IMPROVING RURAL INSTITUTIONAL FINANCE: SOME LESSONS

Nimal Fernando[1, 2]

ABSTRACT

A summary of the major criticisms of the conventional approach to rural credit is presented. Some lessons and experiences in developing rural finance are discussed. The need for a broader view and a holostic approach, importance of building financial infracture, importance of rural infrastructure and non-financial policies, importance of institutional building is emphasized. Subsides in building institutional capacity essential in rural saving mobilizations, roles of private commercial banks, and the need for directed finance progrommes are briefly outlined.

Key words: *Rural finance, financial infrastructure, institutional building, studies, savings.*

INTRODUCTION

In many developing countries government policy agenda stresses rural development for a variety of reasons: rural areas are largely underdeveloped in comparison to urban areas; most of the population and the poor live in rural areas; rural areas offer considerable development potential; rural areas are politically important. Thus the concern for rural development reflects equity, growth and political considerations. To achieve the objective of rural development, governments have offered a multitude of support measures, incentives and assistance. Measures aimed at increasing the flow of credit to the rural sector, particularly to small farmers constitute a major element of such support in many developing countries. More specifically such support includes, inter alia, interest rate subsidies on loans to rural economic activities; establishment and operation of special credit schemes and institutions; budgetary support for rural credit activities; refinance facilities for rural lending operations of financial institutions. Perhaps, there is no developing country government in Asia, Africa, or Latin America which has not extended some specific support for rural credit operations.

International aid agencies, multilateral lending institutions, regional development banks and donor countries have supported in varying degrees developing country initiatives to improve credit flows to the rural sector. In many cases governments have initiated special programs or projects with financial assistance from such external sources. The nature and scale of the programs have differed across countries. But most of the programs have focused on supply of credit.

CRITICISMS OF THE CONVENTIONAL APPROACH

Criticisms of the conventional approach to rural credit are well known and have been widely discussed in literature as well as international and many national fora (von Pischke *et al.* 1983; Braveman and Guasch 1993). Hence the paper does not attempt to detail these approaches. But to put the subject of the paper in proper perspectives a summary of the major criticisms is presented.

These criticisms include: the approach has been too narrow, being confined largely to agricultural credit; rural savings have constituted the "forgotten half" of rural finance; interest rate subsidies and various other subsidies have undermined development of viable rural financial systems by promoting misallocation of credit and encouraging defaults; subsidized credits have benefitted largely the rich and very little had reached the small farmers and the poor; the approach had led to a greater dependency of financial institutions on external sources of funds including government budgetary support and hence undermined the institutional viability and sustainability; the approach has offered strong incentives for political interference in rural credit activities with consequent adverse effects on effi-

[1] The views expressed in this paper are entirely those of the author and do not in any manner reflect the views or policies of the Asia Development Bank.

[2] Project Economist, AG4, Asian Development Bank, P.O. Box 789, MANILA, Phillipines.

ciency of credit institutions and recovery of credit; the number of farmers reached remained small and many farmers served are those who could even have had access to credit from commercial sources[3].

SHIFT TOWARD A MARKET-BASED FINANCIAL SYSTEM

A major response to the weaknesses in the traditional approach to agricultural credit has been a gradual movement towards providing financial services at market-based or market-approximating prices. This approach is widely known as Rural Financial Market (RFM) approach. The RFM approach emphasizes the need to develop rural financial markets rather than increase credit supply and to rely on market interest rates; recognizes savings mobilization as an integral part of rural finance; highlights the importance of building viable and sustainable rural financial institutions (RFIs) through market incentives and allowing private financial institutions to expand rural sector portfolio on market basis; and advocates elimination of subsidies for rural finance activities.

There were some changes in the old supply-led approach to agricultural credit in the 1980s. However, the changes have not been wide enough to replace the old approach. In many countries conventional support measures aimed at increasing supply of rural credit seem to continue side by side with the new initiatives though the relative importance of the former is gradually decreasing.

Although the RFM approach had gained considerable popularity during the last decade, still there seems to be no consensus of opinion on how best the rural financial system could be improved to support rural development. Disagreements, for example, exist on most appropriate interest rate policy on rural finance[4]; subsidization of rural finance, the need for specialized financial institutions to cater to rural sector and the need for targeted credit schemes. The arena of rural finance policy and practice has come to a critical and controversial stage where many national and international institutions involved in achieving the objective of improving the rural financial system have begun to take a fresh look at their own policies and strategies.

