POLICY SERIES

Policy Series 1

RURAL FINANCE

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Natural Resources Institute
University of Greenwich

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GOODLAND, Andrew, ONUMAH, Gideon and AMADI, Juliana, with GRIFFITH, Geoffrey (1999) *Rural Finance*. Policy Series 1. Chatham, UK: Natural Resources Institute.

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Production of this publication was funded by the United Kingdom's Department for International Development. However the Department for International Development can accept no responsibility for any information provided or views expressed.

Price £5.00

Copies of this book can be obtained by writing to NRI Catalogue Services, CAB International, Wallingford, Oxon OX10 8DE, UK. When ordering, please quote **EP1**

Natural Resources Institute
ISBN: 0 85954 507 5

POLICY SERIES

CONTENTS

	Preface	iv
	Executive summary	1
1	**Introduction**	3
2	**Financial needs of the poor**	5
	Experience with credit programmes	5
	Needs of the poor	6
	Summarizing the financial needs of the poor	10
3	**Constraints and characteristics of micro-finance for the rural poor**	12
	Sources of micro-finance services	12
	Constraints to formal sector provision of micro-finance services for the poor	13
	The informal rural financial sector	15
4	**Interventions to promote micro-finance for the rural poor**	21
	Is there a need for direct intervention?	21
	Approaches to developing micro-finance for the rural poor	23
	Summing up	37
	References	38
	Abbreviations	42

PREFACE

This series is principally concerned with current policy issues of importance to developing countries but also covers those relevant to countries in transition. The focus is upon policies which affect the management of natural resources in support of sustainable livelihoods. Much of the series will be devoted to concerns affecting the livelihoods of poor people in rural areas, recognizing the linkages with non-natural resource-based livelihoods. It will also include the interests of the urban poor, where these are linked to the use of natural resources as part of livelihood strategies.

The series will take a holistic view and cover both the economic and social components affecting livelihoods, and associated factors notably with respect to health and education. The aim is to provide topical analyses which are based upon field research where appropriate, and which will inform development practitioners concerned with issues of poverty in development.

The series is timely, given the increasing focus upon poverty and poverty elimination in the agenda of the development community. It is also timely with respect to the growing body of recent work which seeks to replace earlier, simplistic structural adjustment programmes, with more flexible approaches to livelihoods, institutions and partnerships.

Policy analysis is often assumed to be the remit of social scientists alone. Whilst it is recognized that social science may play a pivotal role, interactions with other disciplines may also be critical in understanding and analysing policy issues of importance to the poor. The series therefore draws upon a wide range of social and natural scientific disciplines reflecting the resources base at the Natural Resources Institute.

EXECUTIVE SUMMARY

This paper explores issues and experiences in rural finance, focusing on its potential to alleviate poverty in sub-Saharan Africa (SSA). Consideration is given to the types of services demanded by the rural poor. Women have a special position in this because they are poorly served by existing services, despite their predominance among the poorest sectors of society, and the important role they play in the rural economy.

Most experience with the provision of rural financial services has focused on livelihood promotion aiming to increase productivity and incomes through improved access to cheap credit. Yet this has had relatively little impact on poverty, because programmes have proved unsustainable and have been criticized for promoting inappropriate investments and indebtedness. The poor are often more concerned with livelihood protection and maintaining minimal standards of living. Fragile and high-risk livelihoods require insurance or insurance substitutes, and for this reason the poor may prefer savings over investment.

Whilst micro-finance plays an important role in rural economies, the poor face considerable difficulties in accessing it. This reflects poor information, high risks, lack of collateral, physical distance from service providers, and small individual transaction requirements. Together, these factors increase the cost of servicing the poor. This is exacerbated by perceptions of the poor as being uncreditworthy, unable to save and therefore a potential liability. The informal sector has evolved to overcome these constraints and has flourished, whilst the formal sector has failed to reach the poor. There is little evidence that the informal sector is necessarily exploitative; its main problems are that it is limited to short-term finance and is small scale.

Improvements to financial services, both formal and informal, must be tailored to the needs of the poor. This requires innovative approaches to lower costs and increased accessibility. Two key strategies are savings mobilization, and linking the informal and formal sectors. Banks could help mobilize the savings of the poor by removing restrictions on withdrawals from savings accounts and simplifying lending operations and procedures. Credit access programmes should aim to increase women's access to credit within the formal sector, either through direct contact or by linking informal and formal financial activities.

The decentralized/linkage banking model has considerable potential. It seeks to build on the relative strengths of existing formal and informal units. It adopts a holistic approach, which integrates the complementary roles of financial and non-financial public and non-governmental organizations in reducing gaps in the supply of financial services to the poor. Group-based activities, both for savings and credit, can potentially play a significant role in improving access to financial services, as they provide a means for risk-sharing and a reduction of transaction costs.

Attention must be given to the limitations of the poor in making savings and, importantly, using credit in productive ways. The impact on incomes tends to be greater when credit is combined with non-financial business development activities. The macro-economic context is also critical: price stability and fiscal policy are particularly important factors.

POLICY SERIES

1

INTRODUCTION

This is one of a series of papers which seeks to elaborate the relationship between poverty, rural livelihoods and key policy areas. The papers are intended for a wide audience in developing country governments, donor agencies, research institutes and other organizations concerned with development or governance. They are intended to contribute to an increased focus on poverty by informing and stimulating debate, policy and action amongst key players in the development process.

This paper was originally prepared as a briefing paper for the European Union (EU). The EU briefing papers have sub-Saharan Africa as their primary focus, although case study material may also be drawn from other African/Caribbean/Pacific country experience. The information they contain is based principally on a review of secondary data and documentation, although some specific aspects have been explored through short, focused field studies.

The purpose of this paper is to alert policy-makers and development practitioners to the key policy issues which arise in the context of rural finance and poverty alleviation. Rural finance encompasses the availability and accessibility of credit, savings and insurance services. Rural finance in this paper is considered in two ways:

- firstly, as a means to invest in productivity and increase profits for both farmers and those involved in non-farm income-generating activities
- secondly, as a way to provide security or insurance to poor families in order to alleviate the adverse affects brought about through problems, such as drought, which reduce their incomes below that required to maintain a minimum acceptable standard of living.

The ways in which these financial needs are met, and the mechanisms required to enable this, tend to overlap. There are no discrete paths for either investment finance or the provision of security.

This paper addresses three sets of issues relating to rural finance and poverty alleviation:

- the types of finance required by the rural poor;
- the delivery mechanisms currently in place, both formal and informal; and
- the steps required, where appropriate, to improve both availability and accessibility of financial services.

The focus of the discussions in this paper is on 'the poor', with specific consideration given to women, who make up 70% of those classified as poor by the UN Development Programme. Although we do not attempt to debate poverty definitions, it is recognized that the poor are not a homogeneous group, and that they have different needs and levels of access to financial services.

2

FINANCIAL NEEDS OF THE POOR

EXPERIENCE WITH CREDIT PROGRAMMES

It was widely believed that the provision of credit for the rural poor would result in significant productivity increases. As a consequence, large amounts of money have been channelled to micro-finance programmes over the past 20–30 years, much of it providing cheap credit for agricultural production. This supply-led approach was based on the premise that credit was an important entry point for promoting development, and that advances in other sectors such as health and education would follow naturally.

Many of these interventions have proved to be disappointing (for example, see Adams and Von Pischke, 1992). Although initial criticisms targeted the design of the policies and programmes, more recent evidence suggests that the concept was flawed (Dawson and Jeans, 1997).

- Firstly, it is apparent that access to productive credit (investments in productive activities) cannot alone increase incomes in the renewable natural resources (RNR) sector. Individuals and small enterprises also require a conducive economic environment which creates incentives for production, and services which facilitate market access (including transport infrastructure and market information systems). Supply-led, subsidized credit may lead to inappropriate investments and, consequently, indebtedness.
- Secondly, low productivity is only one component of poverty; access to health care, education and political representation represent other dimensions of poverty. Only by adopting a broader, holistic approach will ambitious poverty reduction targets be met.
- Thirdly, an initial presumption was that the poor had no other financial service needs apart from productive credit. A deeper understanding of

the financial needs of the poor has dispelled this myth. Projects now are less likely to focus narrowly on productive credit; increasingly they include savings components and, occasionally, insurance.

