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# Challenges, Opportunities and Options for the Development of Rural Financial Institutions

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# CHALLENGES, OPPORTUNITIES AND OPTIONS FOR THE DEVELOPMENT OF RURAL FINANCIAL INSTITUTIONS

**by**

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**March 2000**

This paper was prepared by the author as a staff member of the International Fund for Agricultural Development (IFAD), a specialized agency of the UN in Rome. It is also available as IFAD Rural Finance Working Paper No. 96345 from Y.Diethelm@ifad.org.

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# PREFACE

Why does IFAD need rural finance guidelines? With its exclusive emphasis on rural poverty alleviation, IFAD enjoys a competitive advantage over other development agencies, and should strengthen its role by providing support for the development of rural finance as an important instrument. The goal of IFAD's support for rural finance is the sustainable improvement of the livelihood of the rural poor. This paper offers guiding principles to IFAD's staff and partner institutions to stimulate innovation and deepen impact by providing options for the effective development of sustainable financial services of increasing outreach to the rural poor. Once adopted, it will serve as a basis for the elaboration of more specific technical papers as well as strategy papers within IFAD's regional divisions.

In a nutshell, the guidelines focus on **the improvement of access of the rural poor as users and user-owners to sustainable local financial institutions which mobilise their own resources, cover their costs from their operating income, and finance their expanding outreach from their profits.**

IFAD faces a number of concerns in rural finance. Its experience shows that frequently, there have been wide gaps between the objectives of programs and actual achievements. In some countries, there is little evidence of how assistance for rural finance has helped alleviating poverty and making countries richer. How to use aid effectively – this is a first concern.

Under competition, microloans are to be invested in agricultural and nonagricultural microenterprises with the highest rates of return. This makes the poor, the lending institutions and their country richer. Yet, IFAD's loans have frequently been used by governments of poor countries to target predominantly investments in low-yielding agricultural activities. How to make the poor, their microfinance institutions and their countries richer, not poorer – this is a second concern.

In many countries, IFAD and other donors have supported development finance institutions. A few have been reformed; but many are poorly performing or have been closed. This has cut off access by the poor to financial services. How to make rural financial institutions sustainable and increase their outreach to the poor as users and owners – this is a third concern.

IFAD, governments, financial intermediaries and the poor are all accountable for the good use of their funds. In many instances, monitoring and supervision of implementing agencies and participating development finance institutions have not been adequate, resulting in inefficiencies and repayment problems. Transparency in the use of the funds and their impact on sustainable rural poverty alleviation and development – this is a fourth concern.

IFAD has prepared rural finance guidelines to better cope with these concerns. Yet, modesty has to prevail in their presentation. There are no *best* practices and *optimal* solutions that could simply be replicated. In the infinitely complex and constantly changing world of development, one can only offer options to be adjusted according to circumstances and experience; and these options may differ according to region, country and area. In fact, innovations in rural finance have frequently resulted from a crisis in the financial system, rather than its smooth development; and the innovators have frequently been local people risking their own money, and not necessarily donor or government experts. This has an important consequence for us at IFAD: respect for the autonomy of people and their institutions in responding to the challenges of poverty and determining the shape of their own financial system. Their autonomy in decisionmaking pertains to ownership and governance, target clientele, strategies and instruments, and the terms and conditions of financial contracts including loan purposes, interest rates, maturities and instalment periods. No such decisions should be administratively imposed.

There is yet another, deeper reason for our modesty. This lies in our experience, over the past half century, that there is no shortcut to development. Microfinance is no panacea; and sustainable financial institutions will not eradicate poverty overnight. It is important for the poor to have access to savings deposit and credit facilities *now*, and this will certainly have *some* impact on their income and wellbeing. But the deeper impact of microfinance will only be felt in the long run, when the conditions for rural development are in place, such as physical and social infrastructure, appropriate pricing and rural-urban terms of trade, marketing opportunities, and effective non-financial services. Sustainable rural financial institutions have to be in place when these opportunities emerge lest they be wasted. Institutional sustainability and self-reliance are thus long term objectives, not short-term prerequisites of support. This poses a certain dilemma for IFAD and its partners: Poverty is rampant now and needs to be alleviated. This may require direct investments, which are within IFAD's mandate, as well as transfer payments and charity, which are not. Yet, at the same time, crucial criteria for investing IFAD's scarce resources are the sustainability of poverty alleviation and the leverage of its support. IFAD and its partner governments may thus be confronted with situations in which the importance of sustainable results that will only be felt in the long run has to be carefully weighted against support with short-term effects that may not be sustainable.

This policy paper is meant to be a living document. Based on the learning experience of IFAD, its partner institutions and the poor, it will be periodically revised and adapted to the requirements of participants and local conditions.

# SUMMARY

## INTRODUCTION

**Rural finance, an important tool of poverty alleviation, but no panacea:** IFAD considers rural finance to be an essential tool for poverty reduction. Most of IFAD's target group are marginal and small producers with agricultural and non-agricultural activities. Their direct access to financial services affects productivity, income and food security. At present Fund resources dedicated to rural finance account for about 25% of the IFAD portfolio. To provide an overall framework for the work of the Fund on rural finance, IFAD is in the process of defining a corporate policy framework and, eventually, adapted regional strategies. On that basis, guidelines will be prepared in due course for use by staff, consultants and partner institutions, to provide scope for innovations as well as for consolidation of successful existing practices.

Rural finance is no panacea. It is but one of several important areas for investment in poverty reduction; and its impact may only be fully felt in the long run. However, through these guidelines IFAD confirms its commitment to continually search for better ways of providing support to the rural finance sector for the benefit of the rural poor. It is understood that general guidelines cannot be mechanically applied; they need to be adapted to the requirements of each area and its socio-economic setting.

**Defining rural finance:** Given IFAD's special concern for women and the very poor, a major, but not exclusive, emphasis is placed on rural *micro*finance, which is beyond the purview of conventional banking. Rural finance comprises formal and informal financial institutions, small and large, that provide small-size financial services to the rural poor, as well as larger-size financial services to agro-processing and other small and medium rural enterprises, thus generating employment for the rural poor. Rural finance also flows through other channels, such as trader and processor credits, which tend to be less sustainable than institutions and less efficient in terms of transaction costs.

**IFAD's history of rural finance** started in most countries with credit as an agricultural input handled by project staff. This was followed by credit channelling through agricultural development banks and their retail intermediaries. Early on, the Fund also contributed to institution-building, most notably of the Grameen Bank. However, in a policy environment of financial repression, many programmes failed to cover their costs and turned out to be unsustainable; there were adverse effects; and outreach stagnated. IFAD support is now shifting to institutional diversity and rural finance systems development, with the emphasis on access of rural poor to financial services. This involves the strengthening of the sustainability of rural financial institutions, as well as the viability of the farm and non-farm enterprises of the poor.

IFAD has drawn lessons from various notable **new developments in rural finance.** In a number of countries, macroeconomic stability and deregulation have created a conducive policy environment. This has prepared the ground for reforming rural financial institutions, among them rural banks, savings and credit cooperatives, agricultural development banks, Grameen banks and credit NGOs. New banking legislation has provided a legal framework for initiating regulated microfinance institutions on a commercial basis. This has also created opportunities for upgrading informal financial institutions, which in many regions are based on ancient traditions among the poor of forming self-reliant savings and credit groups through self-help. As a result, increasing numbers of poor people now have access to financial services in these countries – not only as users but also as owners. However, in the majority of countries, there are still major **shortcomings in rural finance**, requiring country-driven, coordinated interventions.

## CHALLENGES IN RURAL FINANCE

Based on the experience of the various stakeholders, a **new consensus** has emerged: Many of the poor can save, invest and repay their loans. They need **access** to credit, deposit, insurance and other financial services. Only **sustainable financial institutions** - which cover their costs, mobilize their own resources and make a profit to finance their expansion - can reliably provide such services and continually increase their outreach to the rural poor. Many diverse types of financial institution can become sustainable over time. This requires sound practices and a conducive policy and regulatory environment. In addition to finance, a functioning system of nonfinancial services, such as marketing, supply and extension is needed for effective impact on poverty. Hence, while institutional sustainability and outreach with impact can be made compatible and mutually reinforcing, there may be short-term trade-offs between them, requiring special interim strategies.

**Goal and objective:** IFAD's development goal is reduced poverty amongst the rural poor, through sustainable improvements in household food security and incomes. In order to contribute to that goal, one of IFAD's objectives is to support provision of financial and related non-financial services in rural areas that meet the needs of the rural poor; and to promote an effective system of rural finance accessible to all segments of the rural population, including women and the poor, as users or user-owners of sustainable financial institutions. IFAD is confident that it can substantially contribute to **expanding the frontier of institutional sustainability and outreach to the poor**.

In rural finance IFAD will support solutions to the following **key challenges** in rural finance as major areas of work:

- Enhanced participation of stakeholders, including the rural poor, in the development of the rural financial sector
- Diversified rural finance infrastructure and provision of financial and related non-financial services according to local conditions
- Improved capacities within financial institutions to provide services and among households to use such services
- Policy and regulatory frameworks that are conducive to the healthy development of rural financial services and their use by the rural poor

**Domestic resource mobilization** is of crucial importance for self-financing and institutional self-reliance. Yet, local savings and other domestic resources are frequently not sufficient to allow full exploitation of economic opportunities. **Credit lines** may fill that void. However, they have not always adequately responded to the challenge of sustainability. In some regions, this has resulted in low disbursement rates. The bankable poor need local financial institutions offering a broad range of financial services , as addressed in Salvador by Prodap-II (Box 2.1). In Bénin, the poor have established local institutions with their own equity, being users and owners at the same time (Box 2.2). Not all poor people require credit, as demonstrated by the vast numbers of savers in reformed cultural development banks (Boxes 2.10, 2.12). In response to the universal demand of the poor for deposit services, Plandero in Honduras has helped an indigenous organisation to establish rural savings banks for the landless poor (Box 2.4). However, credit lines may have start-up and bridging functions for new institutions anywhere in the developing world, including the extremely undermonetised rural economies of Eastern Europe (Box 2.3). Care has to be taken that they do not counteract a drive for sustainability and self-reliance.

## A. ENCOURAGING STAKEHOLDER PARTICIPATION

Effective project planning and implementation requires the active participation of all stakeholders. Governments, which are IFAD's direct partners, have generally not performed well in their combined roles as planner, banker and entrepreneur. In rural finance, their special role is to provide a conducive policy and legal environment to encourage the active involvement of all private and public stakeholders. Participation patterns according to sex, social strata or group affiliation are culture-bound; in case of conflict, participants must determine the balance between their social and economic concerns.

**(I) Participation by the poor in the development of rural finance,** through their representatives in organized production groups, self-help groups, networks and NGOs, is of crucial importance. IFAD will strengthen their decisionmaking role as users and as owners of MFIs. In P4K, Indonesia, the poor have initiated the transition from a top-down credit project to a genuine self-help movement, with women being the prime movers (Box 2.6).

**(II) Stakeholder coordination** at national level is required to ensure an integrated approach to the development of an effective system of rural finance. Cameroon is an example of how government and donor agencies, together with networks of MFIs and NGO as representatives of the poor, effectively design a comprehensive microfinance project (Box 2.5). IFAD may enter into strategic linkages with donors who have a strong presence in the field.

**(III) An international dialogue on rural finance policies**, in which IFAD is actively involved, prepares the ground for innovative approaches and provides back-up to national project coordination and strategic linkages.

## B. BUILDING A RURAL FINANCIAL INFRASTRUCTURE

**(IV) Different types of financial institutions and strategies** are required; there is no single *best* type. IFAD encourages variety and competition, as in Guatemala (Box 2.7), and engages in dialogue with stakeholders to encourage, and support, initiatives such as: promoting informal financial institutions as in Bénin, Indonesia and the Philippines (Boxes 2.2, 2.6 and 2.11); mainstreaming savings and credit cooperatives as in Tanzania (Box 2.8); promoting networking and apexing as in Cameroon (Box 2.5); transforming credit programs into user-owned institutions as in Nepal (Box 2.8); reforming agricultural development banks as major microfinance providers as in Thailand and Indonesia (Boxes 2.10, 2.12); linking banks and self-help groups as in India, Indonesia and several other Asian and African countries. Action research usually precedes the national implementation of an innovative approach. Three of these approaches are presented below in more detail.

**(V) Mainstreaming and upgrading informal financial institutions** deserves IFAD's special attention. Whereas financial self-help groups are extremely widespread among the poor, they are usually small and isolated. Mainstreaming and upgrading to higher legal forms are encouraged by incentives for joining a network such as training and consultancy services, liquidity exchange and refinancing, and accreditation.

**(VI) Networking among MFIs and providing them with apex services** are a major strategy for the expansion of rural financial services and institutions. Support services should be provided by network apexes as part of a sustainable structure, rather than external agencies. Such services may include interest articulation, policy dialogue, training, consultancy, self-regulation and supervision, liquidity exchange and bank linkages, research and development, information dissemination, and donor linkages.

