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# **A STRATEGY FOR RURAL FINANCIAL MARKET REFORM: APPLYING THE FINANCIAL SYSTEMS APPROACH IN GHANA**

by  
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## **ABSTRACT**

We construct, using methods advocated in one strand of the Financial Systems Approach literature, a reform-and-renewal program for one of Ghana's struggling Rural Banks--the Kaaseman Rural Bank. Questionnaire results, local informal financial practices, recent institutional innovations in Ghanaian finance, the experiences of successful "Nontraditional" rural finance institutions in developing countries, and the operating structure of the Rural Bank program indicate that this bank can implement a group-lending scheme that will reduce significantly its transaction costs and those of its customers. We thus demonstrate how the Financial Systems Approach can be employed to promote sustainable rural financial intermediation in a specific socioeconomic and institutional setting. The potential for our reform proposals to succeed in the local Ghanaian context is analyzed carefully.

## **I. INTRODUCTION AND LITERATURE REVIEW**

Throughout most of the post-World War II period, governments across the developing world have intervened in rural financial markets (RFMs) in order to promote income expansion and alleviate rural poverty. In many of these efforts, especially during the 1950s, 1960s, and 1970s, the authorities pursued the "Directed Credit Approach." Smallholders were viewed as unable to better themselves (e.g., increase production and productivity, and adopt new technologies) without external assistance in the form of credit, since they were too poor to save. But private banks could not (or would not) lend on appropriate terms to this sector, and thus farmers were forced into the hands of moneylenders. The solution: establish government-owned specialized institutions to provide subsidized credit to the target population.

The uniformly disappointing results of these so-called "traditional rural credit projects" were first exposed in critiques of the Directed Credit Approach associated with the Ohio State School of rural credit in the late 1970s and early 1980s.<sup>1</sup> The so-called "New View" of rural credit that developed out of this literature advocated more careful study of RFMs in terms of the demand for financial services, institutional design, informal financial sector practices, and the role of government policy. In the process, the goals of RFM reform came to be understood as 1) to enhance the efficiency of financial intermediation, and 2) to expand access to financial services--on a sustainable basis--for small farmers, small-scale enterprises, and the rural poor.

By the early 1990s, two general approaches to financial market reform had taken shape. The first, known as "Financial Liberalization", was based upon the theory of "Financial Repression". The second has been labeled the "Financial Systems Approach" or, alternatively, the "Financial Systems Development Approach". Restrictive government policies, theorists in the former tradition argue, are the principal cause of

the shallow, fragmented, and inefficient financial systems plaguing many developing countries (McKinnon 1973). To enhance the efficiency of the financial system and to create more access to financial services for marginalized groups, the prescription is straightforward: liberalize the financial system by eliminating restrictions on interest rates, mandatory sectoral credit allocations, and credit ceilings.<sup>2</sup>

Students of RFMs working in the tradition of the latter approach focus on the key structural features of the economic environment within which Rural Finance Institutions (RFIs) operate. These features--incomplete information, missing markets, and imperfect contract enforcement--influence the nature of savings and credit transactions in important ways. The ability of an RFI to cope with these features thus determines its ability to provide desired financial services to the target population on a widespread and sustained basis. Outreach and financial self-sustainability, therefore, are the criteria to be used when evaluating RFI performance (Yaron 1994). If an RFI does achieve significant outreach on a sustainable basis, analysts in this tradition argue that it is likely to have the desired impact on rural income and poverty.<sup>3</sup>

Adherents to the Financial Systems Approach have grouped themselves into two separate schools of thought. The first, which we call the "Linkage" school, argues that each financial-system segment (formal, informal, semi-formal) has specific comparative advantages in providing financial services. Reform efforts should focus on exploiting these advantages by creating savings and credit linkages among existing formal, semi-formal, and informal financial institutions. Each segment, then, should be encouraged to operate freely within its specialized market niche.<sup>4</sup>

The second strand of Financial Systems Approach thought can be termed the "Learn From Success" school. Advocates of this view argue that locally-successful informal financial sector practices should inform the design and policies of formal RFIs. In addition, the experiences of so-called "Nontraditional" RFIs, which combine features of formal and informal finance to serve small savers and borrowers effectively in many developing countries, should be drawn upon when designing RFM reforms. By adopting and adapting key features of local informal financial practice and successful Nontraditional RFIs, therefore, the outreach and self-sustainability of formal-sector RFIs can be enhanced.<sup>5</sup>

The purpose of this paper is to show how the Learn From Success school of thought can be operationalized in a particular institutional and economic setting. Specifically, we combine widespread informal financial practices in Ghana with some key features of successful Nontraditional RFIs in the developing world to develop a package of policy reforms that has the potential to re-invent one of Ghana's struggling Rural Banks as the institution it was originally intended to be. Our efforts thus constitute a substantive contribution to the Financial Systems Approach literature, for in only a few cases has the knowledge obtained from studying informal financial practices in the developing world and the features of successful RFIs actually been used to redesign the operating procedures of an existing, struggling, formal RFI.<sup>6</sup> Furthermore, the approach we take in developing our reform proposals, essentially that of "demonstrating the possibilities of an appropriate environment" (Braverman & Guasch 1986: 1253), suggests a concrete method of formal-sector RFI reform that may be more feasible in many contexts than attempting to re-engineer an entire rural credit program from the top down.

Ghana's Rural Bank scheme was initiated in 1976, under the auspices of the Bank of Ghana (the country's central bank). The purpose of this program was to serve small borrowers and savers in rural areas, who at the time had essentially no access to institutional savings and credit facilities. RFM specialists would recognize in this program many elements of the Directed Credit Approach. For its time, however, the Rural Bank project was relatively well thought out. Many features of this program, indeed, foreshadowed the yet-to-be developed Financial Systems Approach to RFM intervention.

During its first decade of operations, the Rural Bank program proved, in general, to be a success. By the late 1980s, however, many individual Rural Banks were floundering. The government attempted to reinvigorate the program via a macroeconomic Financial Liberalization effort initiated in 1988 and a comprehensive Rural Bank restructuring exercise begun in 1991. Despite these efforts, in the mid-1990s the 125 Rural Banks in operation were, in general, not fulfilling their promise--and struggling financially (Yeboah 1994), (Essel 1996), and (Aryeetey 1996). We focus our reform proposals in this paper not on the entire Rural Bank program, but rather on one particular Rural Bank--the Kaaseman Rural Bank. This institution was established in 1987, in the heart of a cocoa area in the Western Region, to serve the local cocoa-farming clientele. Our work, therefore, can be considered an example of localized research, conducted within a specific socioeconomic and institutional context, of the sort advocated by Aryeetey & Udry (1994). We take as given these authors' observation that "credit transactions reflect the [specific] economic environment within which they occur", and design our reform-and-renewal program accordingly. We make no claim, therefore, that the specific reforms we advocate for the Kaaseman Rural Bank are generalizable to the Rural Bank scheme as a whole. We thus agree with another adherent to the Financial Systems Approach (Yaron 1994), who reminds students of RFM reform that socioeconomic environments, hence social value systems, are localized and specific. Reforms that prove successful in one setting, therefore, may not work at all in another.

The organization of this paper is as follows. In Section 2 we sketch out the history of institutional rural credit in Ghana. In the process, we focus explicitly on the operations of the Rural Bank program from its inception in 1976 to the mid-1990s. In Section 3 we use secondary and primary data sources to analyze the performance of the Kaaseman Rural Bank in terms of its structure, activities, problems, and future prospects. We construct a specific reform-and-renewal program for this institution in Section 4, and highlight the benefits of our proposals for both the bank and its customers. We conclude in Section 5 by analyzing the potential for our proposed reforms to succeed in the local Ghanaian context, in light of the current structure of the Rural Bank program, recent institutional innovations in Ghanaian finance, and the central lessons drawn from both successful and unsuccessful financial practices in Ghana, Africa, and the developing world.