NEEDS OF THE POOR

The poor require a range of financial services, such as opportunities to safeguard earned income, or credit to enable them to maintain minimum levels of consumption throughout the year. The rural economies within which the majority of poor people live and work are characterized by numerous small transactions. Although the units of exchange in these 'penny economies' appear small and insignificant to outsiders, they are an essential component of rural households' livelihoods. The extent of financial services demanded by the poor is only now being fully appreciated.

A useful distinction can be made between livelihood promotion and livelihood protection (Dreze and Sen, 1989, p. 60). Promotion is concerned with improving standards of living, principally through increasing productivity and incomes. Protection is essentially social security concerned with maintaining living standards and incomes at a given level, and defending livelihoods against unexpected shocks. Clearly the two concepts are complementary. The promotion of livelihoods will tend to make them more robust and able to withstand shocks, whilst sound protection will lay the basis for livelihood promotion. Micro-finance has an important role in the achievement of both promotion and protection goals.

Livelihood promotion

Productive finance

The rural poor may require productive finance (i.e. investment and working capital) for a variety of income-generating activities. The most important are shown in Table 1, which lists the kinds of activity requiring finance and the normal time frame over which that finance is required. A less purist perspective would permit some 'consumption' investments to be included in this table, because they positively affect productivity. For instance, Zellor *et al.* (1997) observe that investments in education, health and nutrition have a positive and long-term impact on productivity. Many people considered too resource-poor to make financial investments in productive enterprise do so through less direct paths when given the opportunity.

Table 1 Examples of productive finance needs of the poor in the RNR sector

Income source	Activity	Productive finance needs: More than one season	One season	Less than one season
Smallholder	Seasonal intensive cropping	Land preparation Irrigation infrastructure	Inputs (seed, agro-chemicals, hiring labour)	Harvest labour, equipment hire
	Seasonal extensive cropping		Inputs (seed, agro-chemicals, hiring labour)	Harvest labour, equipment hire
	Tree crops	Initial investment in trees plus maintenance until mature	Seasonal inputs: fungicides, pesticides	Harvest labour, equipment hire
	Small-scale, intensive livestock activities	Veterinary services (preventative) Building for housing livestock Fencing land Purchasing animals Artificial insemination	Veterinary services (preventative and curative) Feed	Veterinary services (curative) Labour hire
Pastoralist (communal land, extensive)	Livestock for meat	Veterinary services (preventative) Purchasing and rearing animals Artificial insemination	Veterinary services (preventative and curative)	Veterinary services (curative) Labour hire
	Livestock for by-products (dairy etc.)	Veterinary services (preventative) Purchasing and rearing animals	Veterinary services (preventative and curative)	Veterinary services (curative)
Landless labourer	(Seasonal) labour: may involve seasonal migration	Skills training		
Small-scale marketing	Storage of produce	Construction of storage facilities	Purchase of stocks for storage Fumigation/pest control	
	Retailing produce			Renting market site Wholesale purchase of commodities
Small-scale processing		Equipment Buildings	Inputs: labour, fuel for machinery, etc. Purchase of raw material	

Livelihood protection

Consumption credit

The poor are vulnerable: they often experience periods of consumption shortfalls. This is generally manifested by periods of food insecurity when access to food is reduced. The majority of the poor in developing countries are directly or indirectly dependent upon the RNR sector for their livelihoods. The seasonal nature of the RNR sector leads to fluctuating labour and capital demands, and to uneven production and income flows. The high risks in agricultural production, especially in marginal areas, and unsteady, uncertain incomes contribute to vulnerability and threaten consumption. Shortfalls may occur seasonally and regularly (for instance prior to the harvest period); or may be longer term (as, for instance, with environmental degradation and soil erosion); or may be unforeseen and sudden (as with external shocks such as drought, flood or a sharp decline in wage levels or the prices of commodities sold by the poor). During such periods, consumption credit may be needed to make up the temporary shortfall. Where credit is not available, households may have to deplete their asset base (spend savings, or sell jewels or livestock) or go without essential items, including food.

Access to consumption credit may play an important role in the *coping strategies* of the poor. To cope with consumption crises, households may employ a number of actions to increase liquidity. These include: supplementing income, possibly through hiring out labour; depleting savings, including the sale of assets; or borrowing, typically from informal sources such as friends or relatives. In extreme cases, households may be forced into depleting their productive resource base in order to survive. Selling land or livestock or defaulting on loans runs the real risk of plunging households into a downward spiral of deprivation. Access to consumption credit can therefore play a critical role in protecting the livelihoods of the poor. It tends to be short-term, needs to be accessed at short notice, and does not necessarily confer any ability to repay.

Insurance

Fragile and high-risk livelihoods require insurance or insurance substitutes. Attempts to arrange insurance against the production risks faced by the poor have proved difficult to sustain. Multi-peril crop insurance schemes

targeted at the poor have generally been expensive failures (Hazell, 1992). The reasons for this include high administrative costs, and political inability on the part of governments to charge fair premiums and enforce impartial loss adjustments. The net result seems to have been that these insurance schemes represented a form of subsidy with very limited value to the poor. Any financially sustainable scheme is likely to focus on large-scale commercial farmers who can afford to pay higher premiums. Formal insurance thus has very little relevance to the poor.

However, to protect themselves against risk, poor households employ a number of different strategies which are, in effect, insurance substitutes. These include:

- saving (money or assets which can be accessed at times of need)
- risk-reducing behaviour (for example, low-yielding but drought-tolerant crop choices)
- investment in social capital (for example, investing in informal 'social safety nets', such as developing ties with peers and relatives to increase access to potential assistance in times of need).

Although such actions may detract from investment in increased productivity, they might nonetheless be preferable to dependence on consumption credit (even assuming it is available). The poor are risk-averse and do not want to be caught in a debt trap or jeopardize assets by using them as collateral. The amount of credit available is, in a sense, a household asset. Households may try to maintain this asset and opt for alternative coping strategies, such as reducing food intake, rather than risk defaulting on a loan and jeopardizing their creditworthiness.

Even though the poor may have no choice other than these informal sources of insurance, this should not detract from the value of these systems.

> This kind of insurance responds to both the customary and unusual needs of lineage members – providing old-age and catastrophic insurance, substituting for a welfare system, and enhancing the security of individuals and society. Based on intimate personal knowledge of both recipients and transferors, it is more efficient than either market-based private insurance or a governmental insurance scheme in that it achieves more safety at a lower cost. A vibrant transfer economy

> therefore considerably lessens the need for alternative insurance or safety net institutions and renders much less compelling the necessity for social security and welfare legislation in Africa.
> (Dia, 1996, p. 191).

Savings

Savings have several potential roles. By foregoing consumption, households will increase their options in the future, whether for investment or consumption. The poor may choose to accumulate savings rather than invest in productive activities. As noted above, savings serve as insurance. The poor want to avoid periods of transitory food insecurity and therefore they accumulate precautionary savings, which increase household resilience and the capacity to absorb risks (Zellor *et al.*, 1997, p. 21).

A preference for savings (over investment), coupled with general risk aversion, constrains the adoption of new technologies by the poor. Households with limited access to finance may hold larger precautionary savings (or have higher optimal levels of precautionary savings), even though this will reduce potential income generation. Only in the longer run, as a secondary course of action, may they be able to afford productive investments which increase (rather than protect) their incomes (Zellor *et al.*, 1997, p. 20).

People may also save to safeguard their money from their own personal consumption, from consumption by another (for instance, a woman may try to safeguard money from her husband), or from theft. In some countries, people will even pay to save (demonstrated by the *susu* system described later in this paper), so strong is the need for the safe-keeping of income.

SUMMARIZING THE FINANCIAL NEEDS OF THE POOR

- The financial needs of the poor are far more sophisticated than mere livelihood promotion through productive finance.
- The two goals of micro-finance (livelihood promotion and protection), and the four elements of finance (productive credit, consumption credit, savings, and insurance), are closely interrelated, with implications for the design of interventions.
- The poor are not a homogeneous group; they have different needs and different levels of access to financial services.