In the meantime several experimental projects aimed at improving rural finance have matured and scaled-up their operations, the notable examples being the Grameen Bank (GB) of Bangladesh and Badan Kredit Kecamatan (BKK) and Kupedes Scheme in Indonesia[5]. The Grameen experience is being replicated in a large number of countries with financial and technical assistance from donors and multilateral financial institutions. Besides these widely-known programs and projects, a large number of small-scale rural finance projects are being operated in many countries[6].

The old approach to rural credit, RFM approach as well as the other new approaches being tried in a number of countries offer many useful lessons for those who are interested in improving rural financial systems. A major purpose of this paper is to highlight *some* of those lessons of relevance to developing countries. The lessons chosen for the discussion in general relate to: the approach; financial and rural infrastructure; financial and non-financial policies; institutions; prices of financial products and services; savings mobilization; involvement of private commercial banks; and directed finance programs.

LESSONS

Need for a Broader View and a Holistic Approach

Experience in a large number of countries shows that our view has to be broadened from agricultural credit to rural finance and the approach from credit supply to development of financial markets. This change has occurred to some extent over the years, but that is not yet complete. There are several dimensions to this broadening.

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[3] For more recent empirical evidence from Bangladesh and Nepal supporting most of these assertions, see Chowdhury and Garcia (1993).

[4] For example, Desai and Mellor (1993) argue in a recent publication that market interest rates on rural loans in certain situations can have considerable adverse effects on mobilization of rural savings and hence the overal profitability of RFLs. They point out that if an increase in interest rates decreases the volume of business, it cuts back on the savings the institutions can accrue from economies of scale, negatively affecting their profitability.

[5] See for an excellent account of these, Yaron (1992); On Grameen Bank, see also, Hossain (1988).

[6] See The Foundation for Development Cooperation (1992); and Hilhorst and Oppenoorth (1992).

First on the "concept broadening". Clearly agricultural credit is only a segment of rural finance. But evidence suggests that rural non-farm sector is also of vital importance for broad-based development[7] and that sector's financial requirements cannot be ignored. Also, the "forgotten half" of rural finance, which is savings, must be made an integral part of intervention measures in rural financial markets. The other type of broadening required is vertical: given the high degree of socioeconomic heterogeneity in the rural society it appears that rural finance should not be conceptualized as banking for the "poor", "marginalized", or "small" farmers. The concept of "finance" is broader, cuts across activities and socioeconomic groups; and compels to direct the focus on financial markets and relationships between different types of participants in the markets. Thus, if the approach is to be broadened from one of segmented to holistic, the broadening of concept to "rural finance" becomes a prerequisite.

Second, on the broadening of the approach. The financial system is an important mechanism by which an economy mobilizes and allocates resources. For the financial system to do this function efficiently there must be efficient institutions, suitable financial instruments and supportive financial and non-financial policies (see Appendix 1). Rural financial markets consist of relationships between buyers and sellers of financial services and assets of different types in rural communities. The narrow supply-led approach to credit cannot cover these important dimensions and hence is unlikely to lead to financial market development through which resources may be efficiently mobilized and allocated.

Financial institutions must also diversify their risks to minimize their overall average risk level. Potential for such diversification is greater when their clientele is not confined to the poor or small farmers. Also, institutions that deal exclusively with small loans and deposits are often unable to meet costs and produce a profit. Therefore, they cannot resort to cross-subsidization of activities to any significant scale, at least until the initial information and other constraints to expansion of their activities are removed and their outreach is broadened to serve an increasing number of small sector clients. This tends to make such institutions heavily subsidy-dependent. Further the apparently popular presumption that those who do not belong to the categories of poor, marginalized or small farmers do not have problems in having access to formal sector financial services, does not appear to be realistic.[8]

Financial intermediation is the most important role of financial markets in development. Financial intermediaries perform this role by pooling and reallocating savings. There is considerable potential for savings mobilization in rural sectors, in part because everybody in the rural sector is not poor. Even poor people save and these savings can be mobilized, pooled and transformed into financial assets (Von Pischke 1978; Fernando 1991a). Also, savings mobilization provides multiple benefits to lenders by enhancing their information base on existing and potential clients which in turn would enable them to improve their lending decisions (Vogel and Burkett 1986).