**(VII) The transformation of agricultural development banks** (AgDBs) into sustainable providers of agricultural finance and other rural financial services, or their closure if unsustainable, is a great challenge. Vast numbers of rural people with agricultural and non-agricultural activities may be offered credit and deposit services by reformed AgDBs like BAAC in Thailand (Box 10) and BRI in Indonesia (Box 12). AgDB reform is a complex process in which close donor cooperation will be required with the banks, the respective governments and the regional credit associations Afraca, Apraca and Nenaraca. IFAD has taken the lead in initiating dialogue on AgDB reform with CGAP, FAO and the regional associations.

## C ENHANCING INSTITUTIONAL SUSTAINABILITY WITH OUTREACH TO THE RURAL POOR

**(VIII) Institutional sustainability** is of fundamental importance for the dynamic growth in the number of rural financial institutions and their outreach to the rural poor. IFAD assists them and their networks in enhancing their capacity to mobilise their own resources, cover their costs and preserve the value of their capital. CARD Rural Bank, a Grameen replicator in the Philippines serving exclusively poor women, is an example (Box 2.11). As a booster, both local and external resources (including credit lines as bridging funds) may need to be mobilised in order to enhance sustainability and outreach, as successfully demonstrated by IFAD's early support to the Grameen Bank. Capacity enhancement includes assistance to build up and strengthen the crucial elements of sustainability: demand-oriented financial products; market-driven interest rates with positive real returns for savers and lenders; appropriate loan and instalment periods; operational efficiency with low transaction costs and excellent repayment performance; staff performance incentives; adequate risk management; incentives for timely loan repayment; prudential standards; effective internal control of portfolio quality; and annual external audits. Cost-effective group and individual technologies may be promoted in marginal and high-potential areas, respectively. IFAD may also encourage innovations such as short-term all-purpose loans with regular instalments from non-agricultural incomes; reciprocal products of long-term contract savings combined with access to term finance; tied doorstep collection of savings and instalments; and food-and-savings-deposits-for-work in remote areas.

**(IX) Good practices** and their continual improvement in a competitive environment are indispensable for the sustainability and outreach of MFIs. Examples are indigenous institutional knowledge in informal finance; innovations in short- and longer-term agricultural finance; and special approaches for marginal and upland areas, inflationary economies, and barter economies. Among the issues which require special action research are **agricultural finance** and **rural microenterprise fi-**

**nance**, where there is wide scope for innovation.

This paper will also serve as a basis for a **conceptual framework** for supporting action research, monitoring and evaluation of innovations, and the dissemination of results through training, workshops, technical papers and a website. Support may also be provided to networks of national and regional banking and microfinance research and training institutes.

**(X) Domestic and external resources are mobilized** with the objective of building a sustainable rural financial system for the poor. IFAD may support rural financial institutions in improving their savings mobilization and capital built-up. Equity financing through appropriate apex institutions may be developed by IFAD as a new instrument, which would provide the much-needed external capital and leverage a multiple of domestic capital. IFAD may also provide credit lines. All such external liquidity should be tailored to the strengthening of domestic resource mobilization at all levels and the efficient allocation of scarce resources to high-yielding investments of the poor. The impact of external resources on productivity and returns and their implications for a country's indebtedness need to be carefully monitored.

## D. PROMOTING A CONDUCIVE POLICY AND REGULATORY ENVIRONMENT

**(XI) A conducive policy environment** is a prerequisite for an efficient financial system, rural development and effective poverty alleviation. Of particular importance are: macroeconomic stability; deregulated interest rates, exchanges rates and agricultural prices; and a legal system protecting property and land use rights, the autonomy of financial institutions, and due legal process. As an advocate of the poor, IFAD will participate in relevant policy dialogues.

**(XII) Prudential regulation and supervision (R&S)** of financial institutions is crucial for the evolution and stability of microfinance systems. IFAD will support efforts to adopt appropriate legal forms for MFIs, prudential norms and self-regulatory organs of MFI networks as part of a delegated system of R&S under a central regulatory authority (except in financially repressive systems).

**(XIII) Effective supervision of IFAD projects** with rural finance components requires adequately regulated and supervised participating financial institutions. Adherence to the groundrules of institutional sustainability is a conditionality for their selection. IFAD will support performance measurement, internal control and annual audits as part of project supervision. IFAD also monitors the impact of its support on the poor, rural financial institutions, local resource mobilization, and external endebtedness. The results are stored in its institutional memory and made available in webpages and technical papers.

## INSTRUMENTS AND PROCEDURES

IFAD provides loans and grants as its main instruments in improving food production systems and the income, productivity and nutrition of the rural poor. Through its financial support for rural finance, it strengthens the capacity of rural financial institutions to mobilise domestic resources and allocate them efficiently to high-yielding productive and other purposes in rural areas. L**oans** will only be given for projects with expected net gains to the country and the poor, taking into account their repayment in the future from earnings in national currencies of decreasing value. **Grants,** up to 7.5% of annually committed resources, may be given to public or private regional and local institutions for innovative project- and action-oriented research and training activities, and for project preparation. The creation of a network of rural (including micro-) finance research institutions akin to CGIAR may present a major opportunity for IFAD in cooperation with CGAP and other donors.

**Use of IFAD Resources:** IFAD's resources may be used either for direct assistance to institutional enhancement, or for the supply of external liquidity as an indirect contribution to the development and use of sustainable services. The main focus of resource allocation should be those investments that promote access of the rural poor to financial services and use of rural finance to create employment for the poor.

IFAD financing may be used in a variety of ways including for example, credit lines, equity participation in apex institutions and rural financial institutions, credit guarantee schemes and start-up capital for microinsurance, microleasing or other schemes. Wherever feasible, liquidity is to be provided only to regulated and properly supervised financial institutions as wholesalers or retailers. Among the criteria of selection and performance (to be reinforced through IFAD support) are professional management and commercial orientation, autonomy from political interference, orientation to self-reliance and sustainability as short- or longer-term goals, additionality of services, satisfactory annual external audits, and exit options. Interest rate subsidies and administratively imposed targeting are rigorously avoided. IFAD makes every effort to reduce or abolish existing discrimination against women and other disadvantaged groups. **Credit lines** may be used to bridge a temporary shortage of loanable funds in expanding or innovating institutions; they are no lasting solution for the absence of local resources, institutions, or term finance. Their impact on domestic resource mobilization and institutional governance will be monitored. **Equity participation,** which avoids some of the pitfalls of credit lines, strengthens the capital basis of apex institutions or rural financial institutions and leverages additional domestic resources in the form of savings deposits or additional equity. It may also be used to fulfil legal minimum capital requirement when transforming nonformal into formal institutions. IFAD proactively pursues **strategic linkages** with multilateral, bilateral and also private donors to provide leverage to its projects in quantitative and qualitative terms. Through co-financing, additional resources are mobilized for larger projects and rural finance sector investment programmes. Through cooperation with technical assistance agencies, the impact of projects on the rural poor may be substantially deepened. Given its emphasis on commercially operating financial institutions, IFAD will seek new forms of cooperation with the private sector. Among them are cofinancing of rural finance initiatives with international private donors; cooperation with foreign banks in the provision of training and consultancy services; and the promotion of linkages of local financial institutions and self-help groups with commercial banks.

**Follow-up:** Implementation of the IFAD guidelines on rural finance will be effected through the incorporation of policy principles in regional and country lending strategies to be prepared by the regional divisions. The implementation of both the corporate policy and the regional strategies will be closely monitored at project level and periodically evaluated through thematic studies. In support of this process, working papers will be prepared on specific operational issues and other topics in rural finance on which the Fund wishes to take a position or provide information to staff and partner organisations.

# 1. BACKGROUND

## IFAD's mandate

IFAD's mandate is to finance projects specifically designed to improve food production systems in the poorest food deficit countries and to improve the income, productivity and nutrition of the rural poor. Loans and grants provide support in nine major areas: agricultural development; rural development; credit; irrigation; livestock; fisheries; settlement of displaced persons, storage, food processing and marketing; and research, extension and training – with a special focus on women, sustainable community development, environmental conservation, and on- and off-farm income-generating activities. In virtually all of these areas, rural finance – the mobilization of domestic and external resources and their allocation to private or public purposes in rural areas – is of crucial importance.

## Defining rural microfinance

Given IFAD's special concern for women and the very poor, a major, but not exclusive, emphasis is placed on rural *micro*finance, which is beyond the purview of conventional banking. Rural finance comprises formal and informal financial institutions, small and large, that provide small-size financial services to the rural poor, as well as larger-size financial services to agro-processing and other small and medium rural enterprises, thus generating employment for the rural poor. Rural finance also flows through other channels, such as trader and processor credits, which tend to be less sustainable than institutions and less efficient in terms of transaction costs.

Financial services comprise (micro-) savings and (micro-) credit as well as other financial services such as (micro-) insurance, (micro-) leasing and transfer services. The prime function of micro- and rural finance finance is the allocation of scarce resources to microinvestments with the highest marginal rates of return, thereby making the poor richer and contributing to rural development. Two types of rural and microfinance institutions (MFIs) are included: MFIs in a narrow sense, comprising small local financial institutions such as rural banks, savings and credit cooperatives, credit NGOs, and rotating or non-rotating savings and credit associations; and MFIs in a wider sense, comprising national or provincial banks and development finance institutions (DFIs) with microfinance services for small savers and borrowers. There is no rigid definition of what constitutes *micro*finance services in terms of average deposit and loan sizes, which vary widely between regions, countries and institutions. They include a range of transactions which are too small for conventional commercial banks and finance companies. In the case of informal financial institutions, there is virtually no lower end in terms of minimum sizes. In some cases, this also applies to formal institutions, eg, BRI *(see Box 2.12)*, which grants loans as small as $5 and accepts deposits of any size.

The *microeconomy* is the primary market of MFIs and includes such populations segments as microentrepreneurs, small farmers and the landless, and other low- and very low-income people, among them women which are frequently particularly disadvantaged. They all belong to the informal sector, which escapes an exact definition. Each of these segments has its own constraints and potential, which need to be carefully analyzed during project preparation.

The new terminology '*rural microfinance'* is embedded in a new paradigm with core concepts and standards shared by IFAD: institutional viability, self-reliance, sustainability, and outreach to the poor (*defined in Annex 3*). Given its mandate of rural poverty alleviation, IFAD will be using the term *rural finance* synonymously with *rural microfinance*, unless specific reference is made to large-size financial services for big farm or other rural enterprises.

**The history of rural finance at IFAD**

The history of IFAD's support for rural finance and its impact on poverty alleviation in the various regions has yet to be written. Since its inception, IFAD has invested a sizeable proportion of its portfolio in the rural credit components of rural and agricultural investment projects and, increasingly, in rural finance projects. By November 1996, IFAD had committed USD1.1 billion, or about 25% of its total lending, to financial service components in 64% out of a total of 461 projects. In April 1999, IFAD had an active portfolio of 99 projects, or USD1.3 billion, with rural finance components amounting to USD 0.46 billion (*Annex 1*). (***Note****: all figures will be updated following the December 1999 Session of IFAD's Executive Board*)

IFAD has supported a variety of rural finance strategies and institutions, frequently at an early innovative stage, with major differences between regions, which has not been fully documented. During an initial phase, credit was subsidized and treated as an agricultural input; and credit lines directed at narrowly defined production purposes were handled directly by project staff who lacked the necessary banking skills. This was followed by loan channeling to farmers and farmer groups through agricultural development banks, with targeting and interest rate subsidization usually continued. As many of these programmes turned out to be unsustainable and outreach stagnated, IFAD explored new ways of providing credit through other institutions, among them cooperatives and, in West Africa, informal financial institutions, frequently with a major institutional emphasis in a particular region. Among the strategies and types of institutions that IFAD supported over time are:

- Agricultural credit programmes handled directly by project staff
- credit channelling through agricultural development banks;
- Grameen banking in Bangladesh and subsequent replications elsewhere;
- savings and credit cooperatives;
- rural banks;
- equity-based informal financial service associations;
- finance-in-kind institutions (grain banks, livestock banks);
- linkage banking, i.e. the promotion of access by self-help groups and microfinance institutions to bank sources.

During the 1980s, there were several constraints to the effectiveness of IFAD's support for rural finance, such as:

- government policies of subsidised, targeted credit and interest rate control, which have prevented the growth of the rural financial sector;
- an emphasis on end-user credit lines with no leverage and little positive impact on institutional sustainability and self-reliance, which has been due to a reluctance of governments to use loan funds for institutional capacity building;
- conflicting donor strategies with regard to targeting and subsidisation, resulting in weak or negative synergies.

IFAD, together with other donors, has experienced notable new developments in rural finance. These are characterized by institutional diversity, the promotion of competition among market oriented financial institutions, and an emphasis on building rural financial systems and enhancing the self-reliance and sustainability of rural financial institutions. Most recently, IFAD and others have been impressed by the remarkable resilience of rural microfinance compared to the commercial banking sector during the Asian financial crisis *(see Boxes 2.11 and 2.12)*. This opens up new avenues of support, including the use of credit lines for building ultimately self-reliant rural financial institutions.