Micro-finance plays an essential role in the livelihoods of the poor, and can contribute to poverty reduction. Zellor *et al.* (1997, p. 25) identify three pathways through which household food security (and poverty) can be influenced by micro-finance:

- via income generation – by creating additional capital to increase household production, and by increasing savings and thereby increasing risk-bearing capacity, which in turn contributes to the adoption of income-generating activities;
- via asset investment or disinvestment strategies to smooth disposable income over time to assure sufficient food consumption levels; and
- via consumption credit, which can substitute for higher-cost insurance strategies.

3

CONSTRAINTS AND CHARACTERISTICS OF MICRO-FINANCE FOR THE RURAL POOR

SOURCES OF MICRO-FINANCE SERVICES

A clear distinction is often made between informal and formal financial services. In practice, this distinction is far from clear: a whole spectrum of financial institutions exists, ranging from highly informal intra-household arrangements for distributing resources, to state-regulated commercial banks. The formal sector can be defined as comprising those institutions which are subjected to government and central bank regulation (Zellor *et al.*, 1997, p. 83). These include commercial banks and specialist agricultural financial organizations, savings and credit cooperatives/unions, and finance programmes operated by non-governmental organizations (NGOs). Conversely, the informal sector operates unofficially and escapes regulation. It comprises a multitude of different institutions and activities, which together play a significant role in many SSA economies. For example, although measurement is troublesome, Buckley (1996, p. 339) concludes that the informal sector in Malawi is more significant than the formal sector.

There are therefore many different sources of micro-finance services, although access to these is variable. When considering the poor, who frequently are not serviced by the formal sector, the significance of the informal sector is magnified. Indeed, the poor often depend exclusively on the informal sector for their financial needs.

CONSTRAINTS TO FORMAL SECTOR PROVISION OF MICRO-FINANCE SERVICES FOR THE POOR

Information is vital for the provision of credit. When lenders have imperfect information concerning the ability and willingness of potential borrowers to repay the loan, three problems arise (from Zellor *et al.*, 1997):

- the lender does not know the default risk (creditworthiness) of each potential borrower, and to collect this information is costly – the problem of screening;
- it is costly to ensure that the potential borrowers will take those actions which will make loan repayment more likely; and
- it is difficult (and costly) to enforce repayment.

To reduce loan delinquency and fraudulent use of bank payment facilities (such as cheques), relations between banks and customers tend to be information-intensive. They often require new depositors to be introduced by existing ones, and may restrict the provision of facilities such as cheques and credit to customers meeting specified criteria. They also use screening devices including track records and references, collateral requirements and standardized credit appraisal systems involving cost-benefit and cash-flow analysis to minimize default risks.

The information systems that these devices require add to *transaction costs*. Transaction costs are those costs incurred during an exchange of assets or services other than the price of the asset or service itself. Transaction costs are often fixed costs (for instance, the time spent setting up the loan may be the same for small and large loans), so smaller loans and savings incur higher per unit transaction costs, making lending to the poor (whose needs are for small amounts) relatively more expensive. Transaction costs associated with lending may be passed on to the borrower via higher interest rates.

The information-intensive system of centralized control, which reflects risk-averse strategies of formal financial institutions (FFIs), could be attributed in part to heavy regulation. Financial systems tend to be heavily regulated for the purpose of maintaining stability and protecting the interests of depositors. 'Traditional' management and organizational systems in most banks in SSA evolved historically from the colonial origins of banking in the continent (as noted by Newlyn and Rowan, 1954; Fry, 1976; Howard,

1978). The indigenous population, including the entrepreneurial class, was largely neglected by the colonial banks (Howard, 1978; Brett, 1995). Post-independence indigenous commercial and development banks were modelled on these systems, and have changed little since (despite the dramatic changes that banking systems have undergone elsewhere). As a result the operations of FFIs continue to favour commerce and large-scale industry, and to neglect the needs of the poor (Brownbridge and Gockel, 1996).

For poor borrowers, the use of track records is hampered by the absence of a record-keeping culture due to high levels of illiteracy and the lack of formality which characterizes their economic transactions. Even though the economic activities in which they are engaged usually involve high and covariant risks, insurance markets and hedging instruments are virtually non-existent, resulting in exposure of lenders to high default risks. The use of collateral requirements to minimize risk exposure is often not possible in the case of the poor. This is either because they lack assets which can be collateralized; or because the utility of such assets, where available, is substantially reduced by enforcement difficulties due to weaknesses in the judicial system, and socio-cultural factors such as common property rights (especially in the case of land) and strong communal ties. Banks, therefore, prefer not to lend to the poor.

The banks' internal control and management information systems are often excessively bureaucratic, resulting in decision-making delays likely to render a loan request obsolete if the client is engaged in time-sensitive activities such as rain-fed agriculture. This bureaucracy promotes, among bank branches and the industry as a whole, an inflexible uniformity of operating systems and culture (including information requirements from customers, banking hours, banking environment, often well-furnished premises, and staff dress code). This adds to costs, limits the capacity of individual branches to adjust creatively to prevailing socio-economic conditions, and alienates significant sections of the poor.

Interest-bearing savings accounts tend to be more popular with the poor, especially the illiterate poor. This appears to be less because of the interest earned (there is evidence that they often patronize informal deposit facilities with negative nominal returns; Gurgand *et al.*, 1994), but more because they are simple to operate. Unlike current (or demand deposit) accounts, which the banks favour, they require only thumbprint

and photographs instead of signatures to authenticate transactions. Balances are recorded in passbooks which can be confirmed by others (such as literate relations).

However, withdrawals from savings accounts are often restricted and holders of these accounts tend to be excluded from accessing credit. This exclusion has been found to discourage savings mobilization among the poor. 'Reciprocity' has been identified as a major incentive to holding financial savings in SSA countries (Gurgand *et al*., 1994). Current (or demand deposit) accounts which do not have such restrictions entail some direct costs (customers are usually charged 'commission on the turnover') and are relatively more complex to operate for the illiterate poor.

Problems of servicing the poor are compounded by ignorance. The poor may be perceived as uncreditworthy, unable to save, and a potential liability. Therefore commercial institutions (and also some state institutions and NGOs) are unwilling to provide or improve the services on offer to poorer sectors of society. For their part, the poor may distrust or feel intimidated by formal institutions.

THE INFORMAL RURAL FINANCIAL SECTOR

The informal sector has evolved to overcome the constraints listed above, and has flourished whilst the formal sector has failed to reach the poor. Transaction costs have been minimized by innovations adapted to local social and economic conditions.

Johnson and Rogaly (1997, p. 16) make the distinction between those informal financial services that are owned by their users, and those that are supplied by an individual, normally at a profit. Box 1 lists some types of informal finance and illustrates the variety of informal finance institutions and mechanisms. Not all people have access to all options, although most people are involved in a complex web of debts and credits to relatives, friends, neighbours and merchants. For example, social exclusion may rule out participation in group-based activities, and some people may not have enough capital to join rotating savings and credit associations (ROSCAs). This particularly applies to the poorest of the poor, and to some extent explains their difficulties in getting out of poverty. Socially outcast, the poorest can remain trapped in life-long indebtedness.

Box 1 Types of informal micro-finance

Sophisticated but unregulated institutions. Regulation may be minimal, such as a licence to operate. Examples include credit unions, indigenous banks, pawnshops.

Moneylenders. Individuals involved in lending money. These are often short-term loans, unsecured by collateral, and charged at high interest rates. Interest rates are typically charged at a daily, weekly or monthly rate. Money lenders are able to provide quick access to funds and do not impose conditions on how the funds are used. They are rarely financial intermediaries as they provide the funds from their own equity. Transaction costs are low due to their exploitation of local information. Clients tend to be long-standing, minimizing the amount of new information that has to be collected.

Merchants. Individuals who are primarily traders who also extend loans linked to the sale or purchase of commodities. No interest may be charged; instead they may alter the price of the commodity they are receiving in return. This provides a good example of how the micro-finance market is linked to other markets.

