Which institutions are financing the rural areas?

Rabobank as partner in rural development

Photo: GlobalAware

With over 100 years of experience offering financial services to rural areas, Rabobank established the Rabobank Development Program to share its expertise with financial institutions in developing countries and emerging markets. Within this program, Rabobank has assisted in the restructuring and improvement of rural financial institutions. Rabobank is able to take equity stakes in rural-related financial institutions and also provides grants and advisory services.

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Worldwide, the financial institutions that provide access to finance in rural areas are mostly non-bank financial institutions, such as Non-Governmental Organizations (NGO) and microfinance institutions. These often don't have a banking licence and are thus not allowed to provide the whole range of financial services. These institutions also often have trouble growing with their customers. As the businesses of their clients expand, their needs in financial services change. For example, entrepreneurs may require loans exceeding the short-term tenors provided, or customers reach the stage where they are no longer the poorest of the poor, and they no longer qualify to borrow. When there are no financial institutions available to offer the necessary range of financial services, the development of the SME sector is stifled, thus hampering vital rural development. In this scenario, the SME sector is left stranded, precisely when it is needed the most for economic development, and for employment generation.
Micro-finance has proven essential in improving access to finance for larger parts of the population. However, it can be argued that it is more efficient to deliver these products through a regular retail banking institution than through a micro-finance organization.

Rural finance, a definition

Rural finance is broadly defined as «access to finance in rural areas.» It includes finance at the micro-level but also finance for small- and medium-sized enterprises (SME), and finance for both agricultural and non-agricultural activities. A number of reasons can be given as to why there is still a lack of financial services provided in rural areas. One is a lack of expertise in rural banking and the perception of high risk with agriculture-related lending. Another is higher transaction costs due to a scattered population.a

Urban-based commercial banks hardly ever enter into rural areas due to the high risks and costs. If they do «scale down» then they tend to «cherry-pick» from the limited number of the larger rural clients. In some cases, banks open branches or windows in rural areas to collect savings that are then either invested in urban larger clients or even government bonds or T-bills. Thus money is taken out of the rural area as opposed to being re-invested in local businesses.

Government support

The typical rural banks are often state-owned. Governments often feel that it is important to step into this market because of a lack of private interest and the importance of agriculture for the country. This often leads to rural banks that are not only involved in banking activities but are also involved in agricultural activities, such as the distribution of inputs and fertilizers. Such activities may take away the focus on banking in, for example, times of sowing.
Participation of governments in these banks can have political implications. In many developing countries over three quarters of the population live in rural areas and represent an important part of the votes. Governments might consider debt forgiveness at election time. This does irreplaceable harm to the image of banking. Customers should be aware that repayment is part of taking a loan. For banks, repayment is important. High loan recovery rates are the best assurance for offering loan products at affordable rates. Banks with government participation are often unable to arrange for their own funding through access to capital markets, deposits and savings, and must seek assistance from the government. This dependence can lead to unexpected

Financing small and medium enterprises in rural areas is one of the main activities of Rabobank in developing countries.

changes as the political focus shifts. While the influence of government is a good reason to privatize rural banks, privatization of rural banks often means half the branches are closed, thereby severely restricting access to financial services.

Financing rural areas

In terms of number of financial institutions, most emerging markets and developing countries are over-banked, especially when benchmarked against mature markets. It seems contradictory but in fact, for while there may be many financial service providers, often a large part of the rural population still has no access to financial services.

Many rural financial institutions lack scale for applying modern banking techniques related to issues such as IT/MIS risk management and access to financial markets. Effective financial service delivery would require the consolidation of existing institutions such as micro-finance institutions, credit cooperatives and small retail banks into a network organization. This is considered the preferred way to meet the requirements of the financial markets, reduce local risks, ensure effective IT development and create efficiency. One of the instruments used by governments to encourage consolidation in the banking sector is to increase the required capital base. In addition to being able to meet the requirements to apply modern banking practices, efficiency is a prerequisite to providing financial services at a level that conforms to the market. Within a network structure, an institution is able to standardize a large number of the procedures, products and operations. Because of the standardization, branches, or local banks, can offer better service to clients because less 'approval' time is needed and overall efficiency is increased. In addition to standardization, other efficiency measures are necessary, such as moving back office activities from the local level to head office.