## II. INSTITUTIONAL RURAL CREDIT IN GHANA, AND THE RURAL BANK PROGRAM

From the 1950s to the 1980s, Ghana employed the Directed Credit approach to intervention in rural credit markets, or what Essel (1996) terms the “Increased Agricultural Production Approach.” Analysts operating in this tradition view the typical Ghanaian smallholder as being able to invest only a small percentage of his/her already-low income. Agricultural output and income, therefore, remain low over time, because farmers are trapped in what Owusu-Acheampong (1986) called the “Little Opportunities Circle”: little capital outlay begets little marketable surplus, little income, and once again little capital outlay. The goal of the Increased Agricultural Production Approach is to break this circle by injecting credit into the farm sector at a point between little income and little capital outlay. The result would be a rise in smallholder disposable income. Savings and investment would increase accordingly, output would expand, farm incomes would rise, and rural poverty would be alleviated. The Bank of Ghana made several attempts in the 1960s and 1970s to implement this approach. For example, it established a Rural Credit Department, charged with mobilizing investment funds for agriculture, in the early 1960s. In 1969 the central bank sponsored a Small Borrower Credit Guarantee scheme through the commercial banks and Development Finance Institutions, in hopes of bringing smallholders within reach of the formal financial sector. The independent Ghana Credit Union, which had been funding investments in rural income-generating activities since 1955, received significant Bank of Ghana financial support in 1974.

During this period the central government implemented additional measures to promote rural development via the Directed Credit Approach. For example, in 1965 the first Development Finance Institution dedicated to agriculture--the Agricultural Development Bank--was established. This bank--a typical “supply-led” financial institution in the tradition of Directed Credit programs around the developing world (Yaron 1994)--was given a mandate to funnel “outside money” (in the form of external grants and loans, and central government funds) to the small-scale rural sector on concessional terms.

These interventions did little to alleviate the problem. By the end of the 1960s, institutional rural credit for smallholders was “nonexistent” according to Okyere (1990), and “virtually absent” according to Essel (1996). Despite all government efforts, including the imposition of sectoral credit-allocation requirements on commercial banks, by the early 1970s only nine percent of all commercial bank and Development Finance Institution credit was going to agriculture. Most of this, moreover, was absorbed by the large-scale, relatively rich farmers.

The formal financial sector, in sum, viewed lending to agriculture as unprofitable. The administrative costs associated with screening, monitoring, and enforcing repayment on small loans dispersed over wide geographic areas were high, along with the perceived default risk. Formal institutions reacted to these costs and risks by imposing burdensome requirements upon would-be borrowers. To qualify for a loan, first of all, a farmer had to be literate: an active current (demand deposit) account at the bank and the ability to provide full business records were standard application

requirements. In addition, would-be borrowers were forced to absorb significant nonfinancial transaction costs such as the time involved in traveling to and from the institution's premises, and the time spent at the institution itself, during the loan-application process. Finally, a farmer was required to put up the title to his/her land as collateral. But most rural dwellers did not (and today still do not) own the land they farm. Institutional credit, therefore, was beyond the reach of Ghana's smallholders. In light of this situation, in 1970 the Bank of Ghana undertook a comprehensive study of the rural credit situation, which resulted in the decision to establish the Rural Bank program in 1976. Each Rural Bank is a unit bank, owned and managed by the local community, with a statutory operating radius of 38 km. The central bank must approve the establishment of an individual Rural Bank, helps to finance it by purchasing shares equal to one-third of the initial share capital, and supervises its operations via the Rural Bank Department. The purposes of the Rural Bank program, according to the Association of Rural Banks (Essel 1996), are

1. To stimulate banking habits among rural dwellers;
2. To mobilize resources locked up in rural areas, for development;
3. To encourage saving among rural dwellers—by providing safe and accessible deposit facilities;
4. To provide credit facilities to small-scale farmers and cottage industrialists operating within the local area.

Rural Banks, therefore, are designed to serve small borrowers and savers. As the Governor of the Bank of Ghana put it in 1987, the Rural Bank program would remove some of the impediments facing farmers in formal credit markets by offering them banking services "at their doorsteps." The Ghanaian press, likewise, was enthusiastic about the program: the scheme was going to be a "God-sent relief [to rural dwellers] from the bureaucracy and out-of-reach demands of the commercial banks," and thus a "golden opportunity" for the Ghanaian farmer to "demonstrate his business acumen" (The Mirror: May 9, 1991; Daily Graphic: May 9, 1987).

The Rural Bank program, clearly, contains many elements of the Directed Credit Approach. Each bank is a formal financial institution, and is subject to all national commercial bank legislation and requirements. Furthermore, each Rural Bank must adhere to specific sectoral credit-allocation requirements: a minimum of 50 percent of its loan portfolio must be in agriculture, a maximum of 20 percent can be in trade and transport, and 30 percent should go to cottage industries.

The Rural Bank scheme, however, is not a classic "traditional rural credit project." Rural Banks, in other words, are not mere disbursement windows for externally-provided funds (i.e., exogenous shocks designed to break the Little Opportunities Circle). Instead, this scheme can be interpreted as an early attempt to employ the Financial Systems Approach to RFM reform and development. The focus of the Rural Bank program is on the creation of institutions (not "project centers") that hopefully will become permanent features of the local economic environment. Each bank's lending resources, for example, are to be generated internally--via explicit efforts to mobilize voluntary savings. Furthermore, each bank's local management has the authority to formulate its own operational policies, pursue branch-office expansion, and

determine loan terms (i.e., sizes, maturities, interest charges)--and thereby tailor its services to local needs. In this vein, Rural Banks are encouraged to engage in group-based lending activities; explicit guidelines governing such activity, similar to those in more well-known group lending schemes such as the Grameen Bank of Bangladesh, are incorporated into the program.

In sum, the overarching purpose of the scheme is to bring desired financial services to local rural communities on a sustainable basis--and hence to enhance the quantity and quality of rural financial intermediation. In this respect the Rural Bank program was ahead of its time, for it included many of the elements of RFI success identified in the Financial Systems Approach literature of the 1980s and 1990s. On the surface, at least, the program appeared built for success.

The first Rural Bank opened for business in 1976, and over the next eleven years (1976-87) the program spread to all 10 regions of the country. By 1987 fourteen percent of the rural population, or 553,000 people, held accounts at 117 Rural Banks across Ghana. Deposits totaled 2.2 billion cedis; deposits per person had climbed 2,913 percent over this period, to reach 3,978 cedis (\$US25.87 at the prevailing exchange rate) in 1987. The program's loan portfolio was valued at 634 million cedis, or \$US4.12 million.

Observers concluded that the program had been "quite successful" in mobilizing savings (Nissanke 1991), and that its provision of safe and secure deposit facilities for rural dwellers was a "major achievement" (Okyere 1990). Moreover, the Rural Bank scheme had contributed to the expansion of agricultural output, because its impact on farm profitability "could not be overemphasized" (Okyere 1990).

The dramatic growth of the scheme during the 1980s, in terms of outreach, can be traced to the Economic Recovery Programme (ERP) initiated by the government in 1983.<sup>7</sup> The Rural Bank program was seized upon as the principal vehicle through which two of the ERP's medium-run goals for agriculture would be pursued:

1. Increases in “the level and efficiency of rural financial intermediation, in order to increase the role of the private sector in agricultural growth, especially small farmers and small rural entrepreneurs” (Okyere 1990: 75);
2. Improvements in the method of producer payment, particularly in the cocoa sector (Ghana’s principal cash crop).

The first of these goals was fully consistent with the original purpose and aims of the Rural Bank scheme. The second led to the government’s decision to have the Rural Banks manage a new cocoa-farmer payment scheme.

When selling cocoa to the Produce Buying Division of the Ghana Cocoa Marketing Board (GCMB-PBD), farmers were now to be paid with a special check--an “Akuafu Check.” At the farmer’s request, the PBD would specify the “beneficiary” of the check--the bank at which the farmer plans to cash the check. The central government would then distribute funds for check-redemption to the Rural Banks in each cocoa area, based upon estimates of the area’s total PBD purchases. The banks would purchase the checks from the farmers (and get reimbursed if the necessary money had not yet arrived), and receive commissions in the process.