IMPORTANCE OF BUILDING FINANCIAL INFRASTRUCTURE

In the past many developing countries have attempted to improve agricultural or rural credit flows through creating institutions or special schemes that deliver funds. Very little or no attention had been paid until recently on building financial infrastructure to support, strengthen and ensure sustainability of such initiatives. As a result, many schemes and institutions lacked solid foundations and have become fragile and unsustainable. A large number simply ended up as failures. For example, in Papua New Guinea, the Savings and Loans Societies (SLSs) were developed in the 1970s without a suitable and adequate financial infrastructure. This contributed to the failure of most SLSs. Many small depositors simply "lost" their savings with the demise of the SLSs in which they deposited their funds and did not have any legal protection. It was only recently that the policy-makers of Papua New Guinea attempted to address the financial infrastructure issues relating to the SLSs.

Poorly functioning and underdeveloped financial infrastructure impedes efficient financial intermediation by adding to the risk and cost of transactions while development of such infrastructure facilitates market based development by reducing costs and risk and allowing participants in financial

[7] See the significance of rural non-farm activities, Anderson and Leiserson (1980); and Binswanger (1983).

[8] In many developing countries, potential investors in medium and large scale agroprocessing industries and large holder farmers in perennial crops experience difficulties in obtaining loans from formal commercial financial institutions.

markets to transact business easily (Khanna *et al.* 1992). The infrastructure includes: accounting policies, practices and financial disclosure requirements; prudential regulation and supervision of financial institutions; legal framework governing financial transactions and legal procedures for enforcement of contracts; and dissemination of financial and legal information (Khanna *et al.* 1992; World Bank 1989). If rural financial systems are to be efficient and robust and to expand their coverage over time, they must be developed in the context of a suitable financial infrastructure (see Appendix 2). It is essential therefore to pay adequate attention on this aspect which underpins the process of financial development.

IMPORTANCE OF RURAL INFRASTRUCTURE AND NON-FINANCIAL POLICIES

Another underrated and neglected aspect of rural financial development is the significance and relevance of rural infrastructure. Such infrastructure facilities which directly influence economic development potential, returns on investments and level of social development also influence rural financial development, although their bearing has not been adequately recognized by many policy-makers in developing countries. This include, among others: farm to market roads; bridges; primary health care and primary education facilities; and marketing facilities[9]. Condition of rural roads and bridges often will determine whether a loan will be repaid or not while status of primary health care and education facilities may influence utilization of loan funds for the stated purpose.

Rural financial development is also intimately linked with a wide array of non-financial policies. These include chiefly exchange rate and agricultural pricing and taxation policies. In many developing countries, overvalued exchange rates and administered farm output prices make farming less profitable, farm investments unattractive and farmers less creditworthy. The macro as well as sectoral policies contributing to better financial returns on rural investments will have a far-reaching and significant effect on sound rural financial market development. The bottom line significance of sound non-financial policies is the same as that of rural and financial infrastructure: they contribute towards reduction of costs and risk of financial transactions.

The effect of better infrastructure and sound policies is felt on both sides of the financial services equation: on the demand side they enhance debt and saving capacity of potential clients and effective demand for services; on the supply side they result in reduction of costs and risk of financial transactions ,enhance incentives to provide services on a profitable basis, leads to an expansion of supply of finance and contribute toward sustainability of institutions.

Potential viability of rural economic activities is a key factor in development of viable financial institutions. If economic activities are unremunerative, it is unrealistic to expect that there will be bankable demand for loanable funds, nor will there be considerable potential for mobilizing savings in such a situation. Financial institutions that are compelled or required to serve rural sectors that suffer from severe inadequacies of physical infrastructure or that are subject to unfavorable price structures are likely to limit their services to the barest minimum number of clients or experience large losses and become fragile. They are unlikely to be able to build confidence among the rural community as a permanent element of the financial system and therefore may not be able to contribute towards the process of financial development. Unhealthy institutions are unlikely to provide services of good quality.

INSTITUTIONAL BUILDING IS IMPORTANT

For a long time the significance of institutional capacity for rural financial market development was overlooked. Emphasis was placed on making funds available for lending. This is partly why state departments and project management offices were often granted responsibility of delivering credit to rural sector and specific target groups in that sector. Building suitable institutions and their capacity was not a high priority item in many credit programs or projects. This is true even when new institutions were set up for the purpose.

In general, most RFIs were created within and nurtured by a distorted policy environment. Many of the institutions were not market-driven. Hence the signals and directions transmitted to these institutions were simply not conducive for orderly and sound institutional development. Also, such

[9] High default rates are cited as a common characteristic of rural credit. It may be interesting to find out the extent to which poor rural infrastructure is responsible for the default problem.

new institutions were conceived and used as mere conduits for delivering credit rather than essential components of the long term process of rural financial market development. Often they were under-funded, under-staffed; their staff was not given suitable and adequate training; their capacity to appraise projects and manage delinquent accounts was not developed systematically as a part of long term human resource and skill development process in rural finance. Accounting practices of the institutions were not developed in a systematic manner. Management information systems remained poor. Incentives for innovations were conspicuously absent in many institutions. In short, institutional building was considered as an exercise in creating new institutions, physical construction of buildings and appointment of new staff and giving them some training and budgetary support.