Shopkeepers. For example, in Somalia shopkeepers play a role in providing credit which is especially important for small-scale farmers unable to access formal sources of credit. 52% of small-scale farmers took loans from shopkeepers, mainly for consumption; about half of loans from shopkeepers were in the form of food (DeLancey, 1992).

Pawnbrokers. Need almost no information about the borrower as the collateral is physically exchanged for the loan. Pawnbrokers may need a licence to operate.

Loan brokers. Individuals who facilitate contacts among people with money to lend and borrowers, essentially exploiting 'inside' information about potential clients.

Landlords. Provide tenants with loans, particularly sharecropping tenants, as the landlord has a vested interest in the production.

Friends and family. Possibly the most prevalent form of informal finance. Often no interest or collateral, but may be based on reciprocity.

Money guard. A person who safeguards cash for individuals. Rarely does any interest accrue to the saver, and in many instances the saver will actually pay a fee to the money guard for keeping the money safe.

Savings groups. Individuals either regularly or irregularly deposit funds with a group leader. Savings may be for specific occasions such as weddings or funerals.

ROSCAs. Rotating savings and credit associations savings are made regularly by members and are pooled. The savings are given to members in turn, or loans are made to members. Peer pressure, fear of loss of the facility and possible social sanction act as the incentive to repay. There is complete freedom within the ROSCA to spend money on whatever the member desires, including consumables.

ASCRAs. Accumulated savings and credit associations. These are essentially non-rotating savings and credit groups, more advanced than ROSCAs, with opportunities for saving and loans.

Employers. Employees may either ask employers for advances on their pay, or request the employer to withhold payment until a later date, though there will be no interest paid on these sums.

Group activities have drawn particular attention. Self-help groups provide mutual benefits for members, and are non-profit-seeking in their activities. Membership of financial self-help groups is very prevalent in sub-Saharan Africa, and nearly universal in some locations. Box 2 illustrates the characteristics and functions of financial self-help groups in The Gambia. In Cameroon, Schrieder and Cuevas (1992) found 80% of all adult family members participating in at least one financial self-help group, with 71% of the groups providing loan services. These groups provide 27% of all loan requirements and 54% of total financial savings in Cameroon.

Box 2 Group financial activities in The Gambia (from Shipton, 1992)

Gambian villages have groups known as *kafo*, organized around age, specific activities, political interests, etc. Membership is voluntary. Larger ones may have elected officers. They tend to be gender-specific. *Kafo* groups serve diverse economic purposes. Money may be saved from hiring out group labour, fund-raising events or members' dues. Larger, stronger *kafos* may save money in group bank accounts (linking formal and informal sectors) and may make large investments in community projects, such as community centres or agricultural projects. Money may be lent to group members, often as small loans with interest. A common purpose of *kafos* is to help members in times of emergency. Recently, both government and NGOs have looked to *kafos* as a means of disbursing loans, particularly as channels for seed and fertilizer supply. The basis of *kafos* is social capital with social sanctions used to impose discipline.

A newer form of group is the *osusu*, essentially a ROSCA. In The Gambia, these are typically organized by women. A 1987 survey revealed that 17% of women and 1% of men belonged to an *osusu*. All members make fixed contributions of money at regular intervals and each time one member takes it all. If a member's turn comes early, it is a credit mechanism; if it comes late, it is a savings mechanism (early recipients realize a real net gain, those later a real net loss). *Osusu* tend to be grouped around age, ethnic identity and kin, though mixed groups are also common. Some *osusu* run for many years; others suspend operations in the wet season when members are short of money.

The positive attributes of these types of group are that they shelter money; provide services to those ineligible for formal banking; require no collateral; minimize paperwork and travel; increase social ties; instil a feeling of local ownership; and are voluntary. The negative points are that they are not ideally suited to communities with seasonal income, as needs for funds come at the same time for all members; and loans are not available on demand.

In the light of research into the extent of informal finance in rural economies, a new perception of the informal sector emerged during the 1980s. The following points are based on the work of Adams (1992).

- *Informal finance is ubiquitous in developing countries* even where formal markets exist. Attempts to replace indigenous institutions with introduced institutions have had limited impact. As a consequence, there has been a softening of attitudes towards the informal sector amongst policy-makers and development practitioners.

- *Informal finance exists within and between all economic classes*. Informal finance has traditionally been viewed as inferior to formal finance, and as flourishing only due to the inability of formal finance to reach the poor. However, recent research has found that wealthier people also continue to use the informal sector for certain services, despite good access to formal institutions; see for example Heidhues' (1994) study of micro-finance in Cameroon. The function of informal transfers in African societies has, in the West, been replaced to a certain extent by economic institutions far removed from the African extended family/community, but this does not imply that these economic institutions are in any way superior.

- *Informal financial markets are adapted to local conditions*. Indigenous financial institutions have evolved over a period of time and are rooted in local culture and society, many of these being communities dependent upon the renewable natural resources sector. They have developed as a response to particular constraints faced by inhabitants of diverse environments. Informal financial markets are more adaptable to sudden needs and changes and are thus better able to accommodate a short-notice loan request, or a delayed payment.

- *Informal finance provides a wide range of services*. The needs of the poor are considerably wider than provided for by the formal sector, including savings, short-term consumption loans and insurance.

- *There is little evidence of exploitative or monopolistic behaviour*. Contrary to previous beliefs, the informal sector is now considered to be, in general, non-exploitative (though there are some important exceptions to this). High interest rates may be charged, but generally only on very short-term loans, or where costs or risks are very high.

- *Informal finance benefits the poor*. The poor, as we have seen, have little access to the formal finance sector, and depend on the informal sector. Their financial demands differ significantly from wealthier

sectors of society, as they have vulnerable livelihoods, and require short-term cash injections to avoid periods of food insecurity and deprivation. The formal sector is not designed to respond to their demands.

- *Informal finance enhances the efficiency of resource allocation*. Financial intermediation, expressed simply, is the movement of money from those who have an excess to those who have a shortage. This can happen at many different levels: between countries, within countries, within communities, and within households. The principle is the same whatever the scale, and the movement of money to those who make use of it improves resource allocation efficiency. A study of Senegal (Dia, 1996) reveals that the informal transfer economy results in a more equitable distribution of income; with transfers being used for health and education, it increases the access of the poor to these services/investments.

- *Major elements of informal markets are 'intertwined' with formal markets*. "Informal deposits often move to banks, and funds from formal loans, when spent, often circulate through informal channels. It appears that formal and informal finance may be complements instead of substitutes in many cases." (Adams, 1992, p. 4).

The informal sector is successful because it has features which significantly reduce transaction costs. The key is the use of local information and social capital. Community members know who is creditworthy. They know who is likely to default on loans. They know who is likely to be a reliable contributor to group savings schemes. Hence the ability of the poor to access financial services depends greatly on social relations with the community. If they are in any way excluded from their community they may have difficulty in joining groups. Informal lending between individuals and households is often based on an understanding or reciprocity. There is a willingness to lend with a low or zero interest rate if the lender recognizes that in time of need the favour may be returned. If possible, people will try to maximize the number of sources of financial assistance available to them.

Drawbacks of informal finance

(Based on Zellor *et al.*, 1997, p. 116.)

- *Lack of medium- and long-term productive credit* (for technology uptake). The majority of credit available in the informal sector is for consumption or, if for productive purposes, is relatively short-term in nature, rarely extending over more than a crop cycle (for instance, seed may be received on credit and repaid after harvest). Longer-term credit is less common, restricting the amount of long-term investment and planning. Larger land improvement schemes, for instance, which require several years to recoup the initial outlay, are generally not financed by the informal sector.

- *Lack of savings options with real returns*. The incentive for saving is rarely related to potential returns; instead, as seen above, savings are driven by the need to safeguard money or to tie up money and therefore resist other demands upon it. Savers are even willing to pay for this service.