On the basis of its experience, and that of other donors, IFAD is now re-examining its support for rural finance and studying ways in which to contribute more effectively to poverty alleviation, rural development, and empowerment of the poor. As an advocate of the rural poor, IFAD will assist governments and the networks of rural financial institutions **to develop the system of rural finance,** with an emphasis on growth of outreach to the rural poor by self-reliant, sustainable institutions. This requires a long-term perspective. Access to financial institutions by the poor, as users and particularly as depositors and as owners, means **empowerment of the rural poor including women.** IFAD does not expect to carry out all these support activities alone. **Strategic linkages** will be actively sought with other donors. This will also require coordination of their microfinance policies.

**The ancient roots of rural finance**

The history of IFAD's support for rural finance has been part of a much wider process. During the last decade before the new millennium, a new world of rural and microfinance has been spreading throughout the developing countries. In its centre are sustainable local financial institutions that mobilise their own resources, cover their costs from their operating income, and finance their expanding outreach to the poor from their profits. Some of these institutions belong to local communities, government bodies or private people; many are owned and managed by the poor. Donors have frequently provided a push in support of local initiatives. But large numbers of self-reliant institutions have evolved unaided, mostly within the informal financial sector.

The roots of this new world of development finance lie in the successes and failures of the past, some of them ancient. In numerous cultures of Africa, Asia, the Caribbean, Latin America and the Arab world, rotating savings associations and community funds (eg, tontine, susu, sanduq, arisan, hui, kye, paluwagan) are self-help institutions of the poor which have existed for centuries. In many countries, they have demonstrated considerable innovative capacity and are the only major source of financial services, however limited, to which the poor have access. In several parts of Europe, new forms of community-owned and cooperative microfinance evolved during the 18$^{th}$ and 19$^{th}$ centuries, responding to the challenges of extreme urban and rural poverty during the industrial revolution. In some developed countries, savings and cooperative banks - the former microfinance institutions of the poor (*penny banks*) - now account for more than 50% of domestic financial intermediation, demonstrating the growth potential of microfinance. Viability and self-reliance have invariably been inherent principles in all these cases. These experiences provide a basis for new forms of partnership and donor support.

There is a moving frontier between old and new development finance. IFAD, together with governments, civil society institutions and other donors, now proactively confronts the task of pushing this frontier forward and deepening outreach to the poor: as users and user-owners of financial institutions.

### Financial repression and its results

For decades, financial repression has undermined, in many countries, the evolution of a diversified financial sector with cost-effective services. The rural and urban poor in the developing world have been most affected, with little or no access to formal finance. Among the results of financial repression are the following:

- Rural areas have been severely underbanked; in many countries and in most marginal areas, an effective rural financial infastructure is absent.
- Interest rate regulation and inflation have eroded the value of savings and bank capital and prevented institutions from covering their costs.
- Preferential credit programs have tended to ration subsidized credit among big farmers with land titles as collateral, crowding out small producers.
- A credit bias of government-owned development banks has led to a lack of savings deposit facilities, which are much in demand among the poor.
- High transaction costs, low repayment rates and inadequate, frequently negative, real interest rates have undermined the health of agricultural development banks, cooperatives, and other credit channels.
- Agricultural credit has drastically decreased in many areas.
- Informal savings and credit associations based on self-help have been ignored.
- In many countries, there is a lack of suitable legal forms for local financial institutions, preventing local start-up initiatives, deposit collection and the upgrading of nonformal institutions to higher legal levels.
- Microfinance institutions are not supervised, there are no prudential norms, and no enforcement mechanisms.
- This has had serious consequences: for agricultural development banks, many of which are bankrupt; cooperatives and credit unions where credit channelling resulted in widespread inefficiencies, corruption and the breakdown of whole networks; and donor-driven credit NGOs , which are barred from deposit mobilization and have shown limited potential, except when transformed into banks.

### Recent developments

Yet, in all these fields, there have been notable positive developments. Experience in a variety of countries has shown that, with the right policies and strategies, an openness to learn from experience, stakeholder participation and donor coordination, the effectiveness of the rural financial system can be greatly improved. What would have been considered as miracles of market policy reform, only ten years ago, is now becoming more widespread. Viable and self-reliant institutions are now found among savings and credit cooperatives, rural banks, agricultural development banks, credit NGOs-turned-banks, and commercial banks linked to microfinance institutions and self-help groups. Credit lines are no longer poured indiscriminately into development banks and revolving funds that fail to revolve but may be used to bridge a liquidity gap until an institution is able to mobilize its own resources. All these are no longer mere exceptions, but pace-setting examples. However, depending on the political economy, wide differences still prevail between countries and regions.

| **Box 1.1: Recent developments and continued shortcomings in rural and microfinance** | | |
|---|---|---|
| *Topic* | *Recent developments in some countries* | *Continued shortcomings in the majority of countries* |
| Policy environment | Macroeconomic stability; interests rate deregulation; easing of setting up banks, branches, and MFIs with low capital requirements | Inadequate policy & legal environment; slow implementation of deregulation; inadequate property rights and judicial procedures |
| Microfinance institutions | New legal forms for commercially operating MFIs; privately financed start-ups; increasing numbers of self-sustaining MFIs | Lack of appropriate legal forms Excessive capital requirements |
| Nonformal financial institutions | New legal framework provides opportunities for upgrading to formal levels and finiancial market integration | The potential of 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 their own resources and striving for self-sufficiency Donors support unviable NGOs |
| Agricultural development banks | Incipient reforms towards autonomy, viability and self-reliance, with or without privatization | Lack of viability; political interference; inability to meet demand for credit and deposit services |
| MFI regulation and supervision | Controversial discussion on the need for effective regulation and supervision of MFIs | Authorities unable to supervise MFIs; AgDBs escape supervision; lack of MFI self-regulation |
| Agricultural finance | Self-financing from profits and savings plus commercial microcredit replace preferential sources | Self-financing and commercial credit insufficient in meeting the demand for financial services |
| Access of the poor to financial services | Outreach of viable MFIs to the poor as users and owners drastically increased | Vast number of the poor, particularly in marginal areas, lack access to savings and credit services |

### The new consensus on sustainability and outreach to the poor

These new developments have created the foundations for the development a new consensus, particularly during the 90s:

- Many of the poor can save, invest, and repay their loans.
- To develop their agricultural activities and microenterprises, prepare for emergencies and provide for the future, they need access to a range of microfinance services, including savings deposit facilities as a priority, credit and insurance.
- This requires a diversified financial infrastructure of competing institutions and diverse strategies adjusted to a given socio-economic context.
- Outreach can only be maximized by sustainable financial institutions, which cover all their costs, mobilize their own resources, protect their funds against erosion from inflation and non-repayment, and make a profit to finance their expansion.
- With sound practices, any type of financial institution can become sustainable and combine outreach and viability; but in most regions, institutions built on self-help and private ownership have the better prospects.
- Through technical and financial assistance, donors can greatly contribute to the development of an efficient rural and microfinance sector, but must be effectively guided by goals of viability and self-reliance of rural and microfinance institutions.

- The main function of the state is to provide a conducive policy and regulatory framework, including deregulated interest rates, appropriate legal forms for small financial institutions, and effective delegated supervision.

# 2. CHALLENGES IN RURAL FINANCE AND IFAD's EXPERIENCE

**The poor are bankable…**

A new consensus is evolving on rural finance. It grew out of the experience of the stakeholders: governments with their development finance institutions; many donors -particularly IFAD - with their past and ongoing financial and technical project support; and the people themselves with their informal self-help institutions. This experience has shown that government-directed subsidized credit has been generally ineffective and unsustainable; it has undermined the health of channeling institutions; and it has failed to respond to the growing demand of the rural poor for adequate savings deposit, credit and other financial services. Many governments have learned from the experience and are now reluctant to use credit lines that are not tied to institutional development. In a 1997 portfolio review *(to be revised and expanded to other regions!)* of 36 projects in west and central Africa, IFAD found a disbursement rate of only 23 percent in projects that had been effective for at least three years; and 28 percent after five years and longer.

Most importantly, directed credit programs have ignored the fact that, on principle, *the poor are bankable,* i.e., that many are able to save and bear the full cost of credit and other financial services. The poor need local financial institutions in which to deposit their savings, lest these be wasted. The institutions may then transform these savings into loans for investment, emergency, social or consumption purposes. If investment opportunities exceed the local savings capacity, external resources may fill the gap, temporarily; but care must be taken to ensure that the credit lines or equity contributions strengthen the institutions' capacity to eventually mobilize their own funds. *(Box 2.1)*

> *In El Salvador, as in other Latin American and Caribbean countries, credit lines to agricultural development banks, which are not authorized to mobilize savings, have not directly contributed to institutional sustainability. A new generation of projects is now being initiated, which are geared to the development of rural financial markets.*

| **Box 2.1 : El Salvador:**<br>**Transforming rural financial services** |
|---|
| In Latin America and the Caribbean, IFAD's interventions are in a state of rapid transition. From 1990 to 1999, the Smallholders' Agricultural Development Project (Prodap-I) in El Salvador has provided credit as part of a technical assistance package for agricultural and rural production and diversification. A trust fund was set up in the agricultural development bank, Banco de Fomento Agropecunario (BFA), which assumed the full credit risk. Credit assessment was left to the project's agricultural extension agents. Incentives were provided for disbursement, not loan recovery. This resulted in both, high disbursement and default rates, the latter condoned by politically motivated loan forgiveness.<br>Prodap-II builds on this experience. Its objective is to promote a broad range of financial services to poor households, including savings, credit, insurance, money transfer for remittances and currency exchange. The new strategy is based on the promotion of competition among various financial intermediaries that cater to different market segments; the strengthening of the selected institutions; the separation of financial and non-financial functions between the BFA and project staff; and the introduction of incentives for timely loan repayment. |
| The poor need both financial services and nonfinancial inputs. But the institutions and the staff providing them need to be separated: technical inputs in the hands of extension agents, banking in the hands of bankers! |

### … and need access to sustainable financial services

A functioning rural financial system is a prerequisite for economic growth, social development and poverty alleviation. Its main task is to allocate scarce financial resources efficiently to productive and nonproductive uses and social investments and to gradually lower the transaction costs for both the institutions and their users. This requires **sustainable financial institutions that mobilize their own resources, provide adequate financial services, and cover their costs from their operational income.**[1] At the same time, it requires users who pay interest rates that cover these costs, and who repay their loans. Institutional sustainability and outreach to the bankable poor are thus compatible. Access to the services of permanent local institutions is essential for **income security and the sustainable improvement of livelihood.** Such access is necessary for the poor as well as for the near- and non-poor. In several African countries, IFAD has acted as an innovator, introducing a new type of institution: equity-based financial service associations (*Box 2.2*).

> *In various African countries, including Bénin, the rural poor have demonstrated that, with technical assistance and a start-up credit line to temporarily bridge a liquidity shortage, they are able to mobilize their own resources, operate a profitable lending business, and build up sustainable financial institutions for their own benefit.*

**Box 2.2: Bénin:**
**Financial Service Associations, an equity-based financial innovation**

Building on traditions of self-help and informal finance, IFAD took a bold step in Africa, in introducing a new type of institution: financial service associations (FSAs), which are self-financed and self-managed. In Guinea, Congo-Brazzaville, Mauritania, Gabon and Benin, FSAs mobilise local resources in the form of equity. Members with investment opportunities may take short-term loans, for which they pay rural market rates of interest agreed upon by the shareholders. Dividends are paid annually from the profit, according to the size of the investment. In addition, withdrawable savings are accepted for safekeeping; but these are not remunerated, nor can they be used as loanable funds.

In Benin, SYFIPRO, a local NGO, acts as a facilitator for the FSAs and prepares other NGOs for the task. During the one-and-a-half year period from November 1997 to April 1999, 20 FSAs have started business. Membership has grown from 2 800 to 5 000, and paid-up equity from USD 27 000 to USD 75 000. About half the shareholders are also borrowers; while the other half are only investors – not everyone requires credit! Thirty-two per cent of the shareholders are women, holding 18% of the share capital. 32% of the borrowers are women.

The FSAs are still in an experimental stage. Over 200 FSAs are expected to start operating within the next five years, with their own business association and apex services for training, auditing, liquidity exchange and bank linkages. Legal recognition, perhaps as private rural banks or finance companies, and self-regulation are among the issues that the association might deal with.

The experience with FSAs in Africa is yet another example that the rural poor can locally mobilize their own resources and establish sustainable local financial institutions owned and managed by the poor.

**Bridging liquidity shortages through credit lines:** In a number of countries, there are legal and other constraints on the development of local financial institutions, which cannot easily be changed in the short run. In these cases, IFAD has continued to provide credit lines for direct investments in improved agricultural and livestock production.

