PROMISING PRACTICES IN RURAL FINANCE
Experiences from Latin America and the Caribbean

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Mark D. Wenner
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editors

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Foreword

Financial markets play an important role in economic development and growth. Countries with faster rates of economic growth tend to have financial markets that are deeper and more efficient than those where growth is slower. This yields an obvious implication for countries where a substantial proportion of the population is rural and where rural economic activity, both farm and nonfarm, generates a sizeable share of economic value-added and employment. That is, if rural economies are to grow at a faster rate, rural financial markets have to function well. Faster rural economic growth will have a positive impact on income distribution, alleviate poverty, and allow national economies to compete more effectively in an increasingly integrated global marketplace.

Unfortunately, in Latin America and the Caribbean as well as in other developing regions of the world, rural financial markets do not function well. Instead, they tend to be segmented, underdeveloped, noncompetitive, and inefficient. As a result, access to formal financial services in rural areas is quite low and the range of services offered tends to be limited. Few private commercial banks are actively engaged in rural intermediation and the number and effectiveness of state-owned development banks has waned over time. Semi-formal and informal institutions dominate the landscape but they have weaknesses and limitations.

This book reviews the theory and practice of rural finance in the region. It explains why rural financial markets function the way they do and what changes would be needed to make improvements. It also provides an in-depth assessment of the policy and institutional setting in five countries, as well as an overview of the successful experiences of a number of intermediaries and strategic alliances in Bolivia, Costa

Rica, El Salvador, Jamaica, and Peru from which stem important lessons and good practices. The book shows that there is much to be hopeful about and that positive change is occurring in the region albeit on a small scale. The challenge is how to consolidate and replicate some of the positive operational successes and create a more favorable policy environment.

This work should be of value to policymakers, practitioners, and donor staff interested in improving the efficient and sustainable delivery of financial services to the broadest base of rural residents.

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INTRODUCTION

Javier Alvarado, Francisco Galarza and Mark D. Wenner

Despite the increasing pace of urbanization sweeping all the economies in Latin America, large sectors of the population still live in rural areas, and many of them are small-scale agricultural producers. At the same time, over half of rural families are impoverished and more than one-third live in extreme poverty. To develop this sector of the population has been, and continues to be, one of the toughest challenges facing low income nations, particularly those in Latin America and the Caribbean.

During the nineties, rural finance was a forgotten topic in development economics. This is slowly changing and, once again, there is growing interest in meeting the challenge of increasing the competitiveness, depth and efficiency of rural financial markets. This book presents recent reflections on the matter, and in particular, analysis of the reasons why financial services have failed to expand significantly in rural areas. To meet that objective, we have highlighted some of the more interesting experiences in Latin America and the Caribbean, in which several of the obstacles to the provision of financial services have been overcome. These cases raise the hope of one day providing sustainable broad-based financial services, and offer key lessons on how to achieve this broad outreach and solid financial results. The goal is to go beyond a list of what does not work and study what does, and —what is more important— how these experiences can be consolidated and replicated. This book is intended for policymakers, practitioners, staff of donor organizations and researchers.

Since the 1960-to-1980 period, there have been major efforts underway to improve the coverage, depth and efficiency of rural financial markets in develop-

ing nations. Nevertheless, rural areas are plagued by failures. In Latin America, the previously reigning paradigm, that is, direct and subsidized credit, channeled through state agricultural development banks, has largely been discredited and discarded. Today, existing state-owned financial institutions strive to operate as commercial banks.

However, despite the wave of liberalization in the financial market in the late eighties and nineties, private commercial banks largely refrained from entering rural areas. Bank participation has tended to be limited to financing farmers who have tangible fixed assets involved in agricultural exports or agro industry. When all is said and done, those providing the main rural financial services are generally informal or semi-formal financial institutions. Many of them have limits, as do the service provision instruments or mechanisms commonly used. As a result, rural markets continue to be limited, noncompetitive and segmented. This far-from-satisfactory situation has major socioeconomic consequences: less economic growth, more unequal patterns of income distribution, less poverty alleviation, as well as less competitiveness and diversification of rural economies in the context of globalization and ongoing trade integration.