As described, many financial institutions in rural areas were agricultural banks. These have shown little sustainability or continuity, exhibiting high-risk exposure, often to one sector, high transaction costs and ineffective product delivery. Worldwide, many of these banks have either merged into full service banks or they have gone bankrupt.

Rural retail banking needs to be geographically-based, with a product range matching the demand of all potential customers living within the area of a branch. This means that financial services need to be provided to farmers and agri-processors as well as to SMEs sector such as the bookshop and the construction company. In this way, a bank uses its distribution network to the full extent. Making financial services available to all entrepreneurs in different sectors also spreads risk. A broad product range ensures the banks can grow with its customers. This means amongst others larger loans, but also loans with longer tenors. Currently among rural financial service providers, there is a lack of medium- and long-term financing, which is posing a major constraint in the development of the SME sector.

The product range of rural retail banks should preferably also include fee products that do not carry risk, such as insurance and leasing products. This can create a win-win situation for both the bank (fee income) and the organization that carries these products, as it does not need to build up its own distribution network.

In addition to high costs and risk, commercial urban-based banks are also hesitant to provide financial services to rural areas as they lack the necessary agricultural expertise. This lack of knowledge leads to mismatches between loan purpose, cash flow and loan duration, the main causes of poor loan portfolios. Not only is the structuring of a loan important, but rural banks often grant loans based on social criteria rather than economic criteria. Social criteria include, for instance, people whose economic situation fits in the category «poorest of the poor» or «farmer». Credit worthiness, in these situations is not taken into account. Rural banks may even sometimes be instructed to provide loans though it is known in advance that recipients are not able to repay the loans. In this way, the loan acts as a channelling of subsidies. This, together with debt forgiveness schemes, does a lot of harm to the understanding of banking and is still very much common practice in many developing countries.

Cooperative experience

The European experience with cooperative banks, including their supportive role in diversifying the rural economy, is relevant today in many emerging markets and developing countries. Based on the competencies and specific characteristics of cooperative banks, there are a number of main areas in which they could be involved in rural finance. Also, the cooperative structure can be considered instrumental in the consolidation of existing small retail banks and non-bank financial intermediaries, like credit cooperatives and micro-credit institutions. Design and structure depends very much on local market conditions. However, in all cases they need to have the potential to develop to a sufficient scale in order to be able to provide appropriate services for all their members/clients.

Economic development

Access to finance is the backbone of economic development. Without a well functioning financial system, neither aid nor local entrepreneurship can create the right conditions for long-term economic growth. If development in rural areas needs to be realized, there is no choice but to focus on the total range of economic activities, including at the micro-level as well as the SME sector. Studies show that micro-entrepreneurs benefit to a large extent from access to finance. However, from the perspective of contributing to economic development, it is important to focus on SMEs as employers of the population, generating stable incomes for families and preventing further urban migration.

Wage-earning is a much better alternative for people than (semi) subsistence farming. Semi-subsistence is not so much a choice, but is largely due to the lack of employment opportunities. When 60 percent of the population is engaged in some form of agricultural production, there is no possibility to create reasonable income

levels, even with adequate forms of financing. A financial service delivery mechanism is, in this case, only one of the necessary support services.

Enabling environment

It goes without saying that it is essential that there should be an appropriate economic environment, namely macro-economic stability, and a conducive legal and regulatory framework: laws with regard to collateral, title to land, financial institutions, governance issues, etc.. These are essential prerequisites in the development of financial institutions.

Traditionally, many bilateral and multilateral development finance institutions have focused on supplying credit products to target groups without sufficiently taking into account the continuity of the institutions and/or the real market demand for a package of financial services. It is increasingly recognized that financial services such as savings, payment services and insurance, are at least as important as credit. Institutionally, it is understood in development circles that the development of sustainable (subsidy-free) financial intermediaries needs to be the ultimate goal towards facilitating economic development. At the same time, the rural clients need to pay the full cost of these services if they are designed and delivered consistently with their needs in mind.

As identified by the United Nations, in addition to a good policy environment, an important factor in poverty alleviation is donor coordination. While a very important issue, it is frequently lacking.