Experience during the last three to four decades shows that institutional capacity is of vital importance in the process of rural financial market development. Many credit programs and projects have failed, in part, due to the neglect of this aspect. Rural financial development is a tedious, complex and long term task. To accomplish this, a country must have strong financial institutions with trained staff[10]. Recognition of the significance of this factor is illustrated by the fact that GB which is frequently cited and widely claimed as a rare success story in rural finance, spent as much as 10.5 per cent and 28.1 per cent of its administrative costs for training purposes, respectively in 1987 and 1989 (Yaron 1992, p. 39). Functionally also training of staff is considered as one of the most important tasks in GB. Incentives for efficient operation will have to be combined with capacity to respond. In the absence of sufficient capacity, incentives are unlikely to produce desired results.

RFIs must have sufficient ability to promote financial services, efficient system of credit delivery and recovery, suitable eligibility criteria for lending, staff with adequate skills in cash flow analysis, project appraisal and management of delinquent accounts, efficient systems for deposit mobilization and staff trained in deposit mobilization, and a management information system which can produce timely and user friendly information. It is equally important that these institutions enjoy a sufficient degree of autonomy in decision making relating to their day to day activities.

INTEREST RATES DO MATTER

Many developing countries neglected for long the fact that distortions in interest rates can have significant adverse effects on the speed, level and nature of financial development. This was partly a result of the wrong assumption that agricultural sector cannot bear market interest rates. While this assumption has proved to be unrealistic, experience shows that the level and structure of interest rates have to be such that they provide sufficient incentives for the participants in the markets to operate efficiently. This is particularly true in the case of lending rates in the rural sector.

Interest earnings are the principal source of revenue for RFIs. When on-lending rates are kept at artificially low levels with inadequate spreads through administrative decisions, RFIs are forced to use various rationing devices of funds leading to political interventions in decision making, distortions, poor outreach, and significant financial losses. Such systems of pricing of loanable funds also reduce incentives for financial technological innovations which play a major role in rural financial market development. These problems, to a large extent, can be addressed by shifting to a market-based pricing system.

Competition in the financial sector can be ensured only if the interest rates are market-determined. Non-price competition among suppliers of financial products and services also depends to a large extent on the market-determined interest rates. When interest rates are simple administrative prices with no bearing on market movements, for example, the quality of financial services ceases to matter because such administered prices do not lead to a competitive behavior among suppliers.

The issues relating to deposit rates appear to be more controversial than those relating to onlending rates. Yet, empirical evidence seems to suggest that positive real deposit rates can have significant

[10]. According to Hilhorst and Oppenoorth (1992, p. 53) "it is not uncommon to find people with no training in financial matters, such as doctors, social workers, priests and agricultural technicians running the programmes and running them badly. In these circumstances it is not surprising that the rate of failure is so high".

[11]. Desai and Mellor (1993) refute this contention and argue that "farmers prefer to keep their assets in physical form anyhow in seed, equipment, livestock, and so fort-so a change in the rate paid on deposits". However, there is little empirical evidence to support their argument.

favorable effects on rural deposit mobilization[11].

The lesson is that market-based interest rates are important and they do affect significantly the development of rural financial markets. However, this does not mean that interest rates alone can provide a solution to the complex problem of rural financial market development and they should abruptly be allowed to be determined by market forces. The best strategy and the speed with which to shift from a distorted structure to a market-based system will have to be worked out depending on the country situation. The shift needs to be, in general, gradual.

SUBSIDIES CAN BE USED PRUDENTLY TO BUILD CAPACITY

The RFM approach to rural financial development highlights the negative role of subsidies and strongly argues against subsidies, particularly interest rate subsidies. Subsidies made available by donors and governments through budgets and central banks have in general undermined the financial viability and self-sustainability of many RFIs. Yet, in the author's personal view, the lesson from experience in the developing world is not that subsidies are bad and unnecessary: the lesson is quite different.