The Akuafu Check system represented a marked improvement over previous payment methods.<sup>8</sup> But in most of the more remote cocoa areas, no formal financial institutions existed where farmers could cash their Akuafu Checks. Many farmers were thus forced to bear significant expenses (in terms of travel-time, transport fares, and security) in order to receive payment. The solution to this problem was to establish more Rural Banks in the cocoa areas.

The expansion of the Rural Bank network in the 1980s was thus designed, in part, to facilitate the new cocoa payment method. Furthermore, the banks’ management of the Akuafu Check scheme had the potential to enhance their efforts to develop sustainable credit linkages with local cocoa-farming populations; a significant percentage of each Akuafu Check, hopefully, would be transformed into voluntary savings at the banks.

The initial results of the Akuafu Check-Rural Bank connection were encouraging. Okyere (1990: 76) noted that “prompt payment of cocoa farmers through the Rural Bank system” was leading to more patronage of the banks as financial institutions, and increased deposit-mobilization. By the end of the 1980s, according to Okyere (1990), the cocoa sector had become a “major beneficiary” of the Rural Bank scheme.

A significant loan-recovery problem, however, began to appear in the latter half of the 1980s. Default rates across most of the Rural Banks had become high, and were rising. Some borrowers were unable to repay, due to exogenous factors such as weather and/or market conditions. Other recipients had misapplied their credit, diverting it towards non-productive uses such as land litigation and funeral ceremonies (Essel 1996), and hence were also unable to service their debt. Still others were unwilling to repay. Since the Rural Banks were marketed as “for the communities,” some borrowers “saw nothing wrong in owing their communities (the banks) indefinitely, when the means to repay was not there” (Essel 1996: 46). Finally, Rural Bank credit was often perceived as outside money--grant money provided by the central government out of general tax revenues--that did not need to be repaid.



As a result, the Rural Banks became increasingly reluctant to lend to their target populations (i.e., farmers and fishermen). Instead, the banks diverted their credit to salaried workers (perceived as less risky due to a regular income stream), and to essentially risk-free government securities. By 1991 Rural Bank holdings of such securities comprised 30 percent of all interest-earning assets in the system (Essel 1996). The banks thus increasingly violated the scheme's statutory credit-allocation mandate: from 1977 to 1988 the proportion of total credit extended to agriculture fell in half; by 1988 credit to agriculture comprised only 34 percent of the Rural Banks' combined loan portfolio (Nissanke 1991).

The banks' target groups, not surprisingly, began to lose confidence in the scheme. For example, cocoa farmers began to divert their Akoafo Checks away from the Rural Banks and to the few big urban-based commercial banks that dominate Ghana's formal financial sector, despite the expenses that had to be absorbed. This exacerbated the default problem of the cocoa-area Rural Banks, and hampered their savings-mobilization efforts. The public in general, moreover, had "begun to lose confidence" in some of the Rural Banks by the late 1980s, according to the Governor of the Bank of Ghana. A generalized solvency/liquidity crisis was looming; the President of the Association of Rural Banks reported in a 1989 speech that fully 70 percent of all banks were functioning "below the poverty line."

The central government responded to this crisis by implementing a Rural Finance Project in 1990, funded by the International Development Association. This project was one component of the government's Financial Sector Adjustment Program, initiated in 1988 under the auspices of the IMF and the World Bank, the goals of which were financial liberalization and a restructuring of the formal financial system.

The initial phase of the Rural Finance Project, a comprehensive diagnostic study of each individual Rural Bank during 1991, confirmed the problems. Only two of the 123 banks were in full compliance with the Amended National Banking Law of 1989 (PNDC Law 225), and hence met all statutory capital adequacy, liquidity, and manpower requirements. These two banks, therefore, were the only two to receive the central bank's "Satisfactory" rating at that time. The other 121 banks, rated "Mediocre" by the Bank of Ghana, were suffering from capital inadequacy and/or illiquidity, accumulating losses, and having difficulty meeting the withdrawal demands of depositors.

As the reform effort proceeded during 1991-94, some progress was made. For example, by the end of 1994 nearly half (44 percent) of the 125 Rural Banks in operation at that time were rated Satisfactory. Deposits in the scheme rose 192 percent during these years, and deposits per person stood at 22,500 cedis as of 1994--a 465.5 percent increase over the 1987 level.<sup>9</sup>

But problems persisted. Over half (56 percent) of the Rural Banks were still not in compliance with PNDC Law 225 by the end of 1994. Nineteen of these, moreover, had become officially categorized as "Distressed"--they were insolvent, accumulating heavy losses, unable (in the judgement of the central bank) to be repaired by capital injections or restructuring, and essentially collapsed. Furthermore, credit diversion by the banks continued unabated. By 1994 41.4 percent of all interest-earning assets held by the Rural Banks consisted of government securities. Total loans and advances had

fallen to only 48.5 percent of deposits, more evidence of the banks' continued reluctance to lend to their target populations.

Customer-Rural Bank relations as of 1994, therefore, were characterized by generalized "mistrust" (Essel 1996). The sporadic but spectacular cases of misappropriation and embezzlement of funds by bank officials that received national attention in the press during the early 1990s added fuel to the fire, so to speak. The cocoa farmers, as a result, continued to disengage from the scheme by diverting their Akafo Checks away from the Rural Banks. During the 1991/2 cocoa season, for example, the 89 Rural Banks in cocoa areas purchased only 33 percent of the value of all Akafo Checks issued in the country.

The central bank responded by implementing a restructuring program in 1994. This was an attempt "to arrest the situation before people totally lose confidence in the Rural Banks" (Essel 1996: 70). For example, by 1995 the Bank of Ghana had scaled back significantly the lending operations of the Mediocre banks, and suspended entirely all lending by Distressed banks. To protect depositors in the short term, most of these institutions' mobilized resources were channeled into safe government securities. Distressed Rural Banks, moreover, had to accept mandatory staffing reductions to cut administrative expenses.

As of 1996 the government sought to deepen this reform effort by implementing yet more restructuring measures: the central bank focused on making sure that Satisfactory Rural Banks remained in strict compliance with all commercial banking laws and regulations; with respect to the Mediocre and Distressed banks, the government continued to emphasize retrenchment and curtailment of operations. In terms of the Rural Bank scheme as a whole, the Bank of Ghana did not pursue a re-engineering strategy, nor did it seek to re-invent the program as the one it was originally intended to be. The government's response to the Rural Bank crisis during 1994-96, therefore, was similar to governmental responses to formal financial sector problems throughout Africa during these years: on a bank-by-bank basis the government focused on repairing the damage to, and strengthening, the formal financial system; at the macroeconomic level financial liberalization was pursued (African Development Bank 1994), (Aryeetey et al 1997).

### **III. CASE STUDY: THE KAASEMAN RURAL BANK**

#### ***Structure and Operations***

The Kaaseman Rural Bank (KRB) commenced operations on November 3, 1987. Located in Ghana's Western Region, just south of the regional border with Brong-Ahafo and along the international border with the Cote d'Ivoire, the KRB was originally established to serve cocoa farmers in the Kaase Cocoa District (KCD). As of mid-1994 the bank was operating eight branch offices: three within the KCD, four outside the KCD and within the Western Region, and one in Brong-Ahafo. The KRB's current operating radius exceeds 100 km.

The bank's clientele consists of traders, civil servants (e.g., teachers, GCMB personnel, agricultural extension officers, policemen, and customs officials) and, most importantly, cocoa farmers. As of 1994 there were 9,710 cocoa farmers within the KCD, and another 11,700 farmed outside the KCD but within the bank's extended

service area. Depending on the branch, these farmers comprise between 50 percent and 95 percent of the KRB's customers; 75 percent of the bank's total clientele is engaged in cocoa farming.