[1] For the definition and measurement of sustainability and related terms see footnote 2 and annex 3.

> In many of the transitional economies of Eastern Europe, rural microfinance institutions are only just emerging. Credit lines for direct investment in private agriculture provide the urgently needed liquidity in extremely undermonetised rural economies.

| **Box 2.3: Albania, Macedonia and Armenia: Rural Financial Services in transitional economies** |
|---|
| IFAD has supported the development of rural financial services in Albania (North Eastern Districts Rural Development Project), Macedonia (Southern and Eastern Regions Rural Rehabilitation Project) and Armenia (North West Agricultural Services Project), which are at different stages of the development of individual farming and private sector banking. The principal lessons for effective credit delivery are:<br>a) The credit component must have a clear concept, of which the cooperative Village Credit Funds (VCF) in Albania may serve as a model case. Their success is due to the fact that it is a simple operation, readily understood by members and field staff alike, with standard procedures that can be easily implemented. Deviations from its simple design have run into problems.<br>b) Organizational and administrative components must be pilot-tested and prove their effectiveness anew at each stage of implementation.<br>c) Few donors have been able to develop successful wholesale or retail credit mechanisms for improved agricultural and livestock production. The availability of credit for production, moving beyond the establishment of social credit mechanisms, should continue to be one of IFAD's concerns.<br>d) The technical specifications for IFAD-financed credit operations lack a consistent approach. While it is important for the design to meet local needs, there are requirements which are common for all categories of credit development. These concern accounting specifications, legal and financial requirements, and key monitoring and management information systems. |
| When banks are involved in the delivery of rural financial services for IFAD financed credit lines, a due-diligence assessment is required, together with guidelines for their effective supervision. |

**Not all the poor require credit.** Some prefer to accumulate financial assets through savings before they make an investment, instead of incurring debt. Others prefer paid employment. Their employers may include smallholders or small and microentrepreneurs. Some may eventually graduate from wage labour to microentrepreneurship, using the skills acquired and savings accumulated to establish their own microenterprise. All require access to local lending and deposit-taking institutions in order to establish or expand their business, and for emergencies or other private needs.

> *In Honduras, the management of an agricultural development project discovered that, in marginal areas, the poorest of the indigenous poor need a secure place where they can deposit their savings, which they may eventually use for non-agricultural income-generating activities. In responding to this demand, the project has helped the poor to embark on a new course of institution-building.*

| **Box 2.4: Honduras: Rural savings banks (*cajas rurales*) for the landless poor** |
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| Many of the very poor indigenous people in the marginal areas of Honduras own no land and have only limited use for credit. Living in small rural towns, they are more concerned with placing part of their meagre income from wage labour in a secure place and eventually using their accumulated savings for income-smoothing or for some income-generating activity. In response, the National Indigenous Organisation, 'Lenca', asked the management of the Agricultural Development Programme for the Western Region (Plandero) for help in setting up small rural savings banks. There are now 132 *cajas*, registered as semiformal financial institutions under the association law, serving some 2,750 families, i.e., approximately 20 families per bank..<br>This indigenous initiative has opened up new avenues of support by Plandero. The project, which was funded by IFAD, has helped set up a small technical unit in Lenca and has trained three people in each *caja*. This, in |

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| turn, has created an atmosphere of communication in which the newly-trained are now planning the consolidation of their young financial institutions and the establishment of financial apex organisations at the municipal and eventually the departmental level. |
| Responding to local indigenous initiatives, Plandero, an agricultural development project, has learned a new lesson: many of the very poor in marginal areas need savings deposit facilities for the self-financing of non-agricultural activities, rather than just credit. |

IFAD faces four key challenges in rural finance:

⇒ How to enhance **stakeholder participation** in project development and implementation, including target group participation through representatives of networks of user-based rural financial institutions and NGOs, direct involvement of government agencies, and donor coordination;

⇒ How to support diverse **strategies for developing a differentiated rural financial infrastructure**, including, eg, the promotion of savings- and equity-driven financial self-help institutions in marginal areas; the upgrading of nonformal financial institutions; linkages between formal and nonformal financial institutions; the expansion of networks of different types of local financial institutions; the establishment of commercially managed apex funds for rural MFIs; and reform of agricultural development banks and their microfinance services.

⇒ How to enhance the capacity of rural microfinance institutions of providing sustainable services of ever-wider and deeper outreach to the poor

⇒ How to promote dialogues on a conducive policy environment and on a framework of prudential **regulation and supervision** of rural financial institutions.

Whether such interventions start from below, i.e., by strengthening microfinance institutions and their networks; from above, i.e., with an appropriate policy and regulatory framework; or from both ends, will depend on the regional and country context and the priorities of the participating stakeholders.

## 2.1 Stakeholder participation

The first key challenge IFAD faces is effective stakeholder participation. Given the dynamics of the development task, government agencies have usually not performed well in their combined roles as planner, banker and entrepreneur. They were not able to mobilize, through central planning, the full range of human and institutional resources existing in civil society. The participation of all stakeholders is needed in the development of the rural financial system. This means including the poor and their self-help organizations in the decision-making process, as well as government agencies and the private sector; cooperation among all rural finance stakeholders at national level, including strategic linkages; and the coordination of donor policies at international level. Participation is thus a key aspect of a complex communication process which is to permeate all areas and development phases of rural and microfinance. The government has a special responsibility and a new role in this process: to provide a conducive policy and legal environment; and to see to it that all major stakeholders have the opportunity to actively participate in rural financial market development.

*An example is Cameroon, where government agencies and networks of microfinance institutions jointly develop a national system of rural and microfinance, with IFAD playing a catalytic role.*

| **Box 2.5:** **Cameroon:** **Stakeholders develop a national system of rural and microfinance** |
|---|
| In Cameroon, where IFAD's lending had been interrupted for several years, the Fund is now involved in a process of intense interaction with various government agencies, networks of rural financial institutions, NGOs representing the poor and donors. Together they are designing a comprehensive national program for the development of rural and microfinance. This comprises MFI regulations and supervision, the expansion of networks of formal and informal MFIs, and the establishment of central network services for MFIs. Such services may include training, consultancy, auditing, liquidity exchange, refinancing and interest articulation, and the collection and dissemination of appropriate savings and credit products with outreach to the poor. Similar programs are under preparation in Ghana and Niger. |
| There are two special aspects:<br>(1) One is the quality of the participatory process, which rests with the experts from the participating institutions and includes donor coordination.<br>(2) The other is a systems approach, geared to the development of the whole system of rural and microfinance in Cameroon with a long-term perspective. |

Among the participants in the decision-making process, **the poor as IFAD's special target group** are of particular importance. They include people in agriculture and in non-agricultural microenterprise activities. The latter can be highly profitable in a diversified rural economy, much more so than most of agriculture. **Women** have a reputation for being good savers and prudent investors. In some cultures, they are the holders of the family purse. They frequently play a prominent role in informal finance. As users and user-owners of microfinance institutions, women involved in the participatory process can make an important contribution to the effectiveness of rural finance projects and, in return, greatly benefit from effective projects.

*In P4K, a small farmers development project in Indonesia, the poor have formed their own financial institutions, thereby initiating the transition from a top-down credit project to a genuine self-help movement. Women have been among the first to transform small credit-channeling groups into self-reliant savings and credit associations.*

| **Box 2.6:** **Indonesia:** **Self-initiated transition to self-reliance in P4K** |
|---|
| Since 1989 IFAD has supported P4K, a credit project which effectively targets the very poor. Field extension workers in the Ministry of Agriculture receive special training and financial incentives to identify the poor, organize them into solidarity groups of ten, and help them to prepare business plans. Through standardised repeat loans of increasing size, credit is channelled by government-owned Bank Rakyat Indonesia (BRI) through its district-level branch network. BRI enforces timely repayment by cutting off the supply of credit to villages and sub-districts when arrears go above 5%. By mid-1998, two risks, diagnosed five years earlier, had materialised: one deriving from incentives to extension workers geared to group establishment rather than group quality; the other one from BRI's limited interest in government credit projects, which it found riskier, more restricted in outreach and less profitable than its own savings and credit scheme at village unit level. Of the 49,917 small groups |

formed, only 70% had deposited compulsory group savings, and only 32% had loans outstanding. Of the latter, 42.5% had arrears amounting to 23.4% of the outstanding portfolio.
Almost from the onset, many of the participants in various parts of the country found the project's terms of standardised group size and financial contracts too limiting, credit application procedures too cumbersome, and actual access to credit unpredictable. By mid 1998, some 9,000 groups had carried the group fomation approach a step further and established a total of 1,805 informal associations. Membership size ranges from about 30 to 300 per association, which is more in line with the traditional practices of group formation than a standard size of ten. Women were among the prime movers. The associations mobilise voluntary savings, give short-term loans without delay and at conditions set by the participants, and charge interest rates geared to the rapid growth of their loan fund. Their resources are entirely internal. Saver and borrower transaction costs are minimal. Rescheduling is frequent, but defaulting is a rare event. The project's well-functioning monthly monitoring system now records the number of associations, but not their financial activities. After the deregulation of the cooperative sector in 1998, some of the associations are now registering as savings and credit cooperatives. This makes them officially-recognised financial institutions and opens up new opportunities for institutional enhancement, financial deepening and increasing outreach to the poor.

In this project, important lessons have been learned by the users:

(1) Only self-reliance guarantees sustained and timely access to financial services.
(2) Formal cooperative status is stifling and therefore avoided under a repressive regulatory regime in which the government uses cooperatives for purposes of its own. But under a more liberal regime, the protection of the law may be useful, and provide new avenues for the growth of self-organised financial services.

**Patterns of participation** are culture-bound; to be effective, they cannot be uniform. The ways in which different social strata and the sexes interact vary widely between cultures and need at least to be recognized, if not respected. Societies vary along numerous dimensions, among them a continuum from hierarchical and centralized to segmentary and decentralized, with power vested in an upper class vs. the whole people, respectively. Such differences are most pronounced in Africa with its extreme ethnic diversity. For decision-making processes to be effective in hierarchical societies, participation must start at the upper end and may then be extended to the lower strata in a manner to which the authorities consent. It is only in decentralized societies that full participation must start directly at the grassroots level. Even there, due regard may have to be given to influential people who have earned the respect of their fellow-citizens; while at the same time avoiding reliance on administrators who may lack popular recognition. There are other societies on that continuum where clans, secret societies, occupational associations and other civil society institutions play crucial political roles. These systems overlap with different gender-specific structures ranging from near-equality to inequality and discrimination against women. In many cases, countries and societies are a complex mixture of elements along different social dimensions, requiring a delicate participatory balance. This balance, which has not received much attention by development organizations in the past, is impossible to achieve without a careful sociological analysis and considerable skills of communication. More attention has to be given to culturally adequate participation, which pertains not only to communication, but also to the ways in which innovations are introduced in a society.

## 2.2 Building a rural financial infrastructure

The second challenge concerns the establishment of a differentiated rural financial infrastructure. Monolithic financial systems have mostly been ineffective. They unduly restrict people's choices, reduce the variety of financial institutions available, prevent innovation, and limit people's access to a broad range of financial services. They also tend to exclude the poor, depriving them of the chance to mobilize their productive potential. There is no single best type of institution or strategy; what is needed instead is variety and competition, which are the seedbed of innovation. These may be national or local institutions of widely different sizes; they may be privately or government-owned, cooperatively or community owned, user-owned with equal or unequal shares in equity; they may be gender-specific or mixed; they may be savings- or equity-based; they may be bank or non-bank institutions; they may be financial intermediaries mobilizing savings and transforming them into loans, or they may be specialised institutions. What is needed is a variety of legal and paralegal forms for rural financial institutions, and opportunities for their registration.

> In Guatemala, after the end of civil war, donors including IFAD have supported diversity and competition among rural financial institutions. Yet, their continued expansion has been hampered by legislative restrictions on upgrading MFIs to the level of regulated formal financial institutions. MFIs are now taking the initiative into their own hands: some by mobilizing internal and donor resources to register as banks or finance companies; others through self-regulation and voluntary supervision of prudential norms within networks.

**Box 2.7: Guatemala:**
**Supporting growth and institutional diversity in rural finance**

Over the last few years, access to financial services has considerably increased in rural areas of Guatemala. When civil strife ended, the macro-economic environment improved markedly and provided a breeding ground for a diversity of rural financial institutions, among them savings and credit cooperatives, village banks (bancos comunales), credit NGOs, and a restructured, partly privatised agricultural development bank (Banrural). The latter has a two-pronged strategy of increasing outreach: microenterprise support and apex lending to intermediaries closer to the grassroots.

Most of these institutions have received donor support. There is still a bias in favour of credit lines, but increasing attention is being given to institutional development. Two donor-supported credit NGOs are now operating on a self-sustained basis and have applied to become regulated financial institutions: Genesis a commercial bank, ACT a finance company. With assistance from the world credit organization WOCCU, the federation of savings and credit cooperatives (FENACOAC) has expanded its services to members. With support from CGAP, it is now in the process of establishing a self-regulatory system to uphold prudential standards and increase confidence in its banking operations. IFAD has been part of the effort to build up institutions, first with support to Fafidess in the Cuchumatanes project and now, in the Verapaces Programme, with a portfolio of funding the institutional development of a variety of institutions.