Subsidies, in some form, appear to be essential in the development of rural financial systems in most developing countries, if one of the objectives is to expand the outreach to cover bulk of the rural population, particularly low income groups and various disadvantaged groups such as women and those who live in remote areas. Mobilizing small deposits and delivering and recovering small loans involve high administrative costs. A considerable proportion of these costs relate to social intermediation[12] rather than financial intermediation and arises from the low level of social and human development of rural population. Hence, a justification exits for subsidization of operational costs of rural financial intermediaries[13]. Justification of subsidies also depends on the type and the number of clients served by an institution. Obviously subsidies are difficult to justify for those institutions which serve primarily the rich or large farm holders.

Again to illustrate the point it may be pointed out that GB's subsidy dependence was as high as 180 per cent in 1987 and 130 per cent in 1989, according to Yaron's (1992) estimation[14]. GB received a substantial amount of funds from donors and international lending agencies at concessional rates for on-lending and held much of those funds in private banks as long-term high yield term deposits. Hossain (1988) estimated that if the low-cost funds from the International Fund for Agricultural Development had not been available, the average cost of funds of GB would have risen from 3.6 per cent to 8.5 per cent and the cost of operation from 21.7 per cent to 26.6 per cent in 1986.

The author believes that GB would not have been able to serve the clientele it has been serving and have an extensive outreach without such a high level of subsidization. Yet this does not mean that subsidies must be an integral and permanent part of the rural finance structure. This does not also mean that lending rates must be subsidized. In the case of GB the subsidies were used prudently to serve an increasing number of low income group clients, mainly women, while maintaining high recovery rates of loans[15].

In the past subsidies produced widely discussed negative effects because: their purpose was not clearly spelled-out ; they were given largely to maintain concessional interest rates on loans; they were not transparent; RFIs receiving the subsidies were mostly state-owned and subject to a great deal of political interventions which created a vicious circle of subsidies; they were not time-bound; they were not given to right type of institutions and activities.

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12. Bennett (1993) defines social intermediation as "a process of linking those beyond the frontier of formal finance with formal financial institutions and other services that will improve their welfare and make them productive."

13. Subsidies provided to RFIs to cover costs of educating borrowers and providing technical assistance to borrowers may be considered similar to public expenditure on agricultural extension.

14. The subsidy dependence is measured as the ratio between total subsidies (both implicit and explicit) received by a financial institution and its total estimated annual interest income on the average loan portfolio. The ratio measures the percentage increase in the average onlending interest rate required to compensate a financial institution for the elimination of subsidies in a given year while keeping its return on equity equal to the approximate nonconcessional borrowing cost (see for details, Yaron 1992).

15. As of end of June 1990, GB had 660,000 loans outstanding with a total loan volume of $30 million. Its loan collection rate had been over 95 percent (Yaron 1992; Hossain 1988).

If subsidies are to be applied in relation to rural financial development, it is essential to clearly spell-out the subsidy policy. The policy should, among other factors, deal with the activities deserving subsidization, time-frame of subsidies, transparency, financing method of subsidies and how and when effectiveness of utilization of the subsidies may be assessed. In general available evidence tends to suggest that the subsidies be confined to finance start-up costs and institutional development activities (training, development of efficient delivery and recovery systems, improvement of information systems etc.,) and must not be used to make interest rates cheaper to the final borrowers partly because for most rural sector potential clients, availability rather than cost of credit is more important. This seems to be true particularly in respect of short term loans irrespective of the clientele category.

Greater Emphasis on Rural Savings Mobilization is Essential

Mobilization of rural savings is an important part of many successful rural financial institutions. Voluntary savings mobilization generates multiple benefits to financial institutions. Vogel and Burkett (1986, p. 426) note that:

> "...lenders that mobilize deposits automatically obtain information about their depositors as potential borrowers that can lower transaction costs and default risks on loans, while borrowers from FIs (financial intermediaries) that mobilize deposits locally feel an increased obligation to repay loans. Furthermore, deposit mobilization can free FIs from the feast-or-famine cycle of external funding from governments and international donors and thereby strengthen confidence among both depositors and borrowers. Deposit mobilization may, therefore, increase, and loan delinquency and default may fall, as borrower incentives to repay promptly are based in part on future access to credit from an FI".

They conclude that the performance of lenders that accept deposits appears to be significantly better than those that do not in terms of transactions costs for both lenders and borrowers and also in terms of loan delinquency and default.

Despite the potential benefits, the significance of voluntary savings mobilization by rural financial institutions has not been fully recognized and appreciated by policy-makers in many developing countries. As a result many countries have not yet made much progress in establishing savings as an essential dimension of their rural financial development activities. When attempts to promote savings are made they often constitute attempts to graft a saving component onto an existing institution or a scheme rather than attempts to make savings an integral part of the rural finance system.