To study the operations of the KRB, we used both published data and survey data collected through formal and informal interviewing activities. The published sources we consulted included copies of the bank's Annual Reports for the years 1990/91-1993/94, additional records kept by the KRB up through August 1994, and official PBD cocoa purchasing and producer price records for the KCD during the period 1990/91-1993/94. We supplemented this information by administering a questionnaire to each of the KRB's branch heads, the bank's Head Accountant, and one other headquarters staff member. In this questionnaire we asked about the KRB's relations with its local farmer-borrowers, the sizes and types of loans granted, collateral requirements, the bank's perspective on the key sources of difficulty in the loan-granting and recovery processes, and the bank's plans for improving performance. We also sought to learn how the Akuafu Check system operates, what the bank officials perceive to be its central problems, and their thoughts on its future. To flesh out this information, we interviewed several local GCMB-PBD agents and officials of the Kakum Rural Bank (see the Essel & Newsome article in this issue) on an informal basis.

Finally, during late 1993 and early 1994 we administered a questionnaire to a sample of 40 cocoa farmers--five chosen at random from each of the eight areas in which the KRB operates. During these interviews we focused on each farmer's personal history, farming activities, and relations with the KRB and other financial institutions. We sought information about the services each respondent obtains from the KRB, his/her access to credit, any problems they had experienced in their dealings with the KRB, and their future banking plans.

The KRB offers its cocoa-farming customers Akuafu Check cashing services, and its entire clientele has access to deposit and loan facilities. As of March 1994, the KRB had mobilized a total of 292.4 million cedis (\$US302,000 at the prevailing exchange rate) in deposits, held in 18,269 savings and current (demand deposit) accounts. Deposits per person thus equaled 16,006 cedis, or \$US16.53. Savings accounts, which have paid nominal interest of between 10 and 15 percent per year so far in the 1990s, predominate: 86 percent of all active accounts, as of March 1994, were savings accounts.<sup>10</sup> Between 90 percent and 95 percent of these, according to KRB officials, are operated by cocoa farmers. Thus between 14,000 and 15,000 cocoa farmers--roughly two-thirds of all the farmers in the bank's extended service area--bank at the KRB.

The KRB's loan portfolio, as of mid-1994, stood at 333 million cedis (\$US344,000). The majority (61.5 percent) of these loans were scheduled, whereas overdrafts comprised the rest. All loans had maturities of less than one year, and ranged in size (according to KRB officials) from 20,000 cedis (on the order of 20 dollars) to 8 million cedis (over \$US8,200). Regardless of size, each loan carried an annual nominal interest rate of 30 percent during 1992/3 and 1993/4, up from 26 percent the previous two years. The real interest rate on KRB loans, as of mid-1994, was slightly over 6 percent.

To obtain a loan a cocoa farmer has to put up the title to his/her farm or dwelling house as collateral--or provide a "guarantor" who can put up such collateral.

Repayment is secured through deductions from the debtor's savings account and/or from the farmer's next Akafo Check cashed at the KRB.

One of the primary goals of the KRB has been to provide local cocoa farmers with a dependable Akafo Check cashing service. Prior to the establishment of the KRB, there were no institutional banking facilities within the KCD--which meant that the cocoa farmers were unable to cash their Akafo Checks without expensive, arduous, and long (50-100 km or more) journeys outside the KCD to large towns in the southwest part of Brong-Ahafo or to Essam, situated south of the KCD. The bank's branch-office expansion efforts, likewise, have been designed *inter alia* to accommodate the regional cocoa farmers' need for an Akafo Check cashing service.

To summarize the current financial position of the KRB, consider how it ranks against the average Rural Bank as of 1994. The KRB is bigger, by far, in terms of number of accounts, total deposits, and loan portfolio. The average Rural Bank has only 5,700 account-holders, 128 million cedis in deposits, and outstanding loans totaling 62 million cedis. These figures are 31.2 percent, 43.8 percent, and 18.6 percent, respectively, of the KRB's totals. In terms of deposits per person, however, the KRB lags behind; the average Rural Bank held 22,500 cedis (\$US23.24) on deposit per person as of 1994, a figure 40 percent again as large as that of the KRB. Overall, the KRB was rated Satisfactory by the central bank in 1994, whereas the average Rural Bank was ranked in the Mediocre category.

Turning now to the cocoa farmers in our study area, we note first of all that literacy is practically non-existent. Furthermore, they do not own title to the land they farm.<sup>11</sup> The typical farmer in our research sample, more specifically, is male, 45 years old, illiterate, and does not own title to his farmland. He has been growing cocoa for 21 years, and his farm help includes both hired labor and family members.

All are members of officially-constituted "Societies," which function as the agents for the cocoa farmers in their dealings with the GCMB-PBD. The 164 Societies registered with the local marketing board and the KRB each contain between 100 and 200 members, with the average Society size being 130. All area cocoa is sold to the GCMB-PBD at Society offices. Each farmer is free to join the Society of his/her choice, but is subject to a common membership fee: during cocoa sales each Society withholds as dues 1 kg of cocoa per 64-kg bag weighed.

Thirty-five of the forty farmers in our sample (87.5 percent) bank at the KRB. All hold savings accounts. When asked why they operate these accounts, the farmers gave the following reasons (in order of prevalence): to facilitate the cashing of Akafo Checks (94 percent); to obtain credit (80 percent); to safeguard their money (28.6 percent).

Twenty-nine of the thirty-five farmers in our sample who bank with the KRB, or 83 percent, have applied at least once for a loan from the bank. In each and every case, the farmer wanted KRB credit in order to finance "lean season" farm-improvement work (e.g., purchases of inputs such as pesticides, general maintenance and weeding under the trees, expansion of land under cultivation).<sup>12</sup> Only 11 (31 percent) of these farmers have been granted a loan, and each only once.<sup>13</sup> These loans ranged in maturity from one to seven months, with an average maturity of a little over four months. Two loans were for only 10,000 cedis (half the size of the smallest reported loan by KRB officials), the largest was for 300,000 cedis, and the average loan amount

was 104,000 cedis. When we asked the recipients if this credit was sufficient for their desired farm-improvement work, ten of the eleven answered “No.”

With respect to their use of the loans, only five actually used the credit for the stated purpose. The other six borrowers diverted their loans towards school fees, marriage, medical expenses, and the settling of other debts. Repayment problems were reported by half of the borrowers. The sources of these problems, according to them, could be traced to loans that (in order of importance) were 1) too small, 2) too short-term, and 3) carried charges that were too stiff.<sup>14</sup>

Finally, the farmers in our sample who bank at the KRB do not believe that the bank is providing them with a dependable Akuafu Check cashing service. Specifically, over 90 percent stated that they experienced at least some difficulty in cashing their Akuafu Checks at the bank, and fully two-thirds reported “much difficulty.” Only three farmers, in fact, indicated that they have experienced “no difficulty” in cashing their Akuafu Checks.

### ***Sources of Difficulty***

As far as the cocoa farmers are concerned, the KRB does not provide them with the services they desire, namely dependable Akuafu Check cashing and access to farm-improvement loans. With respect to the latter, two points are in order. First, KRB credit is, essentially, beyond the reach of cocoa farmers. Loan applicants, for example, must conduct their business on the bank's premises, during business hours. The process itself is cumbersome, detailed, and requires literacy (or the help of a literate friend). In addition, applicants must purchase all the necessary forms themselves. These non-interest transaction costs probably dominate the explicit interest charges in total borrowing costs.<sup>15</sup> The KRB's collateral requirements, moreover, make credit unavailable to many cocoa farmers at *any* price. As a result of these factors, perhaps, three farmers in our sample who are currently not seeking loans from the bank are actually “discouraged loan-seekers”: each reported that “Others do not get approved for loans, so why should I even try to obtain one”? Second, if a farmer is lucky enough to succeed in obtaining credit, the loan is not tailored to his/her specific farm-improvement needs.