Despite these achievements, policy and regulatory shortfalls continue to jeopardize the healthy development of MFIs. On the one hand, MFIs are left in a legislative vacuum and the barriers to entry in the formal, regulated banking system are extremely high. On the other hand, legislation concerning the formal banking sector is recognised as deficient and has led to a lack of transparency which has led to a number of crises in the financial sector. Therefore, considerable scope remains for policy dialogue to be promoted by donors.

Depending on the policy environment, a country's state of development, and the market-integration or marginality of an area, **different strategies** may be required to build up the financial infrastructure. Such strategies may include:

- upgrading informal or semiformal financial institutions and self-help groups, which may be initiated by incentives for networking; this may also include the transformation of credit NGOs into banks (*see Boxes 2.11 and 2.12*);
- commercialising and expanding savings and credit cooperatives and other microfinance institutions (*see Box 2.8*);
- promoting networks of rural financial institutions and their apex organisations (*see Box 2.5*);
- adapting commercial banks to the requirements of the rural poor;
- transforming national small farmer programs into user-owned local financial institutions (*see Box 2.9*);
- reforming agricultural development banks which in many countries continue to be the biggest provider of microfinance services (*see Box 2.12*);
- linking self-help groups or microfinance institutions to banks;
- initiating new local financial institutions (*see Box 2.2*).

Access to a financial institution by the poor as users or owners might be considered as a **basic human right**. This may be as crucial for people's survival and wellbeing as basic education and health services.

> *In Tanzania, IFAD has supported the transformation of savings and credit cooperatives in upland areas from credit channels into genuine self-help organisations. The emerging results include: empowerment of the poor, substantial increases in food security and income, and sustainable institutions with a broad range of financial services.*

**Box 2.8: Tanzania:**
**Reforming savings and credit cooperatives (SACCOs)**

In thinly populated rural Tanzania, poverty is inextricably interwoven with the lack of financial services. Tanzania's commercial banks are unwilling, and its development banks unable, to serve the rural poor. In this void, IFAD has supported the transformation of rural SACCOs from credit channels to autonomous, self-financed and self-managed institutions functioning like private rural banks. Starting on a pilot basis in the Southern Highlands in 1996, 192 SACCOs with 23,000 members (February 1999) have actively participated. Among the accomplishments are annual increases of 70 % in savings deposits; a diversification of loan products to finance microenterprises in addition to agriculture, including petty trading by women; and, as a result, an increase in the membership of women to 40 per cent. The repayment rate stands at 91%, which is a substantial achievement but still not satisfactory.
The impact of the reform within the local communities has been substantial. *At the institutional level,* credit is no longer treated as a mere agricultural input. Instead, it is one of several financial services provided by local financial institutions on the basis of demand and cost-effectiveness. By mobilizing their own resources, lowering their transaction costs and raising the repayment rate, the SACCOs have vigorously embarked on the road to sustainability. *At the household level,* a mix of agricultural and non-agricultural activities are being financed, partly from savings and partly through credit. With two- to three-fold yield increases of maize and Irish potatoes, this has tended to maximize food security and income. *At the social level,* the SACCO's have brought about fundamental changes within the community in terms of empowerment of the poor. Through access to financial services, ownership of the institutions and self-management of their operations, the poor have gained the necessary confidence and sense of commitment to actively participate in the running of their community and its institutions. Further assistance is needed to improve their commercial capacity and national coverage, their network's auditing and supervisory services, and their compliance with the prudential norms being developed by the central bank.

The poor in the upland areas of Tanzania have demonstrated that they are able to form their own self-help organizations and provide savings and credit services on a sustainable basis.

*In Nepal, IFAD assisted the Agricultural Development Bank (until 1992) to establish an infrastructure of small farmer groups which, 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 an unsustainable project into vibrant financial cooperatives.*

| **Box 2.9: Nepal:**<br>**Transforming an unsustainable credit program into viable local financial institutions** |
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| Since 1975, the Agricultural Development Bank of Nepal has built up its Small Farmer Development Project, a subsidised credit programme targeted at the poor. With assistance from IFAD, as the first major donor until 1992, farmers were organised in some 25,000 small groups (end-1998 data). With repayment rates of 39-54% since 1980, and a savings ratio consistently below 1 %, plus high transaction costs, the program was unsustainable, and growth of outreach to poor farmers remained restricted. However, the credit line to ADBN had enabled poor farmers including women to build up a group structure. In the more liberal policy environment of the 1990s and with assistance from a bilateral donor (GTZ), ADBN has now embarked on positively responding to the farmer's initiatives. The groups under each subproject office are transformed into autonomous *Small Farmer Cooperatives Ltd. (SFCL)*, which mobilize savings and cover their own costs. The initial results have been spectacular: the repayment rate of channelled funds doubled; internal resource mobilisation progresses rapidly; and the repayment rate of loans from internal resources is almost 100%. By the end of 1998, 73 SFCLs had been established, comprising 6,083 small groups. Some are now receiving their limited banking licence, which allows them to further increase their outreach. |
| Two lessons derive from this experience:<br>(1) Through user ownership and vigorous savings mobilisation, unsustainable credit programmes can be transformed into networks of viable local financial intermediaries.<br>(2) As progress may build up only after policy changes and several donor interventions, lessons can be drawn only if information is stored and reassessed in the institutional memory *beyond* the closing of a project. |

***Bank for Agriculture and Agricultural Co-operatives (BAAC), Thailand:***
*Reform of BAAC has been a 30-year process. The result has been a viable, highly efficient government-owned AgDB, which now mobilizes most of its resources through savings and lends to 86% of farm households.*

| **Box 2.10: BAAC, Thailand: The gradual reformer** |
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| IFAD has examined BAAC's reform as part of an initiative with CGAP and the regional agricultural credit associations (RACAs). BAAC's reform has been a perennial process guided by two objectives: outreach to all farm households as its political mandate; and financial viability.<br>BAAC has gone through four major phases of reform: 1966-74, laying the foundation for individual lending with joint liability; 1975-87, expanding its lending operations through access to commercial bank and donor funds while greatly reducing loan channelling through cooperatives; 1988-96, striving for viability and self-reliance, under conditions of controlled interest rates, through savings mobilization, improved loan recovery and increased staff productivity; since 1997, adjusting to prudential regulation by the central bank and diversifying into non-agricultural lending.<br>Important elements in the reform process have been:<br>(1) Respect for the bank's operational autonomy by the government<br>(2) A corporate culture emphasizing cost-effectiveness, productivity and efficiency.<br>(3) Decentralization and expansion of branch network operating as profit centers, reducing saver and borrower transaction costs and permitting cost-effective microsavings and microcredit transactions.<br>(4) Individual lending through joint liability groups as a financial technology attuned to Thai culture.<br>(5) Substantial improvements in portfolio quality, which created depositor confidence.<br>(6) A radical shift in the financial resource base to rural savings mobilization. |

(7) Most recently, a diversification of its portfolio ton include rural microenterprise lending.
Outreach and performance are impressive: As of end-1998, BAAC served 4.8 million borrowers (86% of rural households) with $5.2 billion in loans outstanding and mobilized $4.1 billion in savings on 7.6m deposit accounts. Capital adequacy was 9.3%; operational self-sufficiency 228%; financial self-sufficiency 98%, self-reliance as measured by the loan-to-deposit ratio 83%. Administrative costs were 3.1% of loans outstanding.

BAAC has demonstrated how gradual reform can be carried through under a repressive financial policy regime with ceilings on lending rates, directed credit, and mandated agricultural lending quotas. These restrictions enabled BAAC to expand, forced cost-efficiency upon its staff, and prepared the ground for deposit mobilization at a later stage. The reform agenda is still unfinished:
(1) With the emergence of private depositors as major stakeholders, ownership of BAAC stock needs to be diversified, with adequate representation of the new shareholders on the Board of BAAC.
(2) Lending rates need to be liberalized and re-aligned to reflect the true costs.
(3) BAAC needs a new, performance-related management information system (MIS) which also enables field-level managers to track the performance of both savings and loans of a particular client.
(4) Performance-related staff incentives, presently under pilot-testing, need to be implemented

## 2.3 Institutional sustainability[2] with outreach to the rural poor

The third challenge concerns the sustainability and outreach of rural financial institutions. Rural and agricultural development require viable and sustainable financial institutions that serve all segments of the population including the poor, the very poor and the non-poor. Only institutions can be sustainable; credit lines are not. But credit lines, if properly used, can contribute to the sustainability of institutions.The viability of institutions and the viability of the farm- and non-farm enterprises of their target group are intricately bound together, the growth of the one being contingent upon the growth of the other. Only viable institutions can sustainably respond to the growing demand for financial services; and only viable client-enterprises are good business for the institutions. The sustainability hinges on two main factors**:** viability and self-reliance, to be achieved in a sequence. In the case of institutions, self-reliance is based on increasing internal resource mobilization; in the case of clients, it means increasing self-financing – none can be sacrificed in favor of the other. **Viable** institutions cover their costs, recover their loans, and make a profit. **Self-reliant** institutions mobilise their own resources, predominantly through savings deposits, equity and retained earnings, and they preserve the value of these resources in the face of inflation. Self-reliance implies management autonomy and - in the long run - independence from government and donor subsidies. Institutions are *self-sustained* to the extent that they cover their costs from their operational income (= *viability, operational self-sufficiency*), preserve the value of their resources by accounting for subsidies and the effects of inflation (= *financial self-sufficiency*) and mobilise their resources internally (*self-reliance*) (*see footnote 1, chapter 3*).

*CARD Rural Bank in the Philippines, a Grameen replicator, has changd from being an unsustainable credit NGO to becoming a viable and sustainable rural bank. By mobiliz-*

[2] An organization is sustainable to the extent that it covers its costs, preserves the value of its resources during inflation, and mobilizes its own resources. **Sustainability** has three main aspects: (a) ***viability*** or *operational self-sufficiency:* the extent to which costs are covered from the operational income;. (b) ***financial self-sufficiency:*** the extent to which operational costs are covered (= *viability*) and the value of its resources preserved by accounting for subsidies and the effects of inflation; (c) ***self-reliance:*** the extent to which an MFI mobilizes its own financial resources internally instead of depending on government or donor funding, or perhaps on commercial borrowing which may or may not be included. **Donor and subsidy dependency** are converse terms. *(See Annex 3)*

*ing its own resources from the poor and the non-poor, it has substantially increased its outreach to its target group, very poor women.*

| **Box 2.11: Philippines:**<br>**Are Grameen replicators sustainable, and do they reach the poor?** |
|---|
| The Grameen Bank in Bangladesh is known worldwide for its success in providing credit to the poor. IFAD was one of its first supporters. Subsequent replications in various countries were less successful. Evaluators in the Philippines found that while credit discipline was excellent, administrative costs were exorbitant, and internal resource mobilisation was minimal. Thus, outreach remained mostly insignificant. In 1996, ACPC – the programme's executing agency - noted that "excessive brokering of low-cost funds may discourage savings mobilisation.. " and that "... any attempt... to replicate or expand (the program) should be carried out with great caution."<br>The Center for Agriculture and Rural Development (CARD) is one of a small number of replicators in the Philippines that have recently embarked on a path leading to sustainability and rapid growth of outreach. It is the only replicator that has turned into a formal sector ru1ral bank. During the 5½-year period until June 1999, its outreach soared from 1 711 to 25 130 borrowers; and its operational self-sufficiency ratio increased from 0.46 to 1.09, while its repayment rate stood at 99.9% and its financial self-sufficiency ratio at 0.85. It provides savings deposit services to both poor and non-poor customers. It thus mobilises the resources that have enabled it to substantially increase its outreach to poor women, who have remained the sole borrowers, according to the Center's mandate. CARD Rural Bank's social capital is stated in its *Operations Manual (1998)* and disseminated through its training services. It consists of (a) a core of Grameen practices: high moral commitment on the part of the leaders, based on values instilled through training, peer control to preclude adverse selection and moral hazard, and strict credit discipline; and (b) innovative adaptations to the Philippine context: the adoption of rural bank status with the prudential norms imposed by the central bank, vigorous deposit mobilisation, differentiated loan and insurance products which are profit-making, and a broadening of its outreach to both poor and non-poor clients. |
| The principal lesson is that a Grameen-type MFI can become sustainable and substantially increase its outreach through a core of good Grameen practices, plus innovative adaptations. Introducing effective self-regulation and supervision may greatly contribute to the sustainability and outreach of Grameen replicators. |

**Interest rates** are of crucial importance here, for depositors as well as borrowers. Interest rates with positive real returns on savings above the inflation rate prevent the erosion of the depositors' capital. They are frequently also a major inducement to save, particularly when there are commercial opportunities for the depositors and when there is competition among the institutions for the depositors' money. Interest rates on loans must permit full cost coverage including loan provisioning, plus an adequate profit margin. Profit margins must adequately reward the owners or user-owners; they must prevent the erosion of the institution's capital; and they are an important source of the institution's growth. There is agreement that subsidised interest rates distort the market and undermine, rather than promote, institutional sustainability and outreach to the poor. When interest rates are controlled, sustainability and outreach are incompatible. In fact, the impact of preferential credit has frequently been negative, both on sustainability and outreach, particularly on outreach to the poor.