- *Restricted to community level* and therefore unable to bear covariate risks. As we have seen, risks are borne at both individual and community levels. Illness or other problems affecting households or individuals can lead to consumption shortfalls and the need for smoothing credit, which may be available in the community. However, a larger event such as a climatic disaster or crop failure will affect the entire community, with large numbers of people requiring assistance. As the geographical coverage of informal systems is relatively small, financial intermediaries and equity lenders will struggle to access sufficient funds to satisfy the whole community's needs.

4

INTERVENTIONS TO PROMOTE MICRO-FINANCE FOR THE RURAL POOR

IS THERE A NEED FOR DIRECT INTERVENTION?

The evidence provided from a flourishing informal sector may indicate that direct interventions are not appropriate. Abugre (1994) argues that if local communities have adapted so well to the lack of formal services (as shown by the proliferation of the informal sector), then why intervene at all? It may make better sense to concentrate on stimulating informal systems by investing in, for example, infrastructure and communication, than to overload the system with additional credit. A more subtle approach may be necessary, based on a thorough understanding of the sector. Without the latter, interventions risk displacing informal services and squeezing the options available to the poor. Subsidized interventions tend to be unsustainable (Seibel, 1994, p. 21), and if they displace informal systems, long-term damage to the informal sector could result.

For several reasons already noted, the provision of financial services for the rural poor is often inherently high-cost and risky. The challenge is to find ways to reduce and share costs, rather than supporting subsidized, unsustainable schemes.

Above all, interventions must be tailored to the needs of service users. The poor require certain features in financial services, which may include:

- physical accessibility – services have to be in close proximity
- flexibility of terms for savings and credit
- timely access, without delay, sometimes at short notice (particularly for credit)

- potential access to funds at all times
- low costs of borrowing
- security of savings.

The poor are not a homogeneous group and have different financial needs. There are also degrees of poverty. Of particular concern to donors are the poorest, those groups and individuals which are not reached by most poverty reduction and welfare programmes. Policy-makers and development practitioners also recognize the distinct needs of women and the importance of gender/poverty linkages.

The 'poorest of the poor'

The poor, and particularly the poorest, typically live in a semi-monetary economy. Many transactions do not involve the exchange of money, but the bartering of goods and services, for example the '*goob*' (traditional work group) in Somalia receives payment in food and drink for working (usually specific field-based tasks such as land preparation). There is no monetary payment, and no predefined rules for reciprocation. Similarly, financial services may be non-monetary: assets may be held as savings, and social capital acts as insurance. Formalizing these indigenous institutions and customs is a difficult task, and has frequently proved fruitless. A broader understanding is necessary of the social and economic systems in which the poor live. A full understanding of the non-monetary forms of financial services may contribute to the development of quite different micro-finance intervention strategies. For example, livestock often substitute for banks because this is how some rural communities 'save'. Selective support to livestock services may meet the needs of the poor better than projects aimed at encouraging livestock sales and formal savings.

Women

Women have a special position in the provision of micro-finance. Firstly, they are often amongst the poorest in society. Secondly, they make a substantial contribution to a country's development. However, women, and poor women in particular, face special problems in accessing micro-finance services. In many countries, most women face problems over land rights and control over the factors of production. Lack of land ownership is particularly problematic because of its widespread use as collateral in the formal financial sector. In addition, in some countries it is illegal for a

woman to borrow in her own name – women may borrow only in the name of their husbands, if at all.

Educational inequalities act as a further barrier to women's access to credit – a barrier which will typically be highest for poorer women. Women may be unable to meet the formalities of loan requirements – they may not even be able to sign their name. Problems are compounded by prejudicial attitudes, where formal lenders may not regard women, particularly poor women, as prospective clients. Evidence from several schemes shows that women can be a bankable proposition: women have higher repayment rates than men. Programmes with high female participation have high repayment rates, for example Fundacion para la Promocion y Desarrollo de la Microempresa (PRODEM) (Bolivia), Grameen Bank (Bangladesh), Working Women's Forum (India), and the Self-employed Women's Association (Uganda). In Honduras, Barbados, Guatemala, Senegal, Cameroon, Malawi, Niger, Chad and Ecuador, the US Agency for International Development (USAID) reported higher repayment rates for women than for men (Weidemann, 1992).

APPROACHES TO DEVELOPING MICRO-FINANCE FOR THE RURAL POOR

Four non-exclusive strategies are discussed here:

- strengthening the formal sector
- linking the formal and informal sectors
- promoting self-help groups
- strengthening the enabling environment.

Strengthening the formal sector

These proposals address the twin objectives of enhancing bank capacity to mobilize deposits, and lowering access barriers for the poor. They seek to promote increased flexibility in FFIs without sacrificing established organizational systems, contributing to any specific comparative advantage they may enjoy over informal intermediaries.

Enhancing deposit mobilization among the poor

Expanding the role of banks in deposit mobilization among the poor requires increased flexibility in their systems and procedures. A study of micro-lending organizations in Indonesia, Mexico, Ecuador, India, Bangladesh, Kenya and Ghana demonstrated that access was increased when "micro-lending institutions ... created a friendly environment [for the poor] through a number of means such as simple-looking structures ... and a staff that is dressed simply" (Buechler, 1995, p. 8). Banking hours need to be flexible too. For example, the community-owned rural bank at Garu in northern Ghana operates on Sundays, which are also market days.

Promoting savings accounts, as argued earlier, would enhance savings mobilization among the poor. The poor would want restrictions on withdrawals removed. Evidence from a number of studies suggests that the poor often prefer deposit facilities which allow them to make small but regular savings at minimal transaction cost. Banks could, therefore, adopt the practice of informal deposit (*susu*) collectors, and go to depositors for savings rather than waiting for them to make deposits. This system has been adopted by Women's World Banking in Ghana, and by the Credit with Education programme in Burkina Faso. The evidence is that administrative costs tend to be rather high. Difficulties also arise in monitoring collection staff, to reduce the risk of fraud. These costs discourage commercial banks from adopting this system on any meaningful scale.

The alternative is the development of complementary relations between banks and informal financial institutions (IFIs) such as credit unions and *susu* collectors, as studied by Aryeetey (1994) and Steel *et al*. (1997) in Nigeria and Ghana. Development of this has, however, been constrained by a number of unresolved organizational issues, notably the status of the IFIs *vis-à-vis* the banks. Action research focusing on the organizational bottlenecks could prove beneficial to all stakeholders. This type of arrangement would promote decentralization of deposit collection, thus lowering transaction costs for depositors, particularly small-scale women traders. There is also scope for formalizing and expanding the sharing of information on customers between banks and IFIs, thus addressing the need for track records. Furthermore, the possibility of using the IFIs as loan collection agents could be explored. There is experience of this with the use of field workers for loan recovery by the Freedom From Hunger programme in Burkina Faso and Ghana, and Cooperation for Development in Namibia.

Lowering credit access barriers

In seeking to lower access barriers to credit, the primary objective is to reduce the 'social distance' between FFIs and the poor by alleviating problems of imperfect information, missing insurance markets and high risks faced by poor entrepreneurs. Making deposit operations more poor-friendly to increase patronage will have the additional benefit, noted above, of improving FFI information on the poor.

This has to be complemented by simplification of the lending operations and procedures of FFIs. The following are some of the measures required: easy-to-complete loan application forms; simple, transparent loan decision criteria (openly advertised); reduced red tape in decision-making; and de-emphasis of complex financial appraisals in favour of 'ability to repay' criteria. (It is widely recognized in any case that credit for the poor tends to be less for production purposes than for non-production emergencies.)

Loan repayment terms and schedules need to be flexible as well. Most successful micro-finance schemes have found that regular repayments in small amounts will substantially improve repayment. This could be done through holding regular (weekly) group meetings at which members make payments. Examples include the Kenya Rural Enterprise Programme (K-REP), and the Freedom From Hunger projects in Burkina Faso and Ghana). Borrowers incur additional costs, particularly in terms of meeting time, but in the latter case the regularity of meetings is reduced as customers establish a credible track record with the banks. The women traders' credit programme by Cooperation for Development in Namibia uses an alternative arrangement, involving regular visits to borrowers by credit officers to collect scheduled instalments. In this case the additional cost of debt recovery is borne by the FFI, although it may be reflected in interest rates charged to borrowers.