To compound the situation, the farmers do not understand why the KRB does not provide the desired services. When we asked the farmers in our sample why they experienced difficulty in cashing Akuafu Checks, their responses ranged from “no idea” to “the KRB lies,” “the KRB does not care for farmers,” and KRB corruption. Of the 17 who commented on why the bank turned them down for loans, only three stated that it was for lack of collateral, whereas 14 claimed that they had “no idea.”<sup>16</sup>

As a result, the farmers are losing confidence in the KRB. This has manifested itself in several ways. First, Akuafu Check diversion is on the rise, depriving the bank of the chance to capture at least some of these funds as voluntary savings. During the 1990/91 season, the KRB purchased 61 percent of all checks issued to KCD farmers, but by 1993/94 only 46.2 percent of the KCD's Akuafu Checks were being redeemed at the bank. In early 1995, moreover, the KRB officials estimated that the bank was going to purchase only 24 percent of the Akuafu Checks issued to farmers across its extended service area during the 1994/95 season. But diversion is costly for the farmers: aside from the KRB, even today the nearest formal financial institutions are at

least a full day's arduous and expensive journey away. The fact that check diversion has been occurring on such a large scale, therefore, is indicative of how mistrustful the farmers are of the KRB.

Second, when farmers are able to cash their Akuafu Checks at the KRB, they withdraw as much money as possible--for fear that funds will not be available later. This withdrawal activity, in tandem with increased Akuafu Check diversion, indicates that the farmers have cut back their saving with the KRB. The bank's savings-mobilization efforts have, accordingly, been impaired. Indeed, the dollar-value of savings deposits per person has fallen steadily throughout the 1990s. As of March 1994 this figure stood at only 36 percent of its 1991 peak value (and at 39 percent of the average savings deposit per person during 1990 and 1991).

Third, the KRB's default rate, according to the bank officials we interviewed, has begun to increase.<sup>17</sup> Some farmers who manage to obtain credit from the KRB do not feel obliged to repay. These individuals believe they are getting a government grant, or simply a long-overdue Akuafu Check payment. Others, who have diverted their loans to non-productive uses, default because they cannot repay. Regardless of the reason, defaulting is easy: the farmer can simply divert future Akuafu Checks to another financial institution.

Default-by-check-diversion has damaged the KRB's solvency and liquidity positions. To some extent, therefore, the ability of the bank to honor its customers' deposit-withdrawal requests has been compromised. Many of the farmers we interviewed, indeed, commented on the difficulty they have experienced in making withdrawals from their accounts.

Finally, two-thirds of the cocoa farmers in our sample who currently bank with the KRB are planning to switch banks in the near future. Three of the five members of our sample not now banking with the KRB, moreover, used to hold savings accounts and cash their Akuafu Checks at the bank but have already severed all ties. These three have switched, and 23 others in our sample plan to do the same, because of difficulties they have experienced with respect to (in order of importance) obtaining credit and cashing Akuafu Checks. One other farmer indicated that although he would like to switch banks he is not going to--because in his view no other financial institution is near enough for him to use on a regular basis. He feels trapped.

The KRB, however, considers itself a victim primarily of external circumstances. From the bank's perspective, the Akuafu Check scheme is an exogenous factor impinging on the KRB's performance. Bank officials, for example, have tried to point out to the farmers that difficulties in cashing Akuafu Checks can be traced, primarily, to late-arriving and/or insufficient government check-redemption funds.<sup>18</sup> Exacerbating this problem is the lack of funds at the bank to proceed with check purchases in the absence of external check-redemption money, because Akuafu Check purchases by the KRB mark the beginning of the seasonal inflow of deposits and thus the end of the bank's own "lean season." Deposits thus flow into the bank during the cocoa season, and the accumulated funds peak around December. The farmers then begin drawing down their deposits for expenses: by March the bank's deposit-level is at its annual average point, and from June through August there are barely enough funds in the bank to keep existing accounts from being closed. The KRB's inability to cash its

customers' Akafo Checks at the beginning of the cocoa season appears to be driven, therefore, by exogenous factors.

With respect to loan recovery, bank officials believe that the rising default rate stems from (in order of importance): poor weather, difficulty in monitoring loans, and Akafo Check diversion. The first and last of these factors are beyond the control of the KRB; lack of resources, inadequate staff training, and severe transport and communications difficulties<sup>19</sup> render the bank unable, in general, to monitor loans effectively. A sense of helplessness pervaded the officials' responses to our queries about the default problem.

When asked about the bank's future plans, officials stated that they are determined to improve the loan-recovery rate at all costs. The KRB has, for example, resolved to take legal action against any defaulter. In order to increase the likelihood that assets can be confiscated in event of nonpayment, the collateral requirement for all new loans is to be raised to documentary proof of farm and/or house ownership (i.e., the "guarantor" option is to be eliminated). These measures, however, are difficult if not impossible to implement effectively, especially in the African context (Adams et al 1984), (Besley 1994). The fact that the bank is even considering such action, therefore, may reflect how desperate the bank officials perceive the situation to be.

We conclude from the KRB and cocoa-farmer interview results that even though the KRB has achieved the central bank's highest rating and is in compliance with all national banking legislation, significant problems--most of which are similar to those faced by many Rural Banks, and to those faced by the cocoa-area Rural Banks in particular--plague the bank. The KRB's ability to function as a genuine financial intermediary--and to provide desired financial services to the target population on a sustained basis--has been impaired. Indeed, as one KRB official put it, the bank currently functions as a "payment center" rather than as a savings-mobilizer. Finally, the KRB has not been able to educate its farmer-customers as to its purposes, activities, and the constraints under which it operates.

Given the current attitudes and future plans of both the KRB and the cocoa farmers, we believe that the situation has the potential to deteriorate quickly. The KRB's reluctance to extend credit to farmers at the needed time and on appropriate terms is likely to rise, and because of late and/or insufficient deliveries of government funds, the KRB may continue to experience difficulty redeeming Akafo Checks quickly. If so, the farmers' confidence in the bank will continue to fall, and their mistrust will grow. As a result, the average account-balance at the bank will continue to fall, more Akafo Checks will be diverted every cocoa season, and the lending capability of the KRB will fall. The bank will thus find it harder every season to redeem Akafo Checks without timely and sufficient deliveries of external funds. The result will be yet more diversion of Akafo Checks, less savings-mobilization, a deepening liquidity problem, and less credit-extension to farmers, all in an atmosphere of growing mutual mistrust. The KRB could thus easily lose its Satisfactory rating, slip down into the Mediocre category, and experience a solvency/liquidity crisis.

#### **IV. A REFORM-AND-RENEWAL PROGRAM FOR THE KRB**

We conclude, however, that the KRB is far from doomed to such a fate. The bank's potential to meet the financial-services needs of its cocoa-farming clientele remains intact, despite key features of its economic environment (e.g., covariant risk, lack of information, imperfect contract enforcement, the Akoafo Check program, the rules and regulations of the Rural Bank scheme) that impinge upon its performance. The KRB can, we believe, enhance its outreach to the target population without sacrificing (and possibly moving closer to) its goal of financial self-sustainability.

In order to move itself towards becoming a valuable and permanent fixture of the local economic landscape, the bank must modify its lending procedures. The necessary changes are, fortunately, relatively easy to make--and feasible within the current structure of the Rural Bank program. They can thus be implemented by the KRB directly, without any need for consultation with the central bank or any other government agency.

In constructing our reform package for the KRB, we employ what we have called earlier the Learn From Success school of RFI reform developed in one strand of the Financial Systems Approach literature. In the process, we heed Yaron's (1994: 68-9) warning that "the quest for [workable policy reforms] should involve a careful review of the past track record of similar programs in the country involved and the targeted clientele's experience and perception of the moral obligation associated with loan collection." We thus follow the advice of the World Bank (1989) by advocating only those measures that build upon, rather than supplant, extant and successful financial traditions in Ghana.

More specifically, we incorporate into the local KRB/cocoa farmer context (with the necessary adaptations), the following:

1. Current, widespread practices in Ghanaian informal finance, given that the informal financial sector dominates the provision of financial services to small borrowers/savers, and to rural households and businesses;
2. Some of the key operating features of Nontraditional financial institutions in developing countries that serve small borrowers/savers and microenterprises successfully by combining features of formal and informal finance.