As a booster, both **local and external resources** may need to be mobilised in order to enhance the sustainability and outreach of rural financial institutions. Great care has to be taken that the provision of external resources does not set the wrong signals and turn into a substitute for local resources. Of crucial importance are **demand-driven financial products**, particularly microsavings, microcredit and microinsurance products with cost-effective collection services. In most countries, there is a wealth of local experience, sometimes culture-bound, with good practices in rural finance that can be gathered, reviewed and disseminated for innovative adoption. Many owners and users of rural finance institutions find this more appropriate than donor-driven replications of experience had elsewhere. Resulting innovations may then enter into a national and international exchange of experience.

## 2.4 Regulation and supervision

The fourth challenge concerns the establishment of a **conducive policy and regulatory framework.** In many countries, an inadequate macroeconomic and legal framework has hampered any type of development; while financial repression has stifled the growth of the financial sector, including rural finance. **A conducive macroeconomic environment** ideally comprises:

- macroeconomic stability with budgets under restraint and inflation under control,
- foreign exchange deregulation,
- the liberalisation of external and internal trade, resulting in the free exchange of goods and services.

This will give producers, including smallholders, the opportunity of receiving adequate prices for what they offer on the market, without unfair competition by artificially low imports. This, in turn, will enable them to accumulate assets that can be used as collateral, and pay market rates of interest on their loans.

> *Within a policy framework of financial deregulation, the granting of management autonomy and carefully crafted financial products have turned Bank Rakyat Indonesia into the largest and most successful provider of financial services to the poor and non-poor in the developing world. This has set new standards for agricultural development banks (AgDBs) – they can be reformed! – and the whole microfinance industry: sustainability and massive outreach to the poor are compatible!*

**Box 2.12: Bank Rakyat Indonesia:**

**The agricultural development bank which revolutionized rural finance**

The case of Bank Rakyat Indonesia (BRI), IFAD's partner in P4K, is evidence that, in a deregulated policy environment, the microbanking division of an ailing government-owned agricultural development bank can be transformed into a highly profitable, self-reliant financial intermediary. Since 1984, BRI has evolved into a major microfinance provider. Massive staff retraining in the new microbanking culture with its new financial services and incentive schemes has been of crucial importance. Its 3 700 local units serve some 20 million savers and 2.5 million borrowers (December 1998). With non-targeted loans from $5 to $5000 at rural market rates of interest and deposits of any (small) size, it reaches out to vast number of the poor and the non-poor. Making good use of a start-up liquidity injection, it has fully replaced external funds with local savings since 1989.
The ultimate test came with the Asian financial crisis. When the Indonesian banking system collapsed, BRI's Microbanking Division remained profitable. At the peak of the crisis, June to August 1998, the local units attracted 1.29 million new savers during that three-month period. At the same time, demand for credit stagnated because of a lack of confidence in the future. By June 1999, the division's 12-month loss ratio had dropped to 1.5 percent, substantially below its already low, long-term loss ratio (1984-99) of 2.1 percent. Savings balances in the units now exceed loans outstanding by USD 1.8 billion, requiring new strategies to recycle them within the rural economy.

Numerous lessons can be drawn from BRI's experience:
(1) Financial sector policies work and create an environment conducive to financial innovations.
(2) With attractive savings and credit products, appropriate staff incentives, and an effective system of internal regulation and supervision, rural microfinance can be profitable.
(3) The poor can save, and rural institutions can mobilise their savings cost-effectively.
(4) Without credit-biased incentives, the demand for savings deposit services exceeds the demand for credit by

a wide margin.
(5) Incentives for timely repayment work.
(6) Transaction costs can be lowered, and outreach to the poor can be increased by catering for both the poor and the non-poor with their demands for widely differing deposit and loan sizes.
(7) Outreach to vast numbers of low-income people and financial self-sufficiency are compatible.
(8) Agricultural development banks can be transformed into sustainable providers of microsavings and microcredit services.

**A conducive legal framework** comprises:

- different legal forms for a variety of competing microfinance institutions**;**
- a judicial system which protects property rights, including land-use or ownership rights of the poor, and ensures due legal process**;**
- legal stipulations for bankruptcy, with exit options for non-performing institutions;
- legal guarantees for the autonomy of financial sector institutions, including the central bank and agricultural development banks.

**A conducive framework of the regulation and supervision (R&S)** for rural and microfinance institutions comprises:

- the liberalisation of interest rates, which is of fundamental importance for domestic resource mobilisation and cost-effective (micro-) banking;
- the easing of conditions for the establishment of new financial institutions and their branches;
- the prevention of political interference in lending decisions;
- a regulatory system with appropriate prudential norms including reasonable minimum reserve requirements, or, in smaller institutions, capital adequacy ratios;
- a functioning delegated supervision system for the enforcement of prudential norms.

Ultimately, regulation and supervision must be geared to the protection of the users and owners of rural and microfinance institutions and to the stability of the overall rural financial system. It has been one of the chief lessons of the Asian financial crisis that a conducive environment encompasses more than macroeconomic stability and deregulation. What is required, in addition, is freedom from government interference in the lending decisions of financial institutions. This can only be ensured through effective supervision with the power to impose sanctions and an independent regulatory authority with enforcement powers.

Actual experience with effective regulation and supervision of rural and microfinance institutions is limited in developing countries. Most rural and microfinance institutions are entirely unregulated; and and most of those that are regulated are not effectively supervised. Savings and credit cooperatives are a case in point. Given the fear of repressive, rather than prudential, regulation, the scope of regulation and supervision is still controversial: should it be limited to deposit-taking institutions, and big institutions only? Or is regulation and supervision a service to be offered, with incentives, to all rural and microfinance institutions? Should prudential norms also be stringently applied to agricultural development banks in order to turn them into sustainable providers of dynamically growing rural financial services? There is agreement, however, that the answer to these questions should not be imposed by governments or donors, but be found in a participatory process with rural and microfinance institutions and their network representatives.

Ultimately, **the political economy** of a country is of crucial importance for the success or failure of any development effort. In some countries, reform of the policy and regulatory frameworks have been prevented by civil strife or by irresponsible elites, leaving no room for responsible government and private initiative. Peace and security, the rule of the law, accountability of government and some political stability are conditionalities beyond the control of any donor or project. *Without a conducive political economy,* most forms of development assistance are likely to be in vain; and loans may only increase a country's external indebtedness. This leaves donor agencies with only two alternatives**:** policy dialogue, or abstention.

## 2.5 Learning from experience

**Diversity and competition**
Sustainable financial institutions and access by the poor to their services are of crucial importance. This consensus is not matched by agreement on *the best way of attaining outreach and sustainability.* There is much controversy as to the most appropriate type of institution to support; the best strategy of establishing and strengthening institutions; the most appropriate financial products for the poor, the most effective mix of technical and financial assistance; or the role of grants and credit lines. Despite the fervour of some arguments, there is no conclusive evidence to support the overall superiority of a number of strategies and technologies such as: savings-first vs. credit-first; group vs. individual technology; private vs cooperative or public ownership of financial institutions; user-ownership by women only vs. mixed ownership; and the use of credit lines or equity participation vs. a sole emphasis on institution-building. Experience seems to show that there is a multitude of different approaches, institutional types, and good practices. But there is no single set of *best* practices. The appropriateness of a particular practice or approach depends very much on the cultural context, the policy environment, local conditions and – the people themselves as the ultimate decision-makers. Only *diversity and competition* between various institutions or practices lead to innovation. Accordingly, over its twenty-year history, IFAD has had a variegated experience with its support to various types of institutions.

**Learning and development**
In some cases, change comes gradually; but more frequently it takes a crisis to prepare for innovations, as seen recently in several Asian countries. Thus, some interventions appear as a failure in the short run, but show success in the longer run, eg, after a change in the policy environment (*see Box 2.9*). Storing and interpreting such information over time is thus a core task for a *knowledge organization* such as IFAD.

Invariably, change and innovation result *from organisational learning,* i.e, the accumulation of knowledge and its conversion into actual practice. This applies to countries and institutions as well as to projects. They must thus be seen not merely in the light of what they have accomplished, or failed to accomplish, in a given context. More importantly, they must be evaluated in terms of how they have changed, what they have learned, and how this learning experience influences the future. The Peasant Development Fund in Paraguay may serve as an example.

*The transition to a market economy is a long and cumbersome learning process. In Paraguay, the various phases of this process are reflected in IFAD's support to an apex fund. Abandoning the old subsidised targeted credit approach, the Fund first started with loans to local retail institutions. It then added support for institution-building and granted its retailers increasing lending autonomy. Most recently, it has started to promote local capital markets and, through a subsidiary, the markets for land and private technical services.*

**Box 2.13: Paraguay:**
**How an apex fund promotes local financial intermediaries**

The Peasant Development Fund (PDF) was established as an apex fund in 1993. With IFAD funding, it has provided credit to smallholders through rural cooperatives and other retailers. In contrast to the subsidised targeted credit approach of the previous agricultural development bank, the PDF has been set up to strengthen rural financial institutions. It has acted as a wholesale source of refinance and as a provider of technical assistance for institutional enhancement. This has led to an increase in repayment rates of 94-96 per cent during four consecutive years - almost unique in Paraguayan lending programmes.
Yet, there have been numerous impediments to financial market development: PDF's rigid control over the retail lending programmes has stifled innovation; and the government has sent out mixed signals. Despite its commitment to liberalisation, subsidised credit continues to distort rural financial markets. In March 1999, politicians decreed to write off the accumulated debt of retail lenders.
With the participation of all major stakeholders in a consultative committee, the PDF is now in the process of reorientation. It retains its commitment to market-driven financial as well as technical services, but separates them organisationally. As a financial apex providing liquidity to retailers, it will grant them full autonomy over their lending decisions. At the same time, it will promote capital market competition. It has established a subsidiary for technical assistance, with three major tasks: to provide training and consultancy services to local financial institutions; establish a market for private technical services; and promote land markets through land titling. This, in turn, will generate the collateral needed in a functioning rural credit market.

The experience in Paraguay shows that a functioning rural market economy needs effective markets not just for financial services alone, but also for technical services and for land.

In sum, responding to the key challenges of rural finance, IFAD will engage in the following:

(1) Promoting stakeholder participation, including government and the poor, in decisions on the development of the rural financial system – rather than deciding on their behalf.
(2) Assisting stakeholders to build networks of market-driven rural microfinance institutions with access of the poor as users and owners.
(3) Supporting rural and microfinance institutions to become *viable* and *self-reliant*, with sustainable financial services to increasing numbers of the rural poor.
(4) Engaging in policy dialogues with regulatory agencies and networks of microfinance institutions and support their efforts of providing appropriate forms of regulation and delegated supervision.
(5) Fostering diversity and competition, and learning from experience – rather than models which were successful only in a specific socioeconomic environment!

# 3. CHALLENGES, STRATEGIC OPPORTUNITIES AND OPTIONS

Developing a system of rural finance with outreach to the poor and the non-poor requires the full cooperation of all stakeholders. IFAD cannot accomplish this alone. The Fund's mandate is the eradication of poverty; yet there is no single strategy for reaching the poor, including women, that is valid for all countries. How IFAD or any other donor may effectively intervene depends on the situation: the structure of poverty in a country, its cultural diversity, the political economy, the policy environment, the stage of social and economic development, the effectiveness of public and private institutions, and the availability of external assistance.

As an advocate for the poor, IFAD presents below the key challenges, strategic opportunities and options of developing effective rural financial services for the poor. This may serve as a checklist for the analysis of rural finance and the planning of actual projects, covering a wide array of aspects of rural financial systems development. On that basis, the Fund may then decide, in coordination with other stakeholders, as to how and where to intervene.

This is meant to be a living document, to be revised periodically on the basis of IFAD's experience and that of its partners. To make it a useful tool in project planning, it is presented in a logical framework, comprising the development goal, the overall objective and four key challenges (or key result areas). These are, in turn, divided into 13 strategic opportunities (or key results), with options (or optional outputs) for each. In an actual project, items listed here as key result areas or key results may be formulated as project objectives. Activities, indicators and assumptions will then be added. The full framework is presented in *Annex 2*.

## 3.1 Goal, objective and key challenges

Support to rural finance by IFAD and its partner organizations will be geared to the **objective** of:

- establishing an effective system of sustainable financial institutions accessible to all segments of the rural population, including women and the poor, as users or user-owners.

This is to contribute to the **development goal:**

- the sustainable improvement of the livelihood of the rural population, especially women and the poor as IFAD's target group.