Credit guarantee schemes as a means to reduce credit risks, in order to promote lending to small and micro-entrepreneurs, have had questionable impact. Few such schemes appear to be sustainable (see Levitsky and Prasad, 1987; Graham Bannock and Partners, 1995). A recent development which may be replicable involves the provision of guarantees by borrower-groups. It incorporates principles of transparent financial risk-sharing by members into the group lending model (the latter on its own having been markedly less successful in SSA than in Asia). Other non-

financial services, including extension and training, which have proved valuable in successful group lending experiences such as the Grameen Bank case, are also provided. The Mutualist Credit Guarantee Scheme in Ghana, similar to the Chikola Scheme operated by K-REP in Kenya, operates with borrower groups pooling savings (deposits) which constitute the bulk of the guarantee fund. The funds are deposited with the lending FFI to cover loan defaults. Self-selection is a key principle, and in the Ghanaian case the group contribution was matched by donor funding.

Increasing women's access

Credit programmes should aim to increase women's access to credit within the formal sector by (a) direct contact or (b) linking informal and formal financial activities. Credit schemes need to either overcome or by-pass the constraints which restrict women's access to credit. Since the most relevant constraints vary from country to country, one should be wary of a blueprint approach to designing micro-finance schemes. Potential solutions to common constraints include:

- out-of-hours opening or mobile services, or locating services where women are, e.g. in market places;
- relaxing literacy requirements;
- flexible collateral requirements, e.g. accepting jewellery rather than land Weidemann (1992) points out that women's assets are likely to be in non-liquid form such as jewellery or household furnishing; see also ATRCW (1990); and
- allowing loans of a suitable size (usually small).

Experience has shown that women's groups can play an important role. Groups can form the basis for savings mobilization, which is important to ensure sustainability. The programme should seek to relate savings to the client's needs, so that she may draw on surpluses after meeting credit obligations. In addition, credit efforts must seek to improve the repayment rate and provide a system of credit supervision, thus ensuring that the loan is properly used.

Women also need to be able to access savings facilities as a source of finance. Research has shown that women are responsible and disciplined savers. Accion International, for example, has a compulsory savings component with high levels of female participation. Egypt's Agricultural

Credit Project records that 25% of savings are made by women, while women constitute only 20% of participants. In Ghana, mobile bankers help women traders accumulate savings via a small daily deposit which can be as little as 25 cents. This is then returned at the end of the month to enable stock to be replenished or consumption goods purchased. There are over 500 of these mobile bankers or *susu* collectors in Accra. Mobile bankers act as intermediaries between small informal savers, borrowers, and the formal banking sector. They play an important role in mobilizing savings in Ghana through their daily collection.

Women's access to financial services can be facilitated and fostered by organizations that work on their behalf, whether or not based on membership. This participatory or group approach has gained widespread acceptance and has many advantages. In terms of the formal sector, it allows women to access loans of smaller amounts than the bank's minimum. Banks that are unable to lend money to women due to the lack of collateral are coming up with new ideas of lending to legalized women's groups, for example, the Cooperative Bank of Uganda, AID Bank of Ethiopia, and Banque de Development de Rwanda.

Linking formal with informal

The informal financial sector is vitally important to poor people's livelihoods. Family groups, and other social organizations built on social capital, are important as are private individuals, enterprises and organizations which provide specific services, such as private money lenders, pawn shops and money guards.

Private individuals can provide fair and efficient services (although they do not always do so). Their advantage is their ability to use local information and access to clients to reduce transaction costs. However, they are generally not financial intermediaries, and frequently lend from their own equity, thereby limiting the scale of their operations. This may contribute to high interest rates as the limited supply of credit drives up the cost of capital. There may be scope for encouraging the private money lenders and money guards to link with the formal sector. Acting as financial intermediaries would increase the potential supply of credit, and would allow a greater number of participants to enter the profession. Both of these benefits would potentially lower the cost of credit and increase access to credit. Money guards (providing a money safeguarding/saving service) would also benefit from

access to formal financial institutions. They could save the money collected from individuals (as has happened in Ghana), thereby increasing the benefits from safeguarding. This may reduce safeguarding fees, or even, if safeguarders realize a high interest rate and a degree of competition exists, result in interest being paid to individual savers.

The advantages of the informal sector are the low transaction costs, flexibility, easy and rapid access, and innovative ways of overcoming collateral constraints (fear of social exclusion, local information, peer pressure). However, localized informal systems are vulnerable to covariate shocks. Moreover, they rarely provide longer-term loans or savings options, and do not have the same level of legal security as formal systems (though this could be improved by the conversion of informal institutions into formal), meaning that their position could be abused.

Linkage banking

The concept of linkage banking incorporates many of the ideas already discussed, building on the relative strengths of existing FFIs and IFIs. Figure 1 illustrates how various financial and non-financial public organizations and NGOs could collaborate in the provision of financial services for the poor. The use of informal financial intermediaries and non-financial institutions may increase geographical coverage helping to plug information gaps, and reducing and sharing transaction costs.

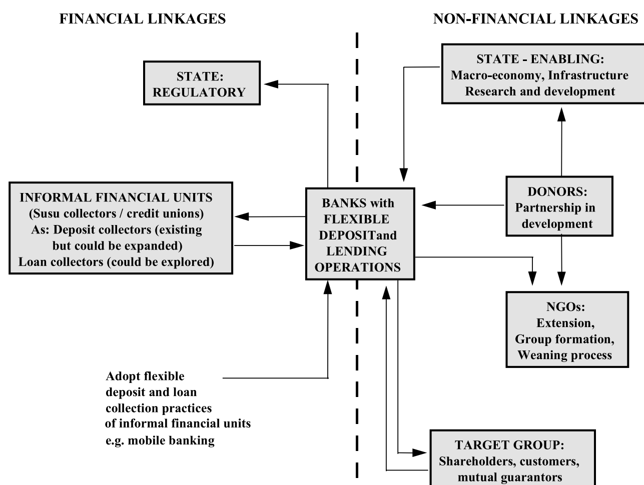

Figure 1 The linkage banking model

Experiences with decentralized banking

Decentralized banking involves the establishment of branches which operate as completely autonomous units. This means that even though units may be networked to central apex bodies (as is the case in Ghana), or to the headquarters of a commercial bank (as in Indonesia), their operations, management and accounts are entirely separate. Different approaches include transforming branches of centralized commercial banks into autonomous units, conversion of non-financial NGOs into financial institutions, and promotion of 'unit banks' (see below) having broad-based private ownership.

The Indonesian Bank Rakyat Indonesia (BRI) or People's Bank of Indonesia is an example of this approach. In 1984 it was converted from a centralized commercial bank to a network of independently operating unit banks (unit *desas*) providing full financial services at the local level. The conversion occurred as part of measures to liberalize the financial sector. It was a means of reducing the impact of financial restructuring of banks on access by the poor (especially the rural poor). The BRI maintained its state-owned status and central monitoring role. Jazayeri (1996) reports on its success in fully covering its lending requirements from mobilized deposits, whilst being financially sustainable and covering a large number of borrowers within a short time span.

The application of this model to low-income agricultural economies could, however, expose individual local banks to covariate risk, causing their collapse. This risk can be mitigated (but not eliminated) by encouraging local ownership, and/or adhering to some sort of apex structure. Local ownership may help create the conditions to realize the main benefit that decentralization offers, i.e. the provision of a service tailored to the needs of its clients (even if they are poor and located in rural areas).

Broad-based ownership of autonomous single unit banks, through the acquisition of shares, by people in communities in which the units are located, has been used successfully to decentralize banking in Ghana and Nigeria. The community-owned rural banks in Ghana and rural banks in Nigeria are unit banks partly owned (through share subscription) and managed by directors (elected from among shareholders) who are responsible for appointing and supervising management staff and other personnel. The banks essentially mobilize finance from, and lend to,

clients within their catchment areas, thus avoiding diversion of rural resources to fund urban non-poor activities.