Savings mobilization efforts, however, should not lead to hasty attempts to graft savings schemes into poorly functioning lending institutions. It is unrealistic to assume that a lending institution that cannot efficiently allocate its existing resources would function more efficiently in mobilizing deposits from a large number of people, synchronizing such resource inflows with credit transactions and managing their funds profitably. As Von Pischke (1991, p. 311) points out:

> "the damage done by failed deposit takers can be large and politically awkward, with disastrous social consequences. It would be specially unfortunate for small savers to find that their savings had disappeared as a result of bad bookkeeping, fraud, or poor lending decisions leading to bad loans and ultimately to the failure of the institution accepting deposits"

While deposit insurance can protect depositors' interests, as shown more recently by the US experience on Savings and Loans Societies, such insurance can lead to moral hazard problems and finally may be costly to the society. Thus Von Pischke (1991, p. 312) concludes:

> "The conclusion to be drawn from recent experience with failed deposit-takers is that institutional sustainability requires a high quality of lending and capital adequate to bear the risks of intermediation. Thus deposit-taking is not a panacea for poorly-performing lenders. The first order of business in improving their performance should be reform of their lending operations, not the addition of deposit-taking. Before deposit taking is introduced, capital should be sufficient to protect the interests of depositors".

An important aspect relating to rural savings is that they are influenced by a variety of factors, not just the deposit interest rate. The most critical determinants of rural savings will have to be identified carefully and savings promotion strategies be designed accordingly to address those critical factors and constraints. The standard prescription of positive real deposit rates is important, but may not be sufficient to generate an adequate response in certain situations where savings are less elastic to interest rate and more elastic with respect to other factors such as level of confidence in deposit-taking institutions, appropriateness of savings instruments and the degree to which access to loans is enhanced through savings.

While the significance of savings for rural financial development cannot be denied, it must be recognized that for a variety of reasons it is difficult for RFIs to use rural savings to finance term loans, if they are to be involved in term lending. This is particularly true when RFIs are to finance perennial crop development where gestation period of investments typically ranges from 3 to 6 years and negative cash flows are experienced for even a longer period by final borrowers and to a lesser extent in regard to financing medium to large-scale agro-processing industries.

The lesson to policy-makers is that if term loans are to be expanded, additional funds may have to be provided to RFIs until such time they develop capacity and generate adequate savings with suitable maturity structures for transformation of relatively shorter term liabilities into longer term assets.

PRIVATE COMMERCIAL BANKS WILL PLAY A LIMITED ROLE

Historically, government interventions in rural credit supply began as a response to market failure. Since private banks were not willing to play an active role, state-owned or controlled institutions were put in place to fill the gap between demand and supply of credit. More recently with measures towards financial liberalization, efforts have been made in several countries (e.g., Sri Lanka, Pakistan) to involve private commercial banks in rural finance, particularly in lending to an increasing number of small farmers and low income people. However, the response has so far been generally poor despite additional incentives provided in some cases in terms of credit guarantees and concessional funds for on-lending.

The reasons for this poor response is not surprising. Cost of lending to small farmers and low income clients still remain high. The administrative costs of small loans even under best circumstances may not be lower than 5 to 6 per cent of the average annual loan portfolio of a RFI (Yaron 1992, p. 40). The risk levels of rural lending have also not come down substantially. Financial liberalization in many countries has also generated relatively more profitable lending areas for private banks than rural lending and hence they are more keen to exploit those opportunities.[16]

Private banks also require marketable collateral to cover perceived risks of lending to agriculture and new clients in rural areas. Many rural potential investors find it difficult to offer such collateral. Thus they continue to lack access to credit from those banks.

The issue of collateral is important even in a liberalized framework within which commercial banks are free to charge market interest rates on loans. In theory, interest rate should reflect risk levels and hence be different when risk levels are different, assuming all other costs entering the interest rate calculation remain the same across borrowers. The banks, however, do not practice interest rate discrimination among most of its clients, though the risk levels across borrowers may be quite different, and, in general, charge a standardized interest rate for a majority of their loans. Thus collateral is essential in cases where the market interest rates are insufficient to compensate for the risks associated with a loan to a particular borrower (Fernando 1991b). The implication of this is clear: most of the potential rural borrowers who lack bankable collateral may find themselves excluded even when lenders enjoy freedom to charge market-determined lending rates[17].

[16] Those who argue for a greater role in rural finance by private commercial banks and criticize private commercial banks for not being active often seem to ignore that what matters in decisions relating to allocation of limited resources is risk-adjusted *relative* profitability rather than profits per se of alternative activities.