##### ***Reform Specifics***

We believe that one key feature of the KRB's current operating environment--the fact that all cocoa farmers in the bank's extended service currently belong to officially-constituted Societies--can be exploited to establish a successful group-lending scheme. First, these groups are homogeneous: all members have the same occupation, similar incomes, similar demands for financial services, and live in the local area. Second, these Societies have been in existence for years, perform specific non-credit-related functions (e.g., all cocoa-purchasing by the GCMB-PBD is done through the Societies, at each Society's office), and finance their operations through membership dues. Several of the success-factors for group lending that have been identified in the literature are thus present.<sup>20</sup> Furthermore, lending to individuals in a group context is a common practice in Ghanaian informal finance. Many households and small



savers/borrowers participate in one of two variants of the *Susu* system of savings and credit: the traditional “Rotating Savings and Credit Association” (ROSCA) version, and the so-called “Welfare-*Susu*” (Gabianu 1990), (Aryeetey & Hyuha 1991), (African Development Bank 1997), and (Aryeetey et al 1997). Should KRB officials decide to open discussions with the Societies on group lending, the cocoa farmers would find themselves--for possibly the first time ever, when dealing with a formal financial institution--on comfortable, familiar ground.

We propose, therefore, that the KRB cease dealing with individual farmers-as-borrowers and lend to the cocoa subsector via the Societies themselves. Since the Rural Bank program requires the KRB to allocate a minimum of 50 percent of its new loan funds each year to local cocoa farmers, the bank could simply distribute this amount of money equally across the Societies (or across a rotating subset of Societies) each year. Each Society could then act as a ROSCA-*Susu* by allocating the available credit across its membership on a rotating basis and enforcing repayment. Each Society would thus serve as the agent for its individual members-as-borrowers, just as it now serves as the agent for its members-as-sellers.

In order to qualify for credit, each Society would be required to place its collected membership dues on deposit with the KRB. The amount of credit available to the Society as a whole would then be made an increasing function of the Society's “Dues Account.” This procedure is, in the language of early Financial Systems Approach analysts adhering to the Learn From Success school (Adams & Fitchett 1992), an application of the lesson of “discipline” from informal finance: each Society must learn to *save first*--and thereby *earn* its creditworthiness--in order to qualify for access to credit. Alternatively, this requirement could be interpreted as a “market interlinkage” that helps resolve the adverse selection problem by providing the lender with information about the riskiness of the borrower.<sup>21</sup>

Individual cocoa farmers, therefore, would be eligible for KRB credit simply by being Society members in good standing (i.e., dues-payers). The criteria for obtaining credit would thus be clear and obvious--which would go a long way towards eliminating the mistrust and misunderstanding that currently pervades bank-farmer relations. But, would this mechanism be familiar, and acceptable, to the KRB's cocoa-farming clientele? Yes: not only do the ROSCA-*Susu* and Welfare-*Susu* systems require members to save first before obtaining credit, but the single most widespread informal financial institution in Ghana--the Single Collector *Susu* System--provides credit only to those who have accumulated prior savings with their individual Collectors (Gabianu 1990), (Aryeetey & Hyuha 1991), (Aryeetey & Udry 1994), (African Development Bank 1997), and (Aryeetey et al 1997). Furthermore, the evidence indicates that rural Ghanaians save in substantial amounts (Nissanke 1991), and that anywhere from 60 percent to 95 percent of their financial savings is mobilized via informal finance (Nissanke 1991), (Aryeetey & Hyuha 1991). It is likely, therefore, that a clear majority of the KRB's cocoa-farmer customers currently save--in order to safeguard their money and to obtain credit--with a local “*Susuman*.”

Borrowing from successful Nontraditional financial institution practice ([e.g., Rhyne & Otero (1992), Berenbach & Guzman (1994), Yaron (1994), Yaron et al (1998)], we recommend that all loan application, processing, disbursement, and recovery activities be decentralized--conducted at Society offices, during the cocoa season--

rather than on the premises of the KRB. This reform not only reduces the non-interest transaction costs absorbed by individual farmer-borrowers, it also has the potential to enhance, immediately, the prospects for loan recovery.

Since the Society Clerk has records on each individual member, when a member-borrower sells his/her cocoa to the GCMB-PBD at the office the Clerk can simply specify the amount of the farmer's Akuafu Check to be withheld for dues (as the Clerk currently does), *and loan-servicing*. These funds would then be deposited into the Society's Dues Account at the KRB. All loan-repayments, therefore, would be made directly from the Society's Dues Account--its effective "Loan Servicing Account"--via deductions by the KRB itself. This procedure thus bypasses the problem of the farmer's ability to specify the beneficiary of the Akuafu Check: even if the farmer diverts his/her Akuafu Check to another institution, the KRB receives its loan repayments.

Borrowers, of course, can still default. But to default in this scheme would require a farmer to bypass the legal cocoa-marketing channel and, in effect, withdraw from the GCMB-PBD Society system. To further mitigate default risk, we recommend that the KRB drop its reliance on traditional physical-asset collateral (an often ineffective enforcement incentive anyway, as the bank's officials themselves acknowledge), and instead motivate recovery by combining two indirect repayment incentives. First, if a borrower defaults, s/he would lose access to future KRB credit. This sanction has proven effective in both informal and Nontraditional finance settings in many developing countries, and is the reason most often specified by informal-sector borrowers in Africa when asked why they repay (Rhyne & Otero 1992), (Berenbach & Guzman 1994), (Aryeetey & Udry 1994), and (Aryeetey 1996). Second, if a borrower defaults, his/her *Society as a whole* would lose access to future credit. We thus incorporate the principle of joint liability into our group-lending proposal: each Society would guarantee the individual loans made to its members, and each Society's access to future credit would be a function of the Society's ability to meet its current debt obligations to the KRB.

But, as Yaron (1994), Berenbach & Guzman (1994), and Aryeetey & Udry (1994) point out, joint liability can motivate individual repayment only in cohesive social groups to which the lender provides benefits that can indeed be cut off from all members in the event of default. Leaving aside until Section 5 the issue of the social cohesiveness of the farmer Societies, does the KRB have this sort of "leverage" over its cocoa-farmer customers' Yes: our survey data indicate that alternative sources of credit *for farm-improvement purposes* are not readily available to the bank's cocoa farmers. In the absence of KRB loans, 29 of the 35 KRB customers in our sample reported that their only source of farm-improvement credit was "own savings," and four of the others stated that they obtained the necessary financing from a combination of own savings and loans from relatives/friends. Only one farmer relied exclusively on loans from relatives/friends to fund farm-improvement activities, in the absence of KRB credit.

These data are consistent with the finding of Nisanke (1991), Aryeetey & Udry (1994), and Aryeetey et al (1997) that informal finance in Africa does not, in general, provide the type of medium-size, medium-term financing for investment purposes that is desired by borrowers such as the KRB's cocoa farmers. We conclude, therefore, that cutting off the entire Society's access to future KRB credit in the event of individual default will "bite." As a result, social sanctions imposed on a would-be defaulter by the

group--in the form of peer pressure to repay, in combination with the threat of expulsion from the group--are likely to be severe, and effective.

### **Benefits**

Our reform-and-renewal program promises to reduce significantly the transaction costs faced by both the KRB and its borrowers. The local small-scale cocoa sector would thus be brought within reach of the KRB as a lending institution, and KRB credit would be brought within reach of individual farmers. Implementing our policy recommendations should therefore put the KRB back on the road to becoming a genuine financial intermediary that provides its cocoa-farming clientele with the financial services it demands, on a sustained basis.