Yet there is also a risk that lack of control from the centre may isolate local banks from (a) accepted standards of operation and (b) scrutiny (leading to increased risk of fraud). Decentralization must therefore be accompanied by any necessary training of local staff, strong systems of accountability, and an effective regulatory framework. Apex structures may play a role in this, whilst also facilitating access to information and giving additional weight to negotiations with national (possibly public) organizations and NGOs.

Although the state played a pioneering role in the establishment of these banks, their operations were insulated from direct political interference. This contributed significantly to their success in mobilizing savings and lending. Notably, there was minimal dependence on donor and central government concessional funds. Savings mobilization was particularly enhanced by the adoption of flexible operating systems and procedures similar to those discussed above. Although the difficult financial environment in which they operated had an adverse impact on their performance, Seibel (1996) observed that they functioned more robustly than other commercial banks (particularly the state-owned ones).

Conversion of NGOs into financial institutions

In recent times a number of not-for-profit NGOs have converted from providers of mainly non-financial services into full-service financial institutions. The best known example in SSA is K-REP in Kenya. This trend owes as much to the failure of liberal market reforms to improve the supply of finance to the poor as to the weak performance of state-sponsored ‘supply-led targeted credit programmes’. Typically, NGOs that converted were those that had achieved substantial success in terms of outreach to the poor in the provision of non-financial services. Provision of credit had generally been a supplement to their core activities, which they used as an entry point.

Despite reported success in Latin America (with the case of Bancosol in Bolivia being the most prominent), the trade-off between increased outreach to the poor and sustainability of financial institutions is becoming increasingly apparent. The majority of NGOs are predominantly grant-

funded by donors and are therefore able to finance activities which do not require full cost recovery and self-financing. This enables them to provide subsidized services for those whom the private sector is unwilling to service (due to high risks and high costs). These grant-funded services are not sustainable. Conversion into formal financial institutions creates new financial demands and necessitates a review of risks and costs, which could lead to a preference for larger, safer and more profitable clients at the expense of the poor. The K-REP experience also shows that the conversion process can be significantly impeded by licensing and regulatory problems.

Facilitating access to finance by reducing production and marketing risks

In lending to the poor, this model helps address high transaction costs in deposit mobilization, high risks, and missing insurance markets. The potential for links between banks and IFIs (such as credit unions and *susu* collectors) to enhance deposit mobilization is discussed above. Here the focus is on linkages which reduce production and marketing risks. NGOs have played a crucial role in piloting such interventions. Two examples from SSA are discussed, namely Sasakawa Global 2000 (SG 2000) and TechnoServe.

SG 2000 operates in a number of African countries including Tanzania, Sudan, Ghana, Zambia, Benin and Togo. It is involved in technology transfer to small-scale farmers. In providing extension services and training for groups of farmers, it relies on the demonstration effect of its Production Test Plots scheme. This hands-on scheme involves a network of organizations including public agencies. State extension services, local research institutions and SG 2000 pool their knowledge, personnel and logistics to transfer production technology to organized farmer groups. Credit for inputs is provided by local banks (the Agricultural Development Bank in the case of Ghana) with SG 2000 staff assisting in screening and monitoring of loan beneficiaries.

SG 2000 also provides credit guarantees ranging from 100% for new borrowers to 0% for those who have established credible track records with the banks (through the programme). SG 2000 is able to assume this risk because of the comparative superiority of its information on the ability of the participating farmers to repay loans. It is in a better position than

FFIs to estimate output due to better knowledge of the production technology being used. A close working relationship with farmers also enhances the ability of its staff to build a more accurate picture of the behaviour of individuals, thus enhancing its capacity to screen out potential defaulters. In principle, as farmers establish a track record, they are weaned off the guarantee scheme.

TechnoServe uses a similar approach in promoting post-harvest crop management. It operates in a number of African countries including Rwanda, Ghana, Kenya, Tanzania and the Democratic Republic of Congo (formerly Zaire). It organizes, trains and assists groups of farmers, microprocessors and larger agribusiness enterprises in adopting appropriate technology needed for improving the shelf-life and marketing of agricultural products. Local banks involved in the programme provide credit for the acquisition of equipment and inputs. TechnoServe provides explicit screening and implicit monitoring support in the credit delivery process.

These programmes have demonstrated the potential benefits from transferring improved production and post-harvest technology to farmers and microprocessors in SSA. They have also shown that credit provision in support of such schemes can be undertaken without sacrificing the commercial interests of banks. The involvement of NGOs and state agencies in improving output and promoting post-harvest management, so as to stabilize incomes, reduces the risks faced by beneficiaries and banks. Close interaction with the beneficiaries reduces information asymmetry problems, leading to lower screening and monitoring costs for FFIs, while improving loan repayment. These factors are crucial in facilitating access to credit.

Such schemes clearly hold promise, and appear to be cost-effective. However, more experience is needed before their wider potential, and their sustainability once NGO support is withdrawn, can be assessed.

Self-help groups

Group saving and credit activities have had some success. Transaction costs are kept down, as the screening and monitoring of loans is performed by the group members (who may have joint liability for loan repayment). If such groups link to the formal sector, there is potential to

reduce FFI transaction costs further by making a single large loan in place of multiple small loans.

Informal self-help groups involved in micro-finance tend to be of two types: those having rotating funds and those with non-rotating funds. Both have received considerable attention. Bouman (1995) reports high levels of participation amongst the adult population in sub-Saharan Africa.

The groups involved may not necessarily have financial activities as their *raison d'être*, but organizations such as church groups or age-based groups may be involved in some sort of financial service provision. As is typical in the informal sector, these groups have evolved to respond to local needs, and therefore have different characteristics and modes of operation. Such self-help groups tend to prosper in times of increased economic activity. In fact, one characteristic of the micro-finance activities of self-help groups is that they tend to be temporary, with the rotation period of ROSCAs often lasting only a year. This is often interpreted as evidence of unsustainability and justification for promoting formal savings and credit cooperatives. Yet in reality it is "precisely the non-permanency that permits the ROSCA and ASCRA to adopt a new strategy to fit the circumstances. They can do that as a self-regulating mechanism; they are both product and producer of change." (Bouman, 1994, p. 378).

However, despite these successes there remain questions: these group-based innovations have not been universally successful, and their ability to reach the poorest members of communities (who may not be able to contribute regular savings) is limited. ROSCAs have a number of drawbacks which diminish their appropriateness for the poor. With a set rotation, members are aware of when they will have their turn to receive the funds, though this will not necessarily fit in with when they need funds. This limits the role of ROSCAs in providing emergency consumption credit, and also the degree to which they can be used for productive credit, especially in the RNR sector where rural populations have a simultaneous need for investment finance at specific stages of the production cycle.

More useful are the more sophisticated organizations in which the fund is not saved and distributed on a simple rotational basis. These institutions have been termed ASCRAs (accumulating savings and credit associations). Like ROSCAs, members pool savings, but these funds are not necessarily redistributed at once. Savings may be voluntary and

irregular. This allows a broader cross-section of members, with poorer members able to contribute less to the savings pool. Loans are made on demand from the savings pool, often carrying high rates of interest. As with ROSCAs there is no model for ASCRAs, each having evolved to provide for local circumstances. Some are very sophisticated, with rules and regulations in print, and requiring a relatively advanced administration (thereby increasing overheads).

Other institutions share characteristics of ROSCAs and ASCRAs. Such hybrids may include auctions for deciding the distribution of rotating funds, or other forms to compensate those receiving the funds at the end of the cycle. Bouman (1994) provides an interesting example from Cameroon (see Box 3). This shows that ROSCAs can develop into fairly sophisticated institutions providing more than one service to their members. Yet neither ROSCAs nor ASCRAs can deal effectively with a simultaneous need for finance by all or most members.

