formula for the provision of financial services to poorer people, though there is increasing consensus that:

- As far as possible interest rates should be market-determined.
- Lending agencies should be decentralised: credit should be taken to the borrowers and local staff should be empowered to take most lending decisions.
- Credit and savings facilities should be provided in tandem as key components of a broader financial services infrastructure. This will ensure that local capital is utilised productively and will assist local people to meet different needs at different times.

Lenders should not become bogged down with monitoring the exact uses to which loans are put, especially when the loans are small. It is important to establish whether borrowers can afford to repay their loans and to ensure that incentives to repay (eg. peer pressure, repeat loans, collateral, social sanctions) are built into schemes. All financial services schemes must retain the flexibility to adapt over time. Early successes must not be allowed to mask the need for experimentation and learning and schemes must not be expanded too fast.

- Do those administering the schemes have both a detailed understanding of the principles underpinning their work and the authority to make course corrections where necessary?
- Has thought been given to isolating the impact of particular design features?
- Have adequate systems for monitoring repayment rates, group performance etc. been established at the outset?

The provision of financial services in rural areas is problematic because of seasonality, the risks associated with agricultural production and the wide spatial dispersion of potential borrowers

DFID financed research

- Improving financial services for RNR development in Ghana (University of Reading - start 1996)
- How can financial interactions work for the poor? (ODI - start 1997)

DFID project experience

- Pakistan: Aga Khan rural support service project (start 1988)
- Uganda: Financial service associations pilot project (PRIDE Africa - start 1997)
- Kenya: Women in economic development. (CARE - start 1996)
- Ethiopia: Koysha integrated rural development programme (ActionAid - start 1993)
- Swaziland: Women's financial trust (Skillshare Africa - start 1994)
- Philippines: Microenterprise development project (Opportunity Trust - start 1993)
- Bangladesh: Support to Proshika (start 1994)

UK and other expertise

- **NGOs (Accion (USA), ActionAid, Cooperation for Development, Opportunity International, CARE, ITDG)**
- **Springfield Centre, Durham** (Credit Policy and Planning)
- **University of Bath** (James Copestake, Alistair MacGregor, Susan Johnson)
- **University of East Anglia** (Ben Rogaly)
- **USAID** (Beth Rhyne)
- **DFID** (David Wright)

Rural Finance *continued*

(which raises servicing costs considerably). These problems are particularly acute in Africa; there have been few successful experiments with the newer models for financial service provision in rural Africa although in places like Kenya more traditional savings and credit cooperatives do reach large numbers of people. It should, though, be borne in mind that some borrowers in remote and risk prone areas may never have adequate debt capacity. Urging credit on such people should be avoided.

Where there is a need for financial services, these may need to be complemented by a range of other community development interventions or lobbying activities.

- ▶ What other constraints must be addressed for financial service provision to be successful (eg. poor availability and high cost of goods and services; poor market access and low demand; the lack of any risk-reducing mechanisms; low skill levels of borrowers; adverse government policy and regulations governing microenterprises or financial services)?
- ▶ Can any of these be overcome by donor intervention?

Unless they are involved in policy advocacy or are helping to establish national financial frameworks, bilateral donors must usually work through intermediaries in the financial services area (NGOs, formal financial institutions or membership organisations). Given the momentum towards developing a viable long-term financial infrastructure in rural areas and the fact that borrowers are less likely to default if they believe in the permanence of the lending institution, institutional sustainability should be a key consideration when selecting a partner. If there is a choice, it is important to ask:

- ▶ Are there statutory barriers to the involvement of any types of organisation (eg. NGOs may not be permitted to mobilise savings or to receive foreign exchange directly)?
- ▶ Which organisations have existing rural networks and skills relevant to the target intervention (eg. rural banks have financial skills, NGOs may have experience of working with the poor and membership organisations may have existing networks)?
- ▶ What reputation does each organisation have amongst target groups? Are there implications for repayment rates and performance?
- ▶ Will all be equally able to operate without political interference?
- ▶ Do any have other institutional objectives that will complicate their task (eg. NGOs can find it hard to exact repayment if they have other ongoing social programmes with borrowers and banks may be distracted by more profitable lending activities)?

As yet, few rural finance schemes are fully self-financing and organisationally sustainable, though there is progress being made towards meeting these objectives. Some kind of external subsidy – to cover training, administration and start-up costs – is invariably required. Donor support therefore continues to be important.

Seminal literature

- Hulme, D. & P. Mosely (1996) *Finance against Poverty*. London: Routledge. (2 Volumes)
- Johnson, S. & B. Rogaly (1997) *Microfinance and Poverty Reduction*. Oxford: Oxfam.
- Otero, M. & E. Rhyne (1994) *The New World of Microenterprise Finance*. London: Intermediate Technology.
- Yaron, J. (1992) *Rural Finance in Developing Countries*. World Bank WPS 875. Washington D.C.: World Bank Publications.
- Zeller, M. *et al.* (1997) *Rural Finance for Food Security for the Poor*. IFPRI Food Policy Review No.4. Washington D.C.: IFPRI.
- Journal of International Development* special issue on 'Sustainable Banking with the Poor'. Vol. 8, No. 2, March-April 1996.

Key Sheets are available on the Internet at: www.odi.org.uk/keysheets/
or through DFID's website

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