

In demand: Technical and institutional innovations

Sustainable microfinance for rural areas

«Pushing the frontier of finance». Almost two decades on, this slogan by von Pischke of Ohio State University is still relevant. Concepts for the sustainable provision of microfinance already exist in urban areas, but the majority of the rural population in developing and transition countries has only very limited access to financial services. Yet most people live in rural areas.

The World Bank, with its Consultative Group to Assist the Poor (CGAP), estimates that, of the approximately 500 million small and micro enterprises worldwide, fewer than eight percent have access to formal financial services. This figure is probably significantly lower in rural areas. In recent years, there has been a growing recognition that lack of access to savings, loans, transfer of funds and insurance represents a major barrier to development.

As a rule, commercial banks either do not provide financial services to rural areas at all, or do not provide sufficient services. Compared to urban areas, the supply of other basic services is also largely non-existent. Despite the considerable successes of the microfinance movement, only densely populated rural areas in Asia benefit from a widescale outreach. Rural parts of Africa and Central Asia still suffer from undersupply. One of the greatest challenges of the next few years will therefore be to develop technologies for the rural areas of these regions which will make it possible to provide sustainable, customized financial services. For rural populations, access to financial services is an indispensable prerequisite for competitive participation in an increasingly globalized world economy and also a way of avoiding any further slide into poverty.

The areas concerned are by no means marginal: they are home to a significant part of the world's population.

Urban-rural disparities

While sustainable microfinance technologies have been successfully developed for urban and semi-urban areas, there is generally no sustainable supply of financial services to the rural areas of developing and transition countries. The reasons include high transaction costs due to low population density and high risk levels based on climatic and covariant risks.

For financial institutions, this results on the one hand in higher costs and on the other hand in lower per capita savings activities and loan demand. Experience shows, however, that rural populations in particular can benefit from suitable financial services provided by means of stronger self-help strategies. Technical and institutional innovations are particularly necessary. Rural areas represent one of the frontiers of the microfinance

In northern Mali, a network of microfinance institutions is emerging in rural areas.



Photo: Ellsäßer

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approach. Pushing these frontiers will be the challenge for the coming years. Donor and implementing organizations, such as GTZ, KfW, the Swiss development agency DEZA and the World Bank, have recognized this challenge. These organizations finance innovative pilot projects and are pushing for appropriate legal framework conditions that will favour the expansion of the financial market.

Despite its disadvantages linked to location, the rural environment also has characteristics that, if exploited correctly for microfinance, could contribute to lowering transaction costs. Rural societies are generally far better organized than urban ones. Microfinance institutions can utilize these organizational forms and the related flows of information. For example, a person's creditworthiness is known at village level. If a microfinance institution assigns responsibility for loan allocation and repayment to the village community, it can tap this information without having to gather it at great expense. In addition, joint-and-several guarantees and social pressure for repayments are significantly easier to create through suitable organizational set-ups in rural areas than in cities. The German Raiffeisen system made use of this fact in the nineteenth century, and the Grameen Bank has based its business model on it.

Poor people are creditworthy ...

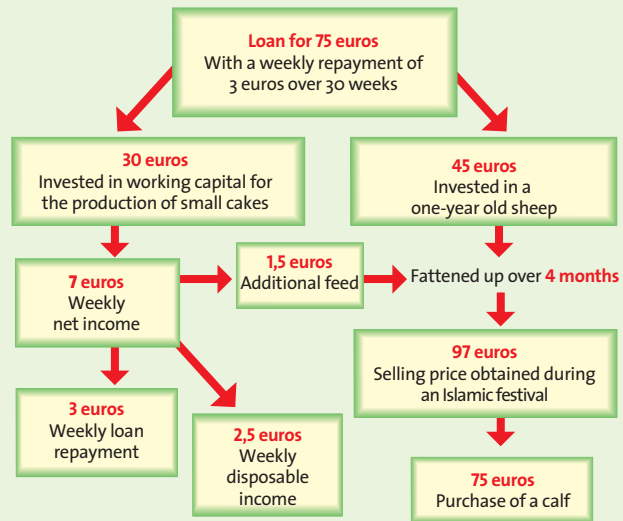
Millions of rural microfinance customers provide living proof every day that poor people are creditworthy and are also willing to pay the full price for high-quality financial services. Recent studies (Rutherford, Zeller) and demand analyses, which FIDES has compiled for the development of new financial institutions, show clearly and consistently that poorer families in particular are also embedded in very complex, largely informal financial systems: «Many of the poor borrow, more save, all insure» (Zeller et al., 2000).

An example from northern Mali illustrates how a loan customer uses a loan to pursue three different strategies: she uses part of the loan as working capital for the production of cakes. By purchasing a sheep, she makes the other part an investment. The investment, in turn, takes the function of insurance. As she is a client of a microfinance institution that does not offer insurance products, she can only obtain insurance indirectly through her own investments.

The greater a household's exposure to risks (such as drought, war or macroeconomic instability), the greater is the demand for financial services other than loans. This demand grows out of the self-

Use of a micro loan

Example: Oumou Cissé, a 28 year old woman with two children in northern Mali



This investment model, which appears complex, demonstrates how a loan, which was officially taken up to finance the production of cakes, is allocated to two investment projects: a production and sales activity that provides income in the short-term and a livestock breeding activity. The short-term activity serves to meet loan repayments and daily expenditure. The livestock breeding is a long-term investment. It begins with the purchase of a calf – to form the basis of a herd of cattle in the longer term. This herd will function primarily as insurance. The woman has combined access to a loan with her knowledge about livestock farming (she comes from a family of nomadic livestock herders).

help strategies that rural households develop as routes out of poverty. In rural areas the household and the business are generally inextricably linked. Surveys undertaken within the framework of a feasibility study for a rural microfinance bank in West Africa have shown, for example, that families use up to 20 different financial instruments at the same time.