Box 3 The *tontine* of the Bamileke people of north-west Cameroon (from Bouman, 1994)

The *tontine* is a sophisticated form of ASCRA. After contributing to a monthly savings pool, a principal auction is held for members to decide who will have the first turn in receiving the pool. The person bidding highest wins the first turn. The amount bid is subtracted from the total and transferred into a loan fund (minus administration costs). This loan fund is then divided into smaller sums which are sold in a secondary auction. Bids in the secondary auction are in monthly interest rates, with a fixed ceiling. All of these loans must be repaid during the next session together with the interest accrued. These repaid sums are then put into another secondary auction. These are added to by the winning bid from the second principal auction. Therefore, the sum available for loans in the secondary auction grows with each round. When the amount available in the secondary auction equals the original sum in the savings pool, an additional principal auction is held, and for that month two members will receive their turn. This reduces the total length of the cycle. At the end of the rotation, the remaining funds are divided equally among all members.
This informal, but sophisticated rotating finance system combines the advantages of the ROSCA with the opportunity to gain timely access to short term credit.

NGOs have had mixed success in trying to link with self-help groups, or to use the principle of self-help groups in project design. Box 4 describes two contrasting experiences from Uganda which demonstrate the potential pitfalls of NGO involvement in self-help groups. Bouman (1995) notes a number of reasons for the mixed experiences:

Box 4 NGOs and rural finance – experiences from central Uganda

Central eastern Uganda has distinctive socio-economic characteristics which have implications for micro-finance services:

- the insurgencies of the late 1980s/early 1990s resulted in considerable social disruption; many families left the area and their assets were lost
- the social disruption has led to local institutions breaking down, including informal institutions which played a role in micro-finance (e.g. savings and credit groups)
- the area has a high proportion of female-headed households (up to 40% in some communities)
- although infrastructure (transport, etc.) and soils are relatively good, poverty is persistent because of capital and labour constraints to the uptake of improved agricultural technology.

Two projects were reviewed, which demonstrated strikingly different approaches.
Vision Terudo (Ngora, Kumi District): this is a well-established local NGO, with a wide portfolio of projects (including health, education, child sponsorship, and savings and credit) supported by donors. The savings and credit programme is funded by a foreign NGO. The programme has been operating for two years, providing relatively short-term credit (maximum repayment period is one year) to individuals. The savings component is a recent addition to the programme, and is not yet operational. The approach to micro-finance is loosely based on Grameen Bank principles (group lending with regular repayments). At the beginning, repayment rates of 60% were achieved. However, these have since fallen to less than 10% in 1997, raising some important issues about the design and implementation of the programme.

- the programme is supply-led, with individuals encouraged to take credit (debt) without much control over how it is used, resulting in some unwise investments and low repayment rates
- local staff had neither significant experience nor training in operating credit and savings programmes
- there were poor accountability systems both at the project and the community level
- services were not tailored to the financial needs of the population.

Koka Foundation is a relatively new indigenous NGO, and is much smaller in scale than Vision Terudo. At present it receives no external funding, though it receives technical assistance from the public sector and from the UN Children's Fund (UNICEF). Its entry point is indigenous women's savings and credit groups (ASCRAs), in which the women pool funds either for working on communal projects or to make loans within the group. It is demand-driven, with the groups paying membership to Koka for technical assistance. Koka provides advice and technical assistance on the establishment and training of the women's groups, and also on production and marketing issues. It has also tried to link the groups to services provided through the public sector and other agencies (such as UNICEF). Koka staff are retired volunteers. The number of groups in the programme has risen each year, and currently stands at over 30. All groups pay their membership fees regularly and promptly, indicating an appreciation and satisfaction with the services provided by the Koka Foundation. Although no funds from the NGO are channelled directly for credit, the assistance provided by the NGO has contributed to the successful operation of these informal savings and credit groups.

These case studies raise some interesting issues. The contrast between the two projects is stark. Vision Terudo has ample funds and has distributed considerable loans, though the communities appear to lack the willingness and/or capacity to utilize and repay the funds. Little effort has been made to strengthen the capabilities of either the project staff or the communities. The Koka Foundation, with no funds for providing loans, has instead concentrated on developing capacities and community linkages – an approach which appears more sustainable.

- models which can be replicated do not exist; self-help groups have evolved to suit the needs of local users and are therefore socially, environmentally and economically specific to their locations;
- most NGOs have little experience in micro-finance; and
- foreign NGOs in particular are "inevitably projecting their own ideologies and objectives onto societies with a completely different culture and normative system" (Bouman, 1995, p. 382).

Fostering the enabling environment

It is possible that too much attention has been paid to the design of savings/credit delivery innovation, and too little to the limitations of the poor in making savings, and, importantly, using credit in productive ways. Evidence shows that greater success (in terms of impact on incomes and sustainability of the group) is achieved when credit is combined with non-financial business development activities (Dawson and Jeans, 1997).

Micro-enterprise development generally assumes the availability of productive resources (land, labour). The poorest, however, may lack land, and may face seasonal labour constraints (though labour is often regarded as 'the poor's greatest asset'). Secondly, micro-entreprise development assumes some degree of entrepreneurship (which is difficult to measure, though it may be related to education and business skills), and less tangible aspects such as self-confidence, ambition and social networks. Clearly, it is not everyone's strength.

If productive credit is not to lead to a debt trap, it is important to consider these issues. Productive credit should be channelled to those who have the ability (and supporting services) to use it well. This will have knock-on effects on the poor, creating labour opportunities – see Dawson and Jeans (1997) for evidence of the labour creation resulting from small- and medium-enterprise development. The poor will make better use of productive credit where health and education needs have been met and infrastructure investments permit access to land and markets.

Macro-economy

Evidence from most studies on financial sector development strongly suggests that an enabling macro-economic environment is an important prerequisite for improved financial intermediation. Price stability and fiscal

policy are critical factors. Fiscal policy which reduces public sector borrowing eases private sector access to credit and lowers nominal borrowing costs. Most SSA countries, however, face considerable difficulty in achieving this. FFIs, with their long history of state ownership and control, are rarely effective in their demands for this, though donor influence can be significant.

Regulations and deposit mobilization

There is evidence that tighter regulation and supervision tend to deepen risk aversion in FFIs (Sheng, 1996; Ncube and Senbet, 1997; Soyibo, 1997). This improves portfolio management as a result of wiser loan decisions, and lower default and per unit operating costs. Relaxing these regulations to ease credit access could be counter-productive, if it leads to poor portfolio quality and ineffective intermediation by banks.

The discussion of decentralized banking highlighted the need for effective controls on the activities of semi-isolated, autonomous rural banks. Promoting effective apex structures of the unit banks to serve as coordinating points in developing linkages would minimize these problems. The apex structures of BRI in Indonesia, Rabo Bank in The Netherlands and the Association of Rural Banks in Ghana are models worth studying.

SUMMING UP

- Rural finance interventions to reduce poverty must be tailored to the needs of the poor.

- Rural finance can be improved by strengthening both formal and informal financial sectors, and by linking them to capitalize on their respective strengths.

- Priorities for the formal sector are (a) deposit mobilization among the poor, and (b) lowering credit access barriers, especially for women.

- The poor are heavily dependent on the informal sector. Policy-makers and formal financial institutions can contribute to improved poverty focus by recognizing the role of the informal sector, and adapting it or complementing it.

- The formal sector must find ways to reduce transaction costs; the informal sector tends to have lower transaction costs due to community-based information systems.

- Group saving and credit activities provide lessons on how to limit transaction costs through group screening and monitoring.

- NGOs can help mobilize groups and provide training but subsidized interventions have not had much success.

- Evidence shows that greater success (in terms of impact on incomes) is achieved when credit is combined with non-financial business development activities.

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ABBREVIATIONS

ASCRA	accumulated savings and credit association
ATRCW	Africa Training and Research Centre for Women
BRI	Bank Rakyat Indonesia
DFID	Department for International Development
EU	European Union
FAO	Food and Agricultural Organisation
FFI	formal financial institution
IFI	informal financial institution
GDP	gross domestic product
K-REP	Kenya Rural Enterprise Programme
NGO	non-governmental organization
PRODEM	Fundacion para la Promocion y Desarrollo de la Microempresa
RNR	renewable natural resources
ROSCA	Rotating Savings and Credit Association
SG 2000	Sasakawa Global 2000
UNICEF	United Nations' Children's Fund

Printed in the United Kingdom by Hobbs the Printers Ltd