OBJECTIVES

This book pursues the following objectives:

(1) To provide an examination of the current situation of rural financial markets in Latin America and the Caribbean and a conceptual framework to understand why rural financial markets function the way they do.

(2) To provide an analysis of the way economic policy, legal frameworks, and financial regulations affect the supply of and demand for rural financial services in five countries: Bolivia, Costa Rica, Chile, El Salvador and Peru.

(3) To present case studies on promising rural financial institutions and innovative products in the five countries mentioned above (with the exception of Chile)[1] and Jamaica, in order to assess the replication potential of such models and understand how to deal with issues of risk management, imperfect information and transaction costs. The book does not deal with issues related to the impact or implications of gender and racial discrimination.

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1 Case studies on Chile are not included for two reasons: (i) there is limited development of small-scale agriculture in Chile, compared with Peru and Bolivia; and (ii) cases analyzed either had showed high rates of payment default (such as the case of government agencies); did not consider the agriculture and livestock sectors as an important part of their portfolios (such as the case of private institutions); or lacked the complete set of financial information required to carry out the analysis (this occurred in every case, in particularly regarding Córpora Aconcagua, the Agricultural Development Institute (INDAP) and the Talagante Savings and Loan Cooperative (Coocretal). The cases studied were as follows: INDAP, a branch of the Ministry of Agriculture, the Chilean Economic Development Agency (CORFO), Banco del Estado de Chile, Banco de Chile, Banco de Desarrollo (where a case study on financial leasing was conducted), the Talagante Savings and Loan Cooperative (Coocretal) and the agro industrial firm, Córpora Acongua.

The book is divided into three main sections. The first provides a theoretical overview of rural finance as well as the context in which it takes place in Latin America and the Caribbean; the second section examines some cases of financial institutions and methods which have proved promising in expanding and broadening rural financial services in the region; and the third lists the main conclusions and recommendations arising from the issues discussed above.

The first section consists of three chapters. In Chapter 1, Mark D. Wenner and Francisco J. Proenza present a survey of access to financial services and efficiency indicators in the region, as well as a conceptual framework which explains why rural financial markets fail to work properly, as a result of the interaction between high unmitigated risk levels and serious problems of imperfect information and transaction costs; they then identify a series of priority areas for action, based on their survey.

Financial reforms swept the countries of Latin America and the Caribbean during the eighties. This followed the notorious failure of state-owned development banks despite the large amount of resources poured into them.[2] As a result, the current situation of many countries in the region reflects improvements in the depth of financial coverage, including the so-called agrarian economies. However, this broader coverage did not go hand-in-hand with greater financial efficiency in most countries of the region, or with any increase in the coverage of loan services and formal savings in rural areas, or with other services such as insurance, futures contracts, warrants and financial leasing.

In this sense, in spite of improvements, rural financial markets continue to be underdeveloped and noncompetitive. This is due, to a great extent, to the existing high levels of risk, caused by frequent variations in production conditions and the prices of inputs and outputs, limited risk mitigation techniques, as well as the classic problems of information and transaction costs, which are a constant in all financial markets. The latter problems are particularly accentuated in rural areas due to difficult access to information, the spatial dispersal of clients, frequently deficient physical infrastructure, communications, transport, etc., and severe weaknesses in the legal and contract enforcement framework. This explains why formal financial institutions have not entered rural areas to a significant degree.

Consequently, the tasks pending in promoting more complete, efficient, competitive and stable rural financial markets include efforts to create more favorable institutional policy settings for rural intermediation; to improve retail capacity of financial intermediaries, improve management and operational efficiency in rural financial institutions, and invest in new technology and financial procedures; and

2 State-owned development banks were created in the fifties to provide subsidized credit to small-and medium-scale agricultural producers in order to foster the technological change that, it was believed, would stimulate production.

encourage the introduction and dissemination of non-credit financial instruments such as deposits, crop insurance, structured commodities financing, hedging, securitization, electronic cards, financial leasing and factoring, which will serve to provide better risk and liquidity management, as well as reduce transaction costs.