The chart illustrates the demand structure for financial resources using an example from rural Tajikistan. Many of these essential financial instruments are provided by the informal sector. An entire network of saving, insurance and loan arrangements form part of the fabric of everyday life for most entrepreneurs in developing countries, with most granting loans (for example to their customers) at the same time as borrowing (for example from moneylenders). Such transactions involve family relationships, friends, neighbours and informal – and in exceptional cases formal – financial service providers. In these networks, rural households either directly or indirectly pay the real costs for financial services; because services can only be offered on a sustainable basis when this is the case. The limitations of these systems are generally not linked to profitability, but to insufficient financial resources. The lack of funds hin-

ders the networks from providing long-term resources for investments.

Financial institutions that are to be created from scratch in rural areas can see themselves as complementing what already exists. They can learn from the reality on the ground: poor people are creditworthy, able to save and prepared to pay for insurance.

... and need a diverse portfolio of financial services, just like the rich

Microfinance research of the last few years shows that the poor want financial services similar to those demanded by the better-off in society. These services mix short and long-term transactions with loans, insurance, savings and transfers. The difficulty in providing these services sustainably lies not in the type of product, but in the low volumes involved. The low income from interest is at odds with the high administrative costs.

A broader package of services

From a development perspective, the growth of the rural financial system presents a key challenge. It depends on the

ability of formal financial systems to provide appropriate financial services on a broad and sustainable basis (financial sustainability and outreach). This also requires the continued development of technical and institutional innovations that are relevant to rural areas. In the medium-term, it will be difficult to provide a sustainable supply to areas which are very poor and also sparsely populated. However, technical progress and suitable institutional concepts can push back the frontiers of what is feasible and can, even in areas with a subsistence economy, include a growing proportion of the population in the economic cycle.

To achieve this, existing microfinance concepts that have proven themselves in an urban context must be custom-tailored to suit rural areas. The network of microfinance institutions currently being established with GTZ assistance in northern Mali within the framework of the Mali-Nord programme is a good example. As with traditional urban microfinance banks, private corporations provide financial services as an economically sustainable business. A supervisory board of investors monitors the business. However, the operations have been adapted considerably to ensure their viability given the low population densities and high levels of environmental risk in the Sahel:

- Modified operational structures that can be implemented with less-qualified local personnel allow profitability even for small scale operations.
- Strong capitalization involving local shareholders increases the pressure to make repayments, and increases the capacity to absorb crises stemming from the wider setting.
- Microfinance is integrated into the banking system by means of refinancing through local banks.

The microfinance institutions already created have reached break-even point after only a short start-up period.

A further example is the microfinance bank in the north of Namibia, which was established by GTZ, KfW and FIDES. Its business model is based on the extensive externalization of transaction costs in a sparsely populated rural area through the establishment of village-based savings and loan associations, which take over certain guarantee and management functions (customer selection, collection of repayments and savings deposits) from the bank. At the same time, the model avoids the governance problems of independent financial cooperatives. Not just technical but also institutional innovations are needed, including control and incentive structures that respect the giv-

en cultural, social and legal context. In the Mali-Nord programme cited above, for example, success was only possible once the principles of the Islamic banking system had been considered.

After the launch phase, the institutions created should work sustainably, in other words independent of external donors. Nonetheless, the innovations described above will continue to require social investment and government involvement, because the development of technologies is frequently too risky for private sector investors. If microfinance strategies have been tested and proven successful, they can expect to attract private sector investment.

In contrast to the traditional logic underlying agricultural financing in the past, the development of rural financial systems is initially more demanding in terms of time and knowledge than in terms of capital. Public funds should therefore flow into

- applied research, evaluation and technology development,
- the establishment of innovative microfinance institutions that set an example for the microfinance sector (benchmarking) and
- capacity building and institutional growth.

Social investors could provide the initial investments for refinancing and capital contributions to complement public sector involvement. This applies particularly to innovative financial systems, target groups with particular risks and for financing rapid growth in the early stages. In recent times, several investment initiatives with this kind of focus have appeared on the market. Successful new microfinance institutions in particular quickly develop a high demand for resources, which has to be met if costs are to be covered through economies of scale.

The objective should be to prepare rural financial institutions to qualify for refinancing on the normal financial market in the medium term. There are numerous examples of this. For example, all microfinance institutions that have been established by FIDES in cooperation with GTZ are now refinanced by commercial banks. An efficient allocation of responsibilities among the various actors is particularly important because a widespread impact can only be achieved by joining forces. Besides establishing a suitable framework, public-sector funding should focus on generating innovations and pilot initiatives. Private-sector capital will then be required to supply a potential market of millions of clients with the technologies that have been developed.

Demand for finance of a household in Tajikistan

Needs that can be planned for and are linked with a person's life cycle would be covered by savings wherever appropriate, trustworthy financial institutions exist. Events that cannot be planned for require informal insurance mechanisms, since formal insurance systems cannot be accessed. Investments are financed via savings and loan mechanisms. This segment, comprising investment in income-generating activities, is the focus for almost all microfinance institutions: it is what they base their loans on. Often, the closeness of the link between household and business is underestimated. At the household level, the available resources are channelled to where they are most urgently needed, even if this is not directly productive (for example to treat a sick child). Studies have shown that only in exceptional cases are loans used solely for the purpose that they were given. In the case studied in Tajikistan, temporary emigration played a role in all three demand sectors. Working abroad could be caused by hunger (distress migration), but could also serve to accumulate investment capital or to prepare for a marriage. Migration movements can play similar roles in Africa and Eastern Europe.

Source: Own research on behalf of GTZ