Four **key challenges** are to be addressed for the attainment of the objective (*see Graph 1*). At the core are two key challenges:

- how to establish and promote a differentiated infrastructure of rural financial institutions; and

- how to enhance their capacity to provide adequate financial services to the poor on a sustainable basis.

The two areas are closely related but are frequently developed at different stages. When institutions have been set up as credit disbursement agencies in a repressive policy environment, their transformation into viable and sustainable providers of timely, convenient and adequate savings and credit services requires a major new effort and a series of projects. Similarly, existing sustainable institutions owned and managed by the poor may face innovation and reform as perennial tasks and continue to require technical and financial inputs.

The two other key challenges are instrumental for the establishment of an infrastructure of functioning rural financial institutions is:

- active stakeholder participation in the design and implementation of measures to build the system of rural finance and all its components.

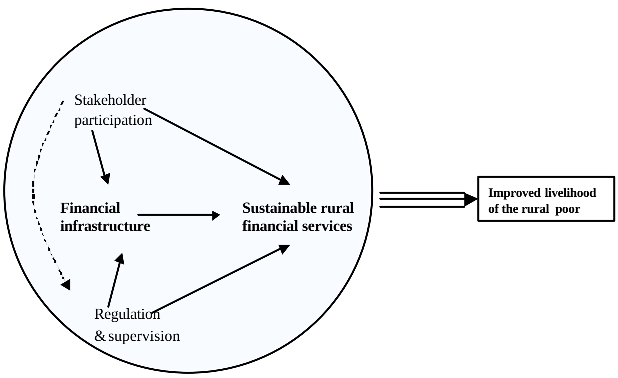
- regulation and supervision, together with a conducive policy environment.

Government agencies, IFAD and other donors have important roles to play, but the basic initiative has to come from the local people themselves - as users, owners and staff members of local institutions and their networks. It is *their* money and their fate, which are at risk.

Policy reform, regulation and supervision are crucial themes on which IFAD, as an advocate for the poor, has to promote a continual dialogue. Financial institutions must not be left alone in their effort to provide sustainable financial services. They require prudential norms resulting from the collective experience of the whole rural microfinance industry. For the continued growth of microfinance institutions and their full integration into national financial markets, these norms need to be enforced through effective supervision. In the same vein, the interests of the poor as users and perhaps also as owners need to be protected through an adequate system of supervision. The results must be made public among the local people, so that they can exert their own direct supervision. In a similar vein, IFAD's project support needs to be supervised; and this can only be done in an adequate fashion if the financial institutions involved in the project adhere to standards of accounting and transparency and are properly supervised.

Participation is of crucial importance for the quality of regulation and supervision. The ultimate responsibility for shaping the policy and regulatory environment lies with the government and the financial regulator, normally the central bank or the bank superintendency as autonomous bodies. However, other stakeholders including the rural microfinance networks as representatives of the interests of their member institutions also need to be involved. As the central authorities are unable to effectively supervise large numbers of small institutions, they have to cooperate with the networks in designing a delegated system in which the networks effectively supervise their member institutions.

Graph 3.1
Key challenges of rural finance for the poor



## 3.2 Strategic opportunities and options

Thirteen key areas of strategic opportunities for the building a financial system accessible to the rural poor are summarised below (*Box 3.1*). A complete overview, including options of intervention, is given in *Annex 2* as a basis for the planning of national strategies and specific projects.

| ***Box 3.1: Rural finance for the poor:***<br>***Development goal and objective, key challenges and strategic opportunities*** |
|---|
| **Development goal:**<br>Sustainable improvement in the livelihood of the rural population, especially women and the poor. |
| **Objective:**<br>An effective system of sustainable financial institutions accessible to all segments of the rural population, including women and the poor as users or user-owners is established |
| **A. Participation:**<br>Stakeholders, including the poor, participate in the development of the rural financial system<br><br>***I.*** Low-income people participate actively in the development of rural finance<br>*II.* The activities of rural finance stakeholders are coordinated at national level<br>*III.* The rural finance policies of donors are coordinated at international level |
| **B. Financial infrastructure:**<br>A differentiated system of rural financial institutions is operational<br><br>IV. Basic strategies for the development of rural finance are tested and disseminated<br>V. Informal financial institutions (IFIs) are upgraded and mainstreamed<br>VI. A comprehensive system of networks of rural finance institutions with cost-effective apex services for network members is operational<br>VII. Bank linkages of local financial institutions and self-help groups are operational<br>VIII. Agricultural development banks (AgBDs) are transformed into sustainable providers of financial services to the rural population |
| **C. Institutional sustainability and outreach to the rural poor:**<br>Sustainable rural financial institutions provide financial services to the rural poor<br><br>IX. Rural microfinance institutions are sustainable<br>**X.** Good practices are identified through applied research and disseminated<br>**XI.** Domestic and external resources are mobilized for rural finance systems development and poverty alleviation |
| **D. Regulation & supervision:**<br>A conducive policy and regulatory framework is operational<br><br>XII. A conducive policy framework is operational |

| | |
|---|---|
| XIII. | An effective system of prudential regulation and supervision of rural finance institutions is operational |
| XIV. | IFAD projects containing financial service components are adequately supervised |

## Stakeholder participation

**(I) The poor, as active participants** in the development of rural finance, are not passive *beneficiaries* but users as well as owners of microfinance institutions (MFIs). This requires a definition and sharpening of IFAD's poverty and gender focus in each project, taking the cultural and socio-economic environment into account. Women and the very poor are among the ultimate decision-makers, together with their representatives in self-help groups, MFI networks and NGOs. For example, empowering the poor as shareholders of MFIs leaves the choice to them, rather than to IFAD and the government, concerning high lending rates with rapid growth of loanable funds vs. low lending and growth rates.

**(II) Stakeholder coordination at national level** ensures an integrated approach to rural finance. Participants identify gaps, agree on basic principles of poverty alleviation and microfinance development, influence the policy and legal framework, initiate the necessary programmes, and monitor the impact on institutions and users. They support competition, but avoid mutually destructive approaches, such as dole-outs.

**(III) An international dialogue on the rural finance policies** eases innovations, provides a back-up to national interventions and gives direction to international movements for poverty eradication and microfinance. It may also lead to caution among donors, who are more successful in supporting ongoing market-processes and activities than initiating them.

## Building a rural financial infrastructure

**(IV) Basic strategies for the development of rural finance** with outreach to the poor need to be tested and disseminated, rather than just mechanically replicated, within a given socioeconomic environment. IFAD will engage in a dialogue with governmental and other agencies to encourage, and support initiatives like the following (with indicative examples):

- ✓ Reforming and expanding MFIs (CARD Rural Bank, Philippines; Box 2.11)
- ✓ upgrading and mainstreaming informal and semiformal MFIs (BancoSol, Bolivia)
- ✓ promoting networks and apexes (National Board of Community Banks, Nigeria)
- ✓ adapting (*downgrading*) commercial banks (Hatton National Bank, Sri Lanka)
- ✓ transforming credit programs into user-owned MFIs (SFDP, Nepal; Box 2.9)
- ✓ reforming the rural banking and cooperative sectors (rural banks, Philippines)
- ✓ reforming agricultural development banks (BRI, Indonesia; Box 2.12)
- ✓ linking banks with MFIs and self-help groups (Apraca & Afraca programs)
- ✓ institutional innovations (financial service associations, Africa; Box 2.2)
- ✓ Grameen banking (Grameen Bank, Bangladesh; see also Box 2.11)
- ✓ facilitating private initiatives through legal status (rural banks, Ghana, Indonesia)
- ✓ special strategies for marginal and upland areas (*caisses villageoises*, West Africa)

Each of these approaches requires detailed elaboration, which is found in the indicative examples listed above and related backup documentation; and in IFAD's *Rural Finance Working Papers*. Three approaches are presented in more detail below and in Annex 2: upgrading nonformal financial institutions and self-help groups; the establishment and enhancement of MFI networks and apex organizations; and agricultural development bank reform.

**(V) Informal financial institutions, based on self-help, are upgraded and mainstreamed.** Given the prevalence of the informal financial sector and its capacity for adaptation and innovation, special support may be given to informal financial institutions, among them financial self-help groups in particular. This may entail enhancing management skills and operational practices; transforming rotating associations, funeral societies, deposit collectors and similar informal institutions into financial intermediaries with a permanent loan fund; utilising opportunities for mainstreaming and upgrading to regular financial institutions; and entering into linkages with the formal sector. A particular strategy to be supported by IFAD might be ***upgrading & mainstreaming through networking among informal IFIs as an incentives-driven option.*** IFIs may be offered assistance to establish a network and enlist as members. The network may be registered under a suitable legal form: as an association, a foundation, a cooperative and eventually perhaps, at a higher evolutionary stage, a formal financial apex institution. The network may offer services as an incentive to join: training, consultancy, book-keeping tools, legal assistance, exchange of experience, interest representation, bank linkages, dialogues with local and national authorities, auditing services and liquidity exchange. As members of the network, the IFIs are free to choose whether they remain nonformal network members or, with network assistance, seek a formal status for themselves. Incentives for mainstreaming are given in Box 3.2.

**Box 3.2:**
**Mainstreaming : a stepwise incentives-driven service to IFIs**

| *Mainstreaming* | *Incentive* |
|---|---|
| 1. Registration | Basic training (accounting) |
| 2. Reporting | Financial management training |
| 3. Legal status | Consultancy services in good practices |
| 4. Prudential norms | Liquidity exchange and refinancing |
| 5. Supervision | Accreditation with a seal of quality |

**(VI) Networks of MFIs and apex organizations** are promoted and expanded. They are assisted in providing central services, such as interest articulation and policy dialogue, training and consultancy, self-regulation and supervision, liquidity exchange and bank linkages, research and development, information dissemination, and donor linkages

**(VII) Agricultural development banks (AgDBs) are transformed** into sustainable providers of microfinance, or closed, as in many parts of Africa and Latin America. For example, the reform of BAAC in Thailand and BRI in Indonesia has turned them into the biggest providers of microsavings and microcredit services (*see Box 2.12*). Experience has shown that AgDB reform requires a complex approach (*detailed in Annex 2*):

- ✓ activating the political will to reform or to close down
- ✓ adequate reform strategies (among them privatization as one alternative)
- ✓ an effective planning process
- ✓ operational autonomy and freedom of political interference
- ✓ an appropriate legal and regulatory framework with prudential norms

- ✓ financial restructuring
- ✓ organizational restructuring
- ✓ human resource development, including staff retraining
- ✓ an effective delivery system (a decentralized network of branches as profit centers)
- ✓ demand-driven financial products
- ✓ financial sustainability
- ✓ effective internal and external supervision.

IFAD's special focus will be on the reform of the AgDBs' microsavings and microcredit services to smallholders and microentrepreneurs with their self-help groups and informal financial institutions. AgDB reform exceeds the capacity of IFAD and requires an explicit joint strategy as well as cofinancing with the World Bank and the regional development banks. In countries where state-owned enterprises (SOEs) are among the major customers of AgDBs, the cleaning up of the bank's portfolio of bad debts may require prior consolidation of the SOEs. Close cooperation, initiated by IFAD, with agencies such as the regional agricultural credit associations (Afraca, Apraca, Nenaraca) and CGAP's working group on AgDB reform is expected to contribute to the generation of the political will to reform.

## Institutional sustainability with outreach to the rural poor

**(VIII) Self-sustained institutions** are socially integrated and accepted. They mobilise their own resources, cover their costs and preserve the value of their capital, thereby generating the income for the dynamic growth of their outreach to the poor. Sustainability and self-reliance are long-range goals to be gradually attained, not overnight. Of crucial importance are demand-oriented financial products, market-driven interest rates for savers and borrowers, operational efficiency, adequate risk management, incentives for timely loan repayment, prudential standards, internal control of portfolio quality and good practices, and staff performance incentives. Annual audited balance sheets are a must. Group technologies may be promoted if found cost-effective, particularly among the very poor and in marginal areas. Individual lending technologies may be promoted, particularly in high-potential areas. Recently successful product innovations that may be promoted include: short-term all-purpose loans with regular (i.e., monthly, weekly) instalments from non-agricultural incomes and no grace period; reciprocal products of long-term contract savings combined with access to long-term loans (*matching assets and liabilities*); tied doorstep collection of savings and instalments (*minimizing user transaction costs*); savings-in-kind (e.g., grains, livestock) in inflationary economies; loans-in-kind in undermonetized economies; and food-and-deposits-for-work in remote areas. IFAD may also cautiously support insufficiently-tested innovations such as professionally managed MFI rating agencies, credit information systems, and apex funds.