The benefits to the KRB include significant reductions in loan-administration costs and default risk. The bank would no longer need to expend resources screening potential borrowers, for the Societies themselves would perform this function. Each group, moreover, would be in a better position than the KRB to determine its individual members' creditworthiness--because of detailed knowledge of cocoa farming, and specific knowledge of members' economic and financial circumstances. The task of loan-monitoring, likewise, would be left to the cocoa farmers themselves. Given the joint liability feature of our group-lending scheme, the bank could rely on the incentive members would have to engage in peer-monitoring.<sup>22</sup> Finally, enforcement costs and problems would be minimized. The indirect repayment incentive mechanisms built into our proposal put the burden of loan recovery upon the Societies themselves, insure that defaulters will lose valuable benefits that only the KRB can provide, and harness the forces of peer pressure and social sanction to motivate repayment.

In sum, our group-lending proposal should mitigate the problems of imperfect information and imperfect contract enforcement that have given rise to the KRB's reluctance to lend to local cocoa farmers. By employing what Yaron (1994: 68) refers to as a "social mechanism that lowers transaction costs while supplying effective peer pressure for screening loan applicants and collecting loans," not only should the KRB's outreach to its target population be enhanced, but its financial position strengthened as well.

From the perspective of an individual cocoa farmer, KRB credit would be more *accessible*, and more *convenient* to obtain.<sup>23</sup> For example, the loan-application process would take place at the Society's office (a regular place of business for members) between Society members, and hence with a minimum of formality. In addition, prospective borrowers would no longer be required to provide what they often cannot (i.e., traditional collateral--due to poorly-defined property rights, and detailed business records--due to illiteracy), in order to be eligible for credit.

Borrowers, moreover, would likely obtain access to *more appropriate* credit facilities, for at least three reasons. First, because all loan transactions would be conducted at Society offices during the cocoa-selling season, the cocoa farmers would be able to obtain credit *when* they demand it.<sup>24</sup> Second, each Society would be free to allocate its total amount of credit across members so as to guarantee that each recipient obtains an amount sufficient to fund his/her farm-improvement needs. Third, Societies would have an incentive, and the ability, to permit longer-term borrowing by individuals (desired by all the farmers in our sample)--even if the KRB maintains its

short-term maturity policy. The possibility of access to a longer-term loan in the future could be incentive enough for current non-borrowers in a Society to tax themselves willingly (to service the debts of fellow members), so that Societal repayment performance can be maintained, and access to future credit assured, even as some members make long-term use of credit.<sup>25</sup>

Because farmers would understand clearly the criteria for obtaining credit, and would begin to obtain the specific financial services from the KRB that they demand, it is likely that less Akuafu Check diversion would take place over time. More cocoa money would thus be transformed into voluntary savings, and the total amount of credit available for cocoa farmers would therefore begin to expand. The farmers' incentive to save at the KRB would thus rise further, and a "virtuous circle" could begin to operate: more saving would beget more credit, less diversion of Akuafu Checks, and thus even more saving and more credit year-by-year. The area's cocoa farmers would finally be given the "golden opportunity to demonstrate their business acumen" that the KRB is supposed to provide, and the bank would be on its way to becoming a viable, dependable source of desired financial services for the local population.

## V. CONCLUSION

The potential for this reform-and-renewal program to succeed in the rural Ghanaian context, we believe, is great. First, it can be implemented by the KRB within the current operating framework of the Rural Bank scheme. The central bank's 1985 Operational Manual for Rural Banks makes explicit allowance for group lending under conditions of joint liability. The Manual, in fact, provides specific guidelines for each bank to follow, should it desire to pursue this practice. Second, students of RFMs within Ghana have advocated group lending repeatedly. Owusu-Acheampong (1986), in his study of rural finance in Ghana, was optimistic about the potential for this practice to be a success. More recently, Essel (1996: 36) notes that group-lending schemes have been "gradually gaining ground among the Rural Banks," and that the benefits reaped by the banks and their customers to date have been significant. He concludes his careful analysis of the Rural Bank program by arguing that the banks should "intensify efforts" to establish group-based lending programs.

Finally, we have observed that our Learn From Success approach has already been employed in Ghana, with, in some cases, excellent results. For example, the State Insurance Corporation launched a savings-and-credit scheme known as the "Money Back" program in February 1987, which was patterned directly after the Single Collector *Susu* System. The initial response was encouraging, and by the end of the decade Gbalianu (1990) could report that there were, in general, "no problems" with the scheme in practice. In the late 1980s the privately-run Bamask Company also employed the techniques of the Single Collector *Susu* System to reach small savers-cum-borrowers in Ghana. The program proved hugely popular: within its first three years of operation Bamask had established branches in nine of the ten regions in Ghana, and by the end of the 1980s more than 30 companies offering a similar service had been established (Gbalianu 1990). With respect to group lending by formal financial institutions, the Agricultural Development Bank itself has begun to employ this

practice in its dealings with farmers, along lines similar to those we advocate for the KRB.

The central question, however, that must be tackled when analyzing the prospects for our reform-and-renewal program is this: *To what extent will the cocoa-farmer Societies function effectively, within the framework of this group-lending scheme?* To make this program successful, each Society must be able to manage its credit, meet the needs of its individual members, conduct loan transactions competently, and motivate recovery effectively. The Societies are thus partners with the KRB in this program, with commitments to fulfill. *Will they be able to do so?* For any group lending program to succeed, the groups must be kept small enough to enable cohesiveness to develop over time, permit the free flow of information among members, and minimize free-rider problems (Berenbach & Guzman 1994), (Yaron 1994), (Mutua 1994), and (Aryeetey 1996). The well-known and well-chronicled Grameen Bank of Bangladesh, for example, operates with groups of five. The farmer-groups that Thailand's Bank for Agriculture and Agricultural Cooperatives has been lending to successfully since 1966 contain no more than 30 members. Kenya's Juhudi Credit Scheme, in operation since 1991, also limits its groups to 30. The regulations governing group lending by Ghana's Rural Banks, indeed, specify that the groups can contain no more than 20 members each.

How a group is formed is also crucial to the success of a program. A hallmark of successful programs in developing countries has been group self-formation. Groups that can choose their own leaders, and have the authority to reject applicants for membership (and expel members who fail to live up to their responsibilities) have the best chance of being able to fulfill the functions required of them (Berenbach & Guzman 1994). Aryeetey & Udry (1994), likewise, emphasize the importance of "pre-screening" by groups; in their review of informal finance in Africa they find that when a group considers a potential new member the key question it asks is not "Can s/he repay?" but rather "Can this person be trusted to meet his/her obligations to the group?"

Allowing individuals to decide for themselves which group to join, on the other hand, can cause a group-based lending program to fail. For example, self-selection can reduce the homogeneity--and hence the social cohesiveness--of the group. In addition, since participants are free to join the group of their choice, each individual group cannot effectively sanction a member in default. S/he can simply drop out, and join another group.

The ability of a group to meet its responsibilities in a joint-liability lending scheme thus depends on its size, homogeneity, the commitment of individual members to the group's goals, and the extent to which reciprocal obligations are morally binding. Groups that are small, homogeneous, and with a committed pre-screened membership are likely to possess (or develop over time) what Besley & Coate (1995) call "social collateral"--which will enable them to manage their credit-related responsibilities well. Groups without the necessary social collateral will in all likelihood prove unable to function effectively.

In setting up a group lending scheme, therefore, one lesson that can be drawn is "do not rush." Putting together such a program on a short-term timetable, with short-term performance objectives in mind, is a recipe for failure: the hurriedly-constituted groups will lack the needed social collateral. The difficulties experienced by the Juhudi

Scheme in Kenya during its start-up phase, for example, resulted from too-rapid group formation in combination with self-selection (Mutua 1994). Aryeetey (1996), in his discussion of donor-financed “innovative credit-retailing schemes” in Africa, notes that rapid expansion of group-lending programs can undermine the forces of peer pressure and social stigma--and hence lead to poor performance.

In light of this analysis, how do the KRB’s cocoa-farmer Societies measure up? First, we address two negatives. The Societies are, of course, too large to function effectively. But they could easily be broken down into the necessary 20-person sub-units. To do this, the KRB could adapt the procedure followed by the now increasingly successful Juhudi Scheme--which embeds smaller sub-units within larger “umbrella” groups. Another problem with the current Society system is that cocoa farmers are free to join the Society of their choice; self-selection is the rule. But this can be changed, too. The KRB can simply mandate that any Society wishing to receive KRB credit must have the authority to pre-screen members and expel defaulters. Cocoa farmers not willing to accept this requirement would become ineligible for KRB credit.