In Chapter 2, Claudio González-Vega focuses his analysis on how to expand the frontier of rural finance, chiefly using the lessons learned from urban microfinance, which have produced the so-called "microfinance revolution." This surge, however, has not occurred in rural areas, where coverage of formal financial institutions has not expanded following the decline of development banks, due the reasons explained in Chapter 1. Most of Chapter 2 deals with the importance of institutional design and the use of appropriate credit technology to achieve sustainable financial results. Two important lessons are to be learned from urban microfinance technology: (i) institutions have to be prepared to charge interest rates that cover costs, and (ii) they have to design products which are well adapted to their clients' needs.

Chapter 3 analyzes the countries studied in the book, observing how macroeconomic, sector and regulatory policies affect the effective supply of and demand for rural financial services in Bolivia, Costa Rica, Chile, El Salvador and Peru. The degree of hostility or incentive found in the particular situation of a country determines to a large degree the type, number and quality of institutions in place, as well as the range of financial products offered. The more hostile the backdrop, particularly with low rates of return that plague many rural activities, the more segmented and underdeveloped formal financial services tend to be.

In the case of the countries analyzed, the fiscal crises of the past two decades made it impossible to continue allocating funds to development banks, and several of them were shut down, as occurred in Peru and Bolivia; in other cases, these institutions were restructured, such as in El Salvador. At the same time, governments changed several policies that blocked agricultural development —such as price controls and steep import tariffs— and launched aggressive reforms, which eliminated control over interest rates, permitted foreign ownership of financial institutions, strengthened supervisory bodies and produced laws that emphasized prudential regulation.

These changes cleared the way for new actors to appear in financial markets. In the nineties, Peru, Bolivia and El Salvador saw the emergence of several nonbank financial institutions and banks specializing in financial services for small-scale and micro business, which have managed to provide services to a large number of clients. However, the financial services provided by most of these institutions were largely intended for urban areas.

The challenges facing the development of rural finance are daunting. As stated by Claudio González-Vega in Chapter 2, a pragmatic focus is needed to limit the more obvious constraints. Depending on the country, actions could introduce improvements in macroeconomic policy, supervision or regulation; improvements in

the institutional framework to ensure contract compliance; or promote investments in infrastructure to lower transaction costs.

Although, as stated above, there have been major and positive changes in the context faced by rural finance in Latin America and the Caribbean, additional improvements, including broadening rural finance, remain to be made. For example, the poor the rural road network in Bolivia, Peru, El Salvador and Costa Rica condition of the substantially increases transaction costs. At the same time, despite progress made to date, there is still a great deal to be done in trade deregulation; work needs to be done to fine-tune legal procedures to reduce the costs involved in enforcing contracts. There is an urgent need for legal recognition of more types of moveable property as collateral. Similarly, in Bolivia, Peru and El Salvador, there are problems with land titling and the definition of property rights.

The second part of the book includes seven chapters. Some of them (Chapters 4-7) provide a detailed analysis of positive experiences of some of the non-bank financial institutions that have managed to respond adequately to several of the challenges involved in providing financial services in rural areas. Chapters 8-10 focus on innovative financial products aimed specifically at rural clients. These cases were chosen using two basic criteria: (i) the products offered are reaching the area effectively and provide the financial services that match the demands of low-income rural producers, and (ii) they are sustainable or show potential to become so in a relatively short time.

In Chapter 4, Sergio Navajas and Claudio González-Vega present the case of Financiera Calpiá in El Salvador, an institution that has successfully made inroads in rural areas after working in urban sectors. This experience has generated several lessons: first, the importance of diversifying an institution's portfolio (rural-urban) to mitigate