[17] It has been argued that this is the case in Papua New Guinea where private commercial banks are free to set their lending rates (Fernando 1991 b). In a case study of the Thai rural credit system, Siamwala *et al.* (1993), p. 164) also reported that the sphere of operations of commercial banks has been almost exclusively in villages where land titles have been issued to the tillers.

[18] Indonesia's Kupedes (kupedes means general rural credit) scheme demonstrates the significance of collateral in expanding the outreach of RFIs. At the end of 1989, one rural household in every twelve had a kupedes loan outstanding and over 60 percent of the borrowers were able to meet the collateral requirement by pledging homes and/or house lots to gain access to credit from Kupedas (See Fernando 1991 b).; Fernando 1991 b).

Since collateral continues to be a key factor in improving access to credit for bulk of the rural people and inducing private commercial banks to play a dynamic role in rural finance[18], measures to address issues relating to collateral must be accorded high priority in rural financial market development. The approach in many countries has so far been largely limited to improving debt recovery laws and very little emphasis had been placed on land title improvements and making land a readily marketable collateral.

'Group liability' has been an important and tested innovation which addresses the issue of rural people's lack of ability to offer marketable collateral to gain access to credit from RFIs.[19] GB had effectively used this "social collateral" to deliver and recover credit. However, 'group liability' is not a universally applicable innovation across countries and it has limited application across different economic activities even within a given country. This method cannot be efficiently used in term lending as it is in short term lending (Fernando 1991 b, p. 17). In such cases, there appears to be no substitute for marketable collateral.

DIRECTED FINANCE PROGRAMS ARE STILL NEEDED

In many developing countries, programs have been designed and implemented to provide credit to specific target groups for specific activities by selected institutions. Such programs are commonly known as directed credit programs. Disappointing results of most of the directed credit programs in the past several decades seem to have contributed to an apparently general view that such programs are an impediment to the development of rural financial markets. Although most directed credit programs in developing countries have had adverse effects on financial market development and failed, it is not logical to conclude that directed finance programs cannot play an important role in the process of rural financial market development.[20] Most such programs failed due to poor design, poor implementation capacity of the responsible institutions and due to the distorted policy and economic environment within which they were created and operated.

The rural sector is highly heterogenous in terms of economic status and social development of people. The access to information, awareness of opportunities available, familiarity with formal sector procedures and instruments and ability to make use of economic opportunities differ considerably among various socioeconomic categories. There are some categories of people, such as women, small farmers, micro-enterprise operators, who are distinctly at a disadvantage in responding to market opportunities. If the development is to be broad-based and people-centered, such groups cannot be left on their own. They need specific assistance. Similarly, the suppliers of financial services due to lack of information and costs and risk considerations may not respond to the financial requirements of such groups. Hence, such groups may find it difficult to be active participants in an exclusively market-based financial development process.

Directed rural financial programs can play an important role in laying the foundation for integration of such categories of people into the formal financial system over time. These programs can, not only be catalysts but also important extension mechanisms and human capital development efforts within such groups. However, learning from the past failures, such finance programs, to be effective, need to be carefully designed, well administered and targeted and must be subject to regular evaluations.

CONCLUSION

The conventional supply-led approach to rural credit had its limitations and weaknesses and was inadequate to address the fundamental issues concerning rural financial development. The current poor status of rural financial markets in most developing countries which followed this approach for over four decades itself is ample evidence to support that hypothesis. However, many years of experience relating to the supply-led approach in a large number of countries seems to indicate the needed redirection in rural finance. The RFM approach and a variety of other new approaches ranging from widely-known GB, BKK and Kupedes to many other smaller scale rural finance projects further enrich our understanding on how to address the complex issue of improving rural finance in developing countries.

19. See advantages and shortcomings of group lending - Braverman and Guasch (1993).

20. In most developing countries directed credits have burdened financial institutions with nonperforming loans, hindered the growth of financial savings, promoted financial indiscipline within financial institutions and among borrowers and interfered with the financial system's efficient operation, (see World Bank 1989; 1993).