On the positive side, the Societies are socioculturally and economically homogeneous. They have been in existence for years, have an operational infrastructure, and perform specific non-credit-related functions. Furthermore, group-based savings and credit activities are an established feature of Ghanaian informal finance; our proposal does not constitute an alien intrusion from another, qualitatively different socioeconomic environment. Finally, in our proposed scheme individual farmers will obtain access to specific financial services that they expressly demand, but which are not otherwise obtainable. The members of each Society will thus have a strong incentive to develop the social collateral needed for them to manage effectively their collective responsibilities.

But our reform-and-renewal program does not represent a “quick fix” for the KRB’s problems. Both the KRB and the farmers will have to be patient, and learn together how to make it work. As Besley (1994) notes, it takes time in any setting for the participants to acquire the “human and organizational capital” necessary for financial markets to operate effectively.

Regardless, we see no clear alternative route for the KRB to take. Should it pursue “business as usual” the bank runs the risk of falling into a solvency/liquidity crisis, as described in Section 3. Its outreach to cocoa farmers would erode, and its financial self-sustainability would be threatened. Should it pursue retrenchment by raising traditional collateral requirements on loans, taking defaulters to court, limiting its exposure to the cocoa sector, and in general operating more like a Ghanaian commercial bank, the KRB will not be able to fulfill its statutory goals. As Rhyne & Otero (1992: 1569) bluntly state: “No bank will succeed with [small borrowers] by applying its standard operating procedures.”

In conclusion, we note that the KRB is currently in much better financial shape than the average Rural Bank. A solvency/liquidity crisis, requiring short-term emergency measures and genuine retrenchment, does not prevail. Right now, then, is a good time for the KRB to consider our reform proposal, and give it a try. What could the KRB lose by doing so? Not very much. What could the bank lose by not doing so? Potentially, a great deal indeed.

## NOTES

1. See, for example, Adams (1978), Adams & Nehman (1979), Adams & Graham (1981), and Adams et al (1984).
2. For a more complete statement of the theory of Financial Liberalization, see Pill & Pradhan (1997). Nisanke (1991), the African Development Bank (1994), and Aryeetey et al (1997) discuss Financial Liberalization efforts in Africa during the 1980s and 1990s.
3. For a general introduction to this approach, see Braverman & Guasch (1986), Hoff & Stiglitz (1990), Srinivasan (1994), and Besley (1994). Good examples of the Africa-specific literature in this tradition are Udry (1990) and Aryeetey & Udry (1994).
4. Early statements of this view in the African context can be found in Nisanke (1991) and the African Development Bank (1994). The policy views of African adherents to the Linkage school are developed more fully in Aryeetey (1996), the African Development Bank (1997), and Aryeetey et al (1997).
5. The first statements of this position grew out of the aforementioned Ohio State School critiques of Directed Credit, and can be found, e.g., in Adams & Vogel (1986), Padmanabhan (1988), the World Bank (1989), and Adams & Fitchett (1992). Other contributors to this school of thought, who often focus on the effective delivery of credit to microenterprises, are Rhyne & Otero (1992), the contributors to Otero & Rhyne (1994), Riedinger (1994), Yaron (1994), and Yaron et al (1998).
6. This point is emphasized in Adams & Fitchett (1992), Rhyne & Otero (1992), and Riedinger (1994).
7. In April 1983 the government agreed to an International Monetary Fund (IMF)/World Bank-sponsored ERP, in the context of a near-total breakdown of the Ghanaian economy. The ERP was a comprehensive economic reform program concerned with short-term stabilization issues, medium-to-long term structural adjustment, and the rehabilitation of the productive sectors of the economy. It remained in force, although its foci shifted as necessary over time, throughout the 1980s and into the 1990s. See, e.g., Younger (1989), and Kapur, Hadjimichael, Hilbers, Schiff, & Szymczak (1991) for analyses of the ERP.
8. In the past, at times the GCMB-PBD paid farmers with cash delivered from the capital city, but that often led to embezzlement and extortion by PBD clerks. At other times the farmers received "chits" for their cocoa, redeemable by the government at some unspecified future date.
9. The cedi, however, depreciated nearly 530 percent against the dollar during 1987-94, so in dollar terms deposits per person fell roughly 10 percent.
10. Perhaps this is because literacy is required to operate a current account (i.e., to endorse a check).
11. Ever since the late 1950s (when the land in this area was first developed for cocoa farming), land transactions have been conducted orally, with the chief, at Adabokrom. These transactions are informal rental agreements, not land purchases, and are generally sealed with gifts of Schnapps or the local gin. The rents are generally left unspecified.

12. Cocoa farming in Ghana has two seasons: an active growing and harvesting season--the "cocoa season"--which runs roughly from late September to early February, and the off-season or "lean season," from March through early September.
13. Eight of them received their loans during 1992/93, and the other three were given loans in previous years.
14. We do not believe that this last source of repayment difficulty can be separated from the previous two: loans that are too small and short-term for the stated purpose may by definition carry terms that are too stiff--regardless of the interest charges.
15. This has been shown to be true in most institutional rural credit programs in LDCs. See, for example, Adams & Nehman (1979), Adams & Graham (1981), Adams & Vogel (1986), Rhyne & Otero (1992), and Adams & Fitchett (1992).
16. Into this category we place various other responses that indicate a lack of understanding of the process, e.g., "the KRB is always unresponsive to farmers," "the KRB lies to farmers," "the KRB never grants loans to farmers."
17. We could not find specific default rate information in the KRB's Annual Reports, nor could (or would) any bank official provide us with that information.
18. Newspaper reports from cocoa areas all over the country during the early 1990s indicated that many Rural Banks and other financial institutions face this problem. Hence we take statements of the KRB officials on this issue at face value.
19. As of mid-1994, no telephone connections existed between branch offices, and only one office had a working telephone system. Inter-agency communications and loan-monitoring take place via the KRB's lone vehicle, which must ply the few poorly-maintained roads in this area as best it can.
20. Reviews of group-lending practices in LDCs can be found in Padmanabhan (1988), the World Bank (1989), Rhyne & Otero (1992), Riedinger (1994), and Berenbach & Guzman (1994). Srinivasan (1994) also contains a summary of theoretical work on group lending. In Yaron's (1994) review of successful Nontraditional rural finance schemes in Asia, two of the programs he studies involve group lending. Aryeetey (1996) and the African Development Bank (1997) discuss group-lending practice in the African context; Mutua (1994) focuses on the Juhudi Scheme operated by the Kenya Rural Enterprise Program--KREP.
21. As Adams et al (1984: 44, 252) has put it: "Deposits generate important information for credit institutions when loan customers maintain accounts with the lender. Deposits can thus provide for continuous insight into the financial situation of borrowers.... [and] help to refine estimates of their creditworthiness."
22. Aryeetey & Udry (1994) and Aryeetey (1996) note, however, that most informal lenders in Africa, and in Ghana, do not monitor loans. Whether the KRB cocoa farmers monitor or not, the decision would be up to them in our scheme.
23. The literature [e.g., Adams & Graham (1981), Rhyne & Otero (1992), Berenbach & Guzman (1994)] consistently finds that the primary concern of small borrowers is not interest cost, but rather availability and convenience of credit.



24. As noted throughout the Financial Systems Approach literature [e.g., Padmanabhan (1988)], “credit delayed is credit denied.”
25. Such a “reciprocal” credit obligation (Adams & Fitchett 1992) could well develop in this context, for reciprocity is a common feature of Ghanaian informal finance. For example, in the Welfare-*Susu* system, the pooled savings of members are not distributed regularly, but rather kept on deposit as credit-reserves for members who have maintained their contributions (Gabianu 1990).

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