Supply chain financing

Although financial services can be most efficiently offered by a bank, if there is no bank, an alternative means of financing in agriculture is to look at supply chain finance. Within the supply chain, the main issue is getting financing to the farmer. The farmer is just a «price-taker» in the chain. The risks involved in financing small- and medium-sized farmers are often too high for finance providers. Traders, agribusinesses and input suppliers could play a role in the financing of farmers. It is important, however, to identify the most effective channels for different circumstances and different products. In order to determine the best financial solutions, supply chains must be well organized. This means that farmers could be organized in cooperatives to ensure they have leverage. Cooperatives can also attract more competitive conditions. Bargaining power and efficiency are the main issues related to the supply chain and impact directly farm income. Further, issues such as collection and transport of products and the role of intermediaries within the chain determine its efficiency and ultimately how finance is offered.

A particular difficulty arises when small farmers cannot be reached directly by a financial intermediary due to size and costs. Rabobank advises on making such constraints surmountable such as through the restructuring of agricultural supply chains and financial alternatives including marketing organisations and input suppliers.

Rabobank contributes

All the activities of the Rabobank Developing Program seek to improve access to finance in rural areas of emerging and developing economies. Rabobank has been active with this program for over 30 years now. In assisting the development of rural retail banks able to provide the full range of financial services to all potential clients in their working area, Rabobank contributes to the economic development of rural areas.

Rabobank approach

Rabobank promotes the development and restructuring of independent, full-service rural retail banks, either through consolidation, the transformation of non-bank financial institutions into banks or through the privatization of state-owned rural banks.

One of the Rabobank Development Program's (RDP) recent projects is the restructuring of the Principle Bank for Development and Agricultural Credit (PBDAC) in Egypt. The aim is to transform this bank over the next three years from a state-owned bank into a modern, privatized retail bank and hereby to improve the access of Egypt's rural population to financial services. RDP seeks to work with predominantly rural institutions towards long-term viability. In this respect, PBDAC is a perfect fit. With 1800 branches and some 30 000 employees, PBDAC is Egypt's largest rural bank serving over 3,5 million Egyptian entrepreneurs.

In the past three years, pilot projects were launched in the governments of Al Fayoum, Giza and Qalubiya. RDP has, amongst others, developed new products and introduced new ways of credit assessment. For instance, PBDAC used fixed interest rates for different types of loans to different target groups instead of assessing entrepreneurs on their creditworthiness. The Netherlands embassy issued a line of credit to bring these new products to market. Further, local bank employees were trained by Rabobank in all kinds of banking skills, such as credit control, marketing and customer relationship management. The best employees were trained as trainers, to spread the knowledge amongst colleagues in other branches. Rabobank also advised PBDAC in ICT architecture and the roll out to branches. Members of senior management of PBDAC travelled to the Netherlands to get a first-hand experience how Rabobank is structured.

The experience-sharing pilot projects will continue over the next three years, to assist PBDAC in its transformation to a modern rural retail bank, and as preparation for privatization.

Case Study: Supply chain financing in Sri Lanka

In Sri Lanka, Rabobank has looked into the tea, spices, fruit and vegetables sectors. Financing of farmers is done to a minimal extent by banks, and through NGOs and microfinance suppliers. It is estimated that only 40 to 45 percent of the short-term credit needs of farmers are covered through these financial service providers, and mid- and long-term credit is non-existent. The only sector in which farmers can access adequate financing is in tea, as it is the most organized sector.

One of the conclusions Rabobank was able to draw is that, before financing can be provided in the sectors, the sectors need to be reorganized. There are never 'magical' financial solutions to solve problems in the organization of the chain. If the chain is well-organized, the full-service rural bank is the optimal provider of financial solutions. In well developed countries, banks have this role. If a rural bank is not available, alternative instruments that can be used within the supply chain include:

- Agricultural Service Centres that apply «closed-loop financing structures» for a select group of participants in a closed agreement;
- «Cluster Models» that organize groups of producers, such as spice producers, and link them with selected processors and exporters. A closely monitored quality assurance is essential for this;
- «Warehouse Receipt Models» for longer shelf-life products such as cereals.

All these instruments are based on elaborate mutual agreements with a clear distinct responsibility for all participants, which enables bank financing in otherwise un-bankable conditions.