**(IX) Good practices,** including adequate MIS software, are collected, tested and disseminated. The information is to be identified through result-oriented action research – for example, on indigenous institutional knowledge, financial innovations for the poor, and special approaches for marginal and upland areas. Maintaining the local terminology of upgraded informal financial institutions can be important in order to ensure a sense of cultural ownership. In inflationary economies, the promotion of savings in-kind (e.g., grain, livestock) may be more appropriate than monetary savings. Cooperation with international research institutes, regional associations and donor consultancy groups or committees, is essential. This may include the promotion of a network of national and regional banking and microfinance research and training institutes. Suitable media for the dissemination of good practices, include workshops, exposure training, technical papers and a website with materials from the staff of IFAD and its partners.

**(X) Domestic and external resources are mobilized** to build a sustainable rural financial system for the poor. External resources comprise credit lines and equity participation in MFIs or apex funds. They are geared to the strengthening of domestic resource mobilisation at all levels and the efficient allocation of scarce resources to high-yielding investments of the poor. The level of external indebtedness and the impact of external resources on productivity and returns need to be carefully monitored.

## Regulation and supervision

**(XI) A conducive policy environment** is a prerequisite for an efficient rural financial system. This requires macroeconomic stability; the liberalization of interest rates, exchange rates and prices; and a legal system protecting property and land use rights, the autonomy of financial institutions and due legal process.

**(XII) Prudential regulation and supervision (R&S)** of financial institutions has been crucial for the evolution and stability of now mature systems of microfinance. It is a service which benefits both owners and users of MFIs. R&S requires appropriate legal forms for MFIs, prudential norms, self-regulatory organs of MFI networks under a central regulatory authority, and effective supervision with sanctioning power. Informal financial institutions may be offered incentives for voluntary registration with a network and for upgrading to higher-level legal forms. Financial cooperatives, which are registered under a ministry of agriculture or cooperatives, are to be effectively regulated and supervised by the appropriate financial authority. The financial health of MFIs, including cooperatives and AgDBs, is to be protected by special safeguards against inappropriate loan channelling and targeting. Stakeholders respond to the challenge of developing a conducive system of R&S through continual dialogue.

**(XIII) Supervision of IFAD projects** containing financial components requires adequately regulated and supervised executiving banks and MFIs. Performance measurement, internal control and annual audited balance sheets are essential (*see Annex 3*). Adherence to the groundrules of institutional sustainability is made a conditionality for the selection of cooperating institutions. IFAD monitors the phased achievement of project objectives and conditionalities, in particular its impact on rural financial institutions, domestic resource mobilization for poverty alleviation by MFIs, and external indebtedness. IFAD stores the results in its institutional memory and makes them available through a website and other suitable media. Evaluation research by OE and independent research institutions may greatly contribute to the quality of projects and their supervision.

## 4. Instruments and procedures [under construction]

Rural finance plays a crucial role in the fulfilment of Ifad's mandate: to improve food production systems and the income, productivity and nutrition of the rural poor. Ifad's **main instruments** are loans and grants including cofinancing grants entrusted to it, which are provided with due attention to economy, efficiency and social equity. Through its financial support, IFAD strengthens the capacity of rural financial institutions to mobilise domestic resources and allocate them efficiently to high-yielding productive and other purposes in rural areas. Its special focus is on a market- and demand-driven approach to empowering the rural poor as users and owners of local financial institutions.

The instruments and procedures applied by the Fund are laid down in the *IFAD Loan and Grant Administration Operational Manual*. **Loans** are provided on highly concessional, intermediate or ordinary terms, depending basically on the GNP per capita of the member country. Loans are given to governments or, in some cases, to financial institutions with full government guarantees. As most of the loans follow an integrated development approach and cover several of the main areas identified for support, they are not officially differentiated into specific lending instruments and may be used for any aspect of the system of rural finance described in chapter 3 and annex 2. The efficiency criterion requires that loans are given only for projects with expected net efficiency gains, taking into consideration that loans will have to be repaid from income earned in national currencies of mostly decreasing value.

**Grants**, which are limited to 7.5% of the resources committed in any financial year, are more flexible. They may be given to public or private, regional or local institutions. They may be used for research & development activities related to risky institutional and financial innovations; stakeholder participation and policy dialogue; dissemination of experience and training, including exposure programs; project preparation and specific components; the promotion and upgrading of informal finance, self-help groups and NGOs; or similar purposes.

IFAD's resources may be used either for direct assistance to rural finance systems and institution-building, or for the supply of external liquidity as an indirect contribution to institution-building. As an advocate of the poor, IFAD takes responsibility for the development of a functioning system of rural finance accessible to the poor, comprising key result areas B and C (*Annex 2*), using its resources accordingly. In cooperation with its sister organizations in the UN family, the Fund participates in the mobilisation of additional resources and the coordination of their use. Within the area of stakeholder participation (*key challenge area A*), the main emphasis of its own resource use is on the inclusion of all categories of rural poor and their representatives at all levels of programme and project design and implementation and in policy dialogue.

In the development of a differentiated rural financial infrastructure (*key challenge area B*), IFAD focuses the use of its resources on the establishment and expansion of local financial institutions and their networks, which give full access to the poor as savers and borrowers, and include them as owners. This may comprise support for both the physical (buildings, equipment, etc.) and corporate parts (for example, human resources, MIS) of rural financial institutions. In close cooperation with other donors and regional associations, IFAD may also selectively participate in the reform of agricultural development banks (AgDBs). These have been neglected in recent years but, in many countries, continue to be the biggest provider of rural financial services. IFAD's own focus here is on the promotion of sustainable microsavings and microcredit services to the rural poor.

Once a rural financial infrastructure of MFIs and AgDB branches exists and expands, the main thrust of IFAD's assistance is on sustainability and outreach (*key challenge area C*). It supports strategies and instruments which strengthen the ability of the rural institutions to mobilise deposits, cover their costs, have their loans repaid, increase their efficiency and make a profit to finance their expansion and outreach to the poor. This includes support for the training of personnel in the utilisation of these instruments and for the establishment of appropriate management and incentive systems. Action research on financial innovations and good practices, and the dissemination of results, may be supported more through grants than loans. A system of national and regional rural and microfinance research institutions akin to CGIAR is still absent and presents a major opportunity for IFAD's intervention in cooperation with CGAP and other donors.

A conducive policy and regulatory framework (*key challenge area D*) is of fundamental importance for the effectiveness and sustainability of rural finance. IFAD supports the government and networks of rural financial institutions in dialogue and coordination measures. It expects other donors, including bilateral agencies, to concentrate on the development of systems of prudential regulation and on capacity-building at the level of financial authorities. The Fund's own support focuses more on the development of the lower part of a system of delegated regulation and supervision, particularly on the enhancement of self-regulation and self-supervision with effective enforcement of prudential norms at MFI network level. IFAD will also strengthen its own capacity for direct project supervision, which is related to the capacity of its partner institutions to ensure effective internal control and self-supervision.

The capacity of rural financial institutions to provide adequate financial services may also be strengthened through the **supply of liquidity** as part of an IFAD loan. The principal forms of liquidity supply are credit lines and equity**;** others include credit guarantee schemes and start-up capital for microinsurance schemes, plus innovations such as microleasing. Executing and intermediary financial institutions must present annual audited balance sheets.

**Credit lines** may be provided to properly regulated and supervised development finance institutions (DFIs) as retailers or to DFIs or apex funds as wholesalers to local retail institutions (cooperatives, rural banks, financial self-help groups, etc.). IFAD's credit lines are designed to strengthen the sustainability of the recipient intermediaries, particularly their capacity to mobilise their own internal resources and build up a profitable lending business. This requires autonomy on the part of the intermediary institutions in determining interest rates, other terms and conditions of financial contracts, and outreach to the poor and non-poor, as market segments. IFAD may contribute to the emergence of a policy framework permitting such autonomy by engaging in policy dialogues. Respect for institutional autonomy needs to be expressed in subsidiary loan agreements. Because of their distorting effects, interest rate subsidies and administratively imposed targeting are rigorously avoided. At the same time, IFAD makes every effort to have discrimination against women and other disadvantaged groups systematically reduced or abolished.

Credit lines are particularly effective in bridging a temporary shortage of loanable funds in expanding institutions, provided the funds are employed profitably. Benchmark criteria concerning the gradual substitution of internal resources for external credit need to be defined and monitored. Credit lines are not a permanent solution for the absence of local resources or for the lack of access to financial services. Any negative effects of credit lines on local resource mobilisation and the governance of local financial institutions need to be monitored and remedied.

**Equity participation** is a new instrument evolving in IFAD, and has yet to be tested. It strengthens the capital base of rural financial institutions and, as an indirect consequence, their capacity for mobilising additional internal resources and expanding their financial services. It may also be used to fulfil legal minimum capital requirements and transform a credit NGO or other type of informal institution into a bank, which is then authorised to mobilise savings from the public. Equity participation tends to avoid some of the special risks associated with credit lines, such as moral hazard and adverse selection of beneficiaries, which may lead to the misappropriation of funds or to default. Direct participation in local financial institutions is normally not feasible for IFAD. A special effort should be made to develop the instrument of equity participation in either apex fund institutions or in trust funds which, in turn, provide equity or credit lines to microfinance institutions. These funds are to be professionally managed and commercially run, and must remain independent of political interference. This may require special institution-building support and safeguards from IFAD or other donors. The legal foundations and operational details are yet to be worked out. Strategic linkages with multilateral, bilateral and private investment companies or funds may be useful in the development and implementation of this new instrument.

**Credit guarantee schemes,** which are to induce commercial banks into microlending, are another, highly leveraged form of the supply of liquidity. Like the raising of equity and the granting of credit, risk-management is one of the basic functions of financial intermediaries. It may need strengthening through technical and financial assistance, but must not be replaced by donor money. Given the unpromising record of financial assistance to government-run credit guarantee schemes, great care must be taken in the selection of partners and the design of programmes. Important criteria are professional management of the scheme, a commercial orientation toward viability and feasibility, a positive impact on outreach (*additionality*), and agreement on a schedule for the transfer of the microcredit risk to the bank (*exit option*).

**Microinsurance** is a new field for IFAD. It may be provided by specialized agencies or by rural and microfinance institutions. The basic functions are loan protection and savings mobilization. Both of these are in the interest of the institution, whereas individual protection is in the interest of the family. Examples of viable microinsurance schemes are found in cattle, fire, health, hospital and accident insurance, some of them backed up by international reinsurers. Financial cooperatives and rural banks, that have the poor among their shareholders, are among the potential microinsurance providers which deserve IFAD's start-up support. In developing countries, most insurance continues to be offered by informal financial institutions and insurance associations, which are based on the principles of self-help, self-reliance, viability and sustainability. Through assistance in the upgrading of such institutions and associations, and the dissemination of their experience, IFAD may greatly contribute to the social security of the poor.

**Strategic linkages** with multilateral, bilateral and also private donors will provide leverage to Ifad's projects in quantitative and qualitative terms. *Cofinancing, particularly with multilateral donors,* will mobilize the resources for larger projects and coordinated approaches, such as rural financial sector development, expansion of networks of microfinance institutions, establishment of central network services and apex funds, and AgDB reform. Ifad as an advocate of the rural poor may also take part as a cofinancier in financial sector adjustment loans, financial intermediary loans, rural sector loans, and technical assistance loans initiated by other donors.

IFAD has no permanent presence in the field. Through close *cooperation with technical assistance (TA) agencies,* including UNDP and bilateral donors, IFAD may greatly enhance the quality of its projects in terms of financial innovation and expansion. TA agencies with a local presence may also provide direct administrative supervision and quality control services.

IFAD may also lend support to its partner organizations, including representatives of MFI networks and the poor, for participating in *policy dialogue* by *the IMF and the World Bank* with government. Policy dialogue is an instrument that may directly contribute to the shaping of the macroeconomic environment and the regulatory framework for rural financial institutions. The active involvement of IFAD and its partners in the dialogue on appropriate legal forms and prudential norms for rural microfinance institutions may lead to a legal framework for private institution-building initiatives. These may include rural banks with moderate minimum capital requirements, financial cooperatives and non-mutualist local institutions with appropriate capital adequacy ratios, apex banks or funds, and the formation of networks of informal financial institutions. Once established, IFAD may support their expansion and consolidation.

IFAD's focus on profitable rural financial institutions and sustainable financial services for the poor may open up new avenues of *cooperation with the private sector.* The Fund may actively promote three forms of cooperation: cofinancing of rural finance initiatives together with international private donors**;** cooperation with foreign banks in the provision of training and consultancy services to decision-makers in partner institutions and rural financial institutions**;** and the promotion of linkages on the part of rural microfinance institutions and self-help groups with commercial banks.

**Follow-up**

This policy paper is a **living document.** It will be periodically revised, to incorporate recent innovations and new insights.

This draft will be discussed with members of IFAD's Executive Board in an informal workshop scheduled for December 6, 1999, and, with due revisions, submitted to the Board in April 2000.

Once agreement has been confirmed on the guiding principles, regional strategies and technical papers will be prepared. These will be made available in the form of Rural Finance Working Papers through a webpage and in hardcopy.

## *Annexes*

For the annexes see *Rural Finance Working Paper No. A1: IFAD Rural Finance Policy*