Many lessons can be drawn from the past experiences with rural credit and finance. These lessons may be fitted into a coherent framework consisting of financial and rural infrastructure; financial and non-financial policies; institutions; market-based prices and market-responsive practices. Development of rural financial systems requires suitable infrastructure and sound financial and non-financial policies. These are necessary but not sufficient. Suitable institutions that adopt market-based prices and that respond to market signals are also essential. It is however becoming increasingly clear that the shift towards a market-based system has to be gradual rather than abrupt. This shift must involve a transitional period during which subsidies and directed finance programs will continue to play an important role. Yet, subsidies need to be used prudently to improve institutional capacity rather than to provide financial services at concessional prices. Similarly, directed finance programs must be carefully designed and well-implemented to address constraints which impede incorporation of specific target groups into the mainstream of formal rural finance. There are however no blue-prints for individual countries. Each country will have to design its own strategy depending on country-specific factors bearing on its rural financial market development.

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Appendix 1. **AN INTEGRATED RURAL FINANCIAL SYSTEM: FRAMEWORK**

System Components	Elements/Characteristics	Effects/Impact
Sound Macroeconomic and Fiscal Policies	exchange rate; wages; prices; trade; taxation.	improves resource allocation;provide incentives for efficient resource use by all parties in the markets;
Financial Infrastructure	prudential regulation;legal framework; accounting policies, practices and financial disclosure requirements information disclosure and dissemination; central bank's capacity to supervise and regulate the financial system.	risks and cost of intermediation are reduced and returns raised; confidential enhanced (see, Appendix 2 for details)
Rural Infrastructure and Support Services	farm to market roads; bridges; market places; market information; extension services; health care; primary education facilities; rural electricity.	returns on rural investments are raised; risks to users and suppliers of finance reduced; incentives to suppliers enhanced; debt capacity (ability to borrow and repay) and savings capacity of clients raised.
Sound Financial Policies	Market-based interest rates; absence of undue portfolio restrictions. outreach and supply; greater ability to diversify risks.	potential returns to financial institutions raised; greater incentives to expand
Institutions and Their Capacity	private involvement in ownership; adequate, trained and motivated staff; sufficient resources and decision making autonomy; appropriate operational systems and simple procedures; reponsive to markets; multiple services and products; efficient accounting systems; reliable and efficient management information systems; market-based prices.	room and incentives for political interventions reduced; business-like behaviour encouraged; returns on services and products are improved; risks lowered; greater incentives for financial innovations to expand markets and returns.

Appendix 2. FINANCIAL INFRASTRUCTURE AND ITS SIGNIFICANCE

1. Prudential Regulation and Supervision of Financial Institutions (FIs)	Why?:	Confidence is a key factor in finance. Lack of adequate prudential regulation will contribute to inefficiencies within FIs and erosion of confidence among clients. Prudential regulation helps ensure solvency of FIs. Uniformity in practices across FIs can be maintained. Through supervision, Governments can obtain information to assess financial health of FIs and effects of Government policies on FIs.Problems may be identified before they develop into crisis proportions.
	Tasks:	Criteria for entry of firms into the industry; Capital adequacy; Exposure limits to prevent undue concentration of risks; Guidelines for classification of assets by quality; Definition of non-performing assess by quality; Definition of liquidity standards.
	Institutions:	Central Bank capacity to supervise FIs must be developed.
2. Legal Framework Concerning Financial System	Why?:	Participants in financial markets must have a legal framework within which they can transact business. Absence of suitable legal framework raises costs and risks. Inability to offer bank able collaterls Impede financial Intermediation. Mortgages over land and real estates are the best form of collaterals from FIs' point of view. Security of tenure, clear land titles and the case with which can be transferred facilitate lending and recovery.
	Tasks:	Enforcement of contracts is major aspect. FIs should be able to recover debts through foreclo sures on collaterals. Legal recognition of property rights is necessary. In the absence of such rights, it may be impossible for potential borrowers to offer security in the form of mortgages
	Institutions:	Laws and legal system need to be improved.
3. Accounting Policies, Practices and Financial Disclosure	Why?:	Financial system is based largely on confidence. Hence regular monitoring is essential. For this purpose, accurate and timely information is required. FIs also need such information to assess and manage their risks which is basic to success of FIs. In many developing countries, accounting and auditing
	Tasks:	Uniformity in accounting practices across FIs; Conformity with accounting practices recom mended by the International Accounting Standards Committee; Loan write-off policy; valuation of assess; classification of assets to facilitate meaningful analysis; Presentation of income statements and balance sheets.
4. Information Disclosure and Dissemination	Why?:	Finance is an information intensive industry. A small error can lead to large losses. Information is essential to distinguish good from bad clients. FIs must make available accurate and timely information. Central banks and Credit Information Bureau can make use of and disseminate the information.
	Tasks:	Mechanisms to collect, process and disseminate information in a suitable format and regular manner without adversely affecting participants in the markets must be developed.