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Poverty reduction and rural finance: From unsustainable programs to sustainable institutions with growing outreach to the poor

by Hans Dieter Seibel

1. Sustainable poverty reduction takes time – and an institutional framework

Only relief achieves short-term poverty reduction, but is ineffective in the long run. Sustainable poverty reduction can only be attained through well-designed long-term development measures. For example, Indonesia is considered one of the most successful countries with regard to poverty reduction. Between 1970 and 1996, it reduced poverty from 60% to 11.5% of its population, a time span of a quarter century during which local financial institutions expanded rapidly. The Asian financial crisis led to a set-back, but also became the departure point for a more sustainable institutional system. (Getubig, Remenyi and Quinones 1997:89; Seibel and Schmidt 1999:8-10) All our experience tells us: there is no short-cut to sustainable poverty reduction and development; and certainly none outside a solid, prudentially regulated institutional framework.

2. Sustainable poverty reduction must build on individual self-help and institutional self-reliance

Sustainable poverty reduction must build on the self-help capacity of people and on the self-reliance of their self-help institutions, among them local financial institutions owned and managed by the poor. (Seibel and Damachi 1982) Sustainable farm- and non-farm enterprises and sustainable local institutions are inextricably bound together. (FAO and GTZ 1998) Aid must strengthen both, individual self-help capacities and institutional self-reliance, not weaken them through well-meaning but inappropriate subsidies. Short-term relief invariably lacks dynamic growth and is in danger of undermining self-help and self-reliance.

3. The growth of outreach to the poor is contingent upon the dynamic growth of self-reliant institutions

The growth of outreach of sustainable poverty reduction is contingent upon the dynamic growth of self-reliant institutions and the self-help capacity of the people. The essence of self-reliance of the poor and their institutions are local financial and non-financial resources:

- savings deposited and accumulated by the poor in local financial institutions are the basis of self-financing and household risk management;
- savings mobilized by local financial institutions are the main source of growth of funds and make them independent of external subsidies and interference.

(Giehler 1999; Ledgerwood 1998; Rutherford 2000; Yaron, McDonald and Piprek 1997).

Savings are a liability of the institutions which collect them, but an asset of the poor who deposit them!

4. Sustainable poverty reduction requires political will and adequate policies

Sustainable poverty reduction requires the political will of the government and an adequate policy framework of prudential deregulation and the strengthening of market processes. No poverty reduction program can be sustainable without good governance and adequate policies. The failures of good governance cannot be remedied by donor-supported poverty reduction projects. Loans for poverty reduction programs to governments which lack political will and fail to provide an adequate policy environment for economic growth and development of all segments of the population will only increase external endebtedness without simultaneously strengthening productive capacities. (Seibel 1996)

5. Rural and microfinance have a crucial role to play in sustainable poverty reduction

Microfinance institutions (MFls) comprise formal, semiformal or informal financial institutions, such as rural banks, savings & credit cooperatives, and centuries-old rotating or nonrotating savings & credit associations (RoSCAs, tontines), the latter sometimes centuries old. They may provide three types of financial services, which complement existing networks of mutual obligations and strengthen the self-help capacity of the poor (Seibel 1996):

- microsavings: savings deposit facilities, including collection services of very small amounts of savings;
- microcredit: access to loans of various sizes and maturities;
- microinsurance: insurance services, which may either be specialized (life, health, accident or cattle insurance) or nonspecialized, providing social protection through access to one's savings or to credit in cases of emergency.

6. Only viable institutions can continually increase their outreach to the poor

To contribute to sustainable poverty reduction with increasing outreach, MFls themselves must be viable, sustainable, and growing in size and outreach. Microfinance is business, not charity. This means:

- MFls must offer attractive interest rates or profit-sharing margins on savings with positive real returns (preventing the erosion of the value of savings) and mobilize their own resources;
- Rural MFls must charge rural market rates of interest on loans (which are considerably above commercial prime rates of interest!) and cover all their costs from the interest rate margin;
- MFls must make a profit and finance their expansion from their returns.

Only those MFls deserve assistance, which have demonstrated their capacity for resource mobilization, cost coverage, profitability, and dynamic growth. Such institutions may be found in the formal, semiformal or informal financial sectors. Governments, with the support of donors, should be encouraged to provide adequate legal forms for the upgrading of informal to semiformal and from semiformal to formal MFIs; and for the establishment of networks and their apex organizations for guidance, training, consultancy services, self-regulation & supervision, liquidity exchange and refinancing. (Lederwood 1998; Seibel 1996)

7. Much progress has been recently achieved in rural and microfinance, but shortcomings continue to hamper outreach and sustainability

Topic	Recent Developments in Some Countries	Continued Shortcomings in the Majority of Countries
Policy environment	Macroeconomic stability; interest rate deregulation; ease of setting up banks or branches; low minimum capital requirements for MFIs	Inadequate policy and legal environment; slow implementation of deregulation; inadequate property rights and judicial procedures
Microfinance institutions	New legal forms for commercially-operating MFIs; privately financed start-up; increasing numbers of self-sustaining MFIs.	Lack of appropriate legal forms; excessive capital requirements
Non-formal financial institutions	New legal framework provides opportunities for upgrading to formal levels and for financial market integration	The potential for upgrading millions of informal financial institutions remains largely untapped
NGOs	Innovative approaches to poverty lending in repressive environments; some successful conversions to formal intermediaries	NGOs are slow in mobilizing domestic resources and in striving for self-reliance; donors support unviable NGOs
Agricultural development banks	Incipient reforms towards autonomy, viability and self-reliance, with or without privatization	Political interference; lack of viability; failure to meet demand for credit and deposit services
MFI regulation and supervision	Controversial discussion on the need for effective regulation and supervision of MFIs	Financial authorities unable to supervise MFIs; agricultural development banks (AgDBs) escape supervision; lack of MFI self-regulation
Agricultural finance	Self-financing from profits and savings plus non-targeted commercial credit replaces preferential sources	Self-financing and commercial credit insufficient to meet the demand for short- and long-term finance; inadequate savings mobilization
Access of the poor to financial services	Outreach of viable MFIs (including rural and other banks) to the poor as users and owners drastically increased	Vast numbers of poor people, particularly in marginal areas, lack access to savings and credit services

(IFAD 2000; Lederwood 1998; Seibel 1996; Yaron, McDonald and Piprek 1997)

8. Here are some examples of how unsustainable project interventions have turned into an amazingly diverse array of sustainable institutions:[1]

✓ **Transition to self-reliance in the Income-Generating Project for Marginal Farmers and Landless (PK4) in Indonesia:** In P4K, a credit project for small farmers and fishermen, agricultural extension workers helped the very poor to form some 50 000 small groups as credit channels. As credit provided through government-owned Bank Rakyat Indonesia turned out to be inadequate (eg, in terms of amount and timely availability), women in marginal areas were the prime movers to transform these small groups into larger, self-reliant savings and credit associations. They thereby initiated the transition from a top-down credit project to a genuine self-help movement. Many associations are now registering as financial cooperatives of growing membership and business volume.

[1] Presented in more detail in the IFAD Rural Finance Policy, 2000, Appendix II

- ✓ **Supporting institutional diversity in Guatemala:** Since the end of the civil war in Guatemala, IFAD and other donors have promoted diversity and competition among rural financial institutions, such as financial cooperatives, credit NGOs, community banks, and a restructured AgDB (Banco Rural). Some MFIs, legally barred from deposit-taking, are now mobilizing internal and donor resources to register as banks or finance companies. Others, like the credit union network, adopt self-regulation and supervision of prudential norms as a means of increasing sustainability and outreach.

- ✓ **Rural Financial Services in Albania, Armenia and Macedonia:** In the transitional economies of Eastern Europe, rural financial institutions are only just emerging. Through credit lines for investments in emerging private agriculture, IFAD provides urgently needed liquidity in extremely under-monetized rural economies. Its support to the cooperative village credit funds in Albania may serve as a model for building local financial intermediaries that adhere to basic banking principles and apply simple standardized procedures.

- ✓ **Transforming an unsustainable credit programme into autonomous institutions in Nepal:** Until 1992, IFAD assisted the Agricultural Development Bank of Nepal (ADBN) to establish an infrastructure of small farmers' groups. They, in turn, formed intergroups and management committees under sub-project offices. On that basis, ADBN is now helping the farmers to establish autonomous local financial institutions, transforming a credit project into a network of vibrant self-governed financial cooperatives. (Seibel, Pant and Dhungel 1998)

- ✓ **Reforming savings and credit cooperatives (SACCOs) in Tanzania:** In the United Republic of Tanzania, IFAD has supported the transformation of SACCOs in upland areas from credit channels into real self-help organizations. They have vigorously mobilized savings and diversified their lending to the agricultural and microenterprise sectors including women traders.. Results in terms of impact include: empowerment of the poor including women as user-owners, substantial improvements in food security and income, and enhanced institutional sustainability.

- ✓ **How an unsustainable credit NGO first turned into a Grameen replicator, then into a rural bank – with rapidly growing outreach to very poor women in The Philippines:** The Center for Agriculture and Rural Development (CARD) in The Philippines, a Grameen Bank replicator, has changed from being an unsustainable credit NGO to a viable rural bank. By mobilizing its own resources from 40 000 poor and non-poor clients, adopting a variety of financial products and enforcing a strict credit discipline, it has substantially increased its lending outreach to its target group: 28 500 very poor women (Dec. 1999). With support from IFAD, CARD disseminates its technology to other MFIs. Seibel and Torres 1999; Seibel 2000b)

- ✓ **BAAC: gradual reform of an agricultural development bank (AgDB) in Thailand:** The reform of BAAC has been a gradual, 30-year process resulting in a viable and efficient government-owned AgDB: mobilizing most of its resources through savings, lending to 86% of farm households, expanding it financial services to rural non-arm enterprises. Its outreach encompasses 4.8 million borrowers and 7.6 million savers (*Dec. 1998*). Its non-subsidized interest rates are among the lowest in Asia; yet, due to its highly efficient financial technologies, the bank is profitable! (Maurer 1999)

- ✓ **Bank Rakyat Indonesia, the AgDB that revolutionized rural finance:** Within a framework of financial deregulation, what is now the Microbanking Division of BRI was cut off from subsidies and granted management autonomy in 1983. Its new *good* *practices* have included: carefully-crafted financial products, high interest rates on savings and loans, staff productivity incentives, rewards to borrowers for on-time repayment, and good governance. As a result, BRI has turned into one of the most successful provider of rural financial services in the developing world. Its 3 700 sub-branches serve 2.6 million borrowers at a one-year loss ratio of 1.35% and carry 25.1 million savings accounts at village level, testifying to an overwhelming demand for deposit services among the poor (*July 2000*). Profits in 1999 amounted to $150 million, excess liquidity mobilized at the village level to an amazing $ 1.5 billion. This has set new standards for AgDBs – they can be reformed! – and the microfinance industry: sustainability and wide outreach to the poor are compatible! This has inspired IFAD, the World Bank and FAO to a new intitiative: the transformation of AgDBs into viable and sustainable providers of microsavings and microcredit services. (Patten and Rosengard 1991; Schmit 1991; Seibel and Schmidt 1999)

9. Donors may contribute to sustainable poverty alleviation by strengthening associations of MFls as well as large-scale financial intermediaries, including AgDBs:

Donors may promote the growth of the microfinance sector in the service of sustainable poverty reduction in some of the following indicative ways:

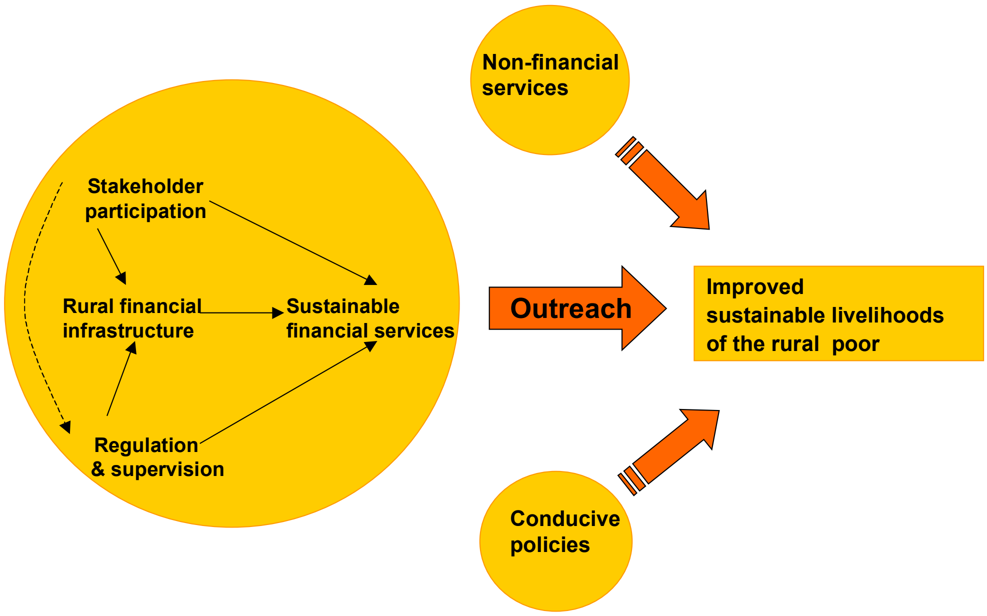
- equity contributions and loans which bridge short-term liquidity gaps to MFls which have proven their capacity for self-reliance and growth;
- TA for institutional development towards higher levels of viability, self-reliance and outreach;
- TA for the establishment and institutional development of networks of MFls;
- TA for the establishment of apex organizations of MFl networks for interest articulation, training & consultancy services to member organizations, guidance and auditing services, self-regulation & supervision, liquidity exchange, access to last-resort sources of refinance, and the mediation of donor support to MFls
- reform of AgDBs (Seibel 2000a)
- TA to financial authorities to provide an appropriate policy and regulatory framework, including legal forms for local financial institutions such as rural banks, financial cooperatives and equity-based savings and credit associations.

8. In May 2000, the Executive Board of IFAD has passed a rural finance policy as a tool for sustainable poverty alleviation:

IFAD RURAL FINANCE POLICY

Rural finance is one of several essential tools to be used in combating rural poverty. The purpose of IFAD’s rural finance policy is to increase the productivity, income and food security of the rural poor by promoting access to sustainable financial services. ***IFAD will strengthen the capacity of rural financial institutions to mobilize savings, have their costs covered and loans repaid, and make a profit to increase their saver and borrower outreach.*** It may also assist in bridging gaps in equity or loanable funds until institutions are fully self-sustained. Creating rural finance systems is not a panacea. Nor is it without its challenges, among them: assuring the participation of all stakeholders; building rural financial infrastructures that are diversified, according to local conditions; enhancing institutional sustainability with outreach to the poor; and fostering a conducive policy and regulatory environment. IFAD’s policy will support solutions to these challenges and promote a diversity of strategies, among them: networking among microfinance institutions and establishing apex services; upgrading and mainstreaming informal finance; linking banks with local financial institutions and self-help groups; and transforming agricultural development banks. Through its policy and strategies, IFAD confirms its commitment to continually seeking more effective ways of enabling – and empowering – the rural poor to create a sustainable means of livelihood for themselves and for the generations to come. The policy paper is available in English (#95906), French (#95908), Spanish (#95909), Arabic (#95910) and Chinese. (IFAD 2000)

Graph: IFAD's approach to rural finance



(IFAD 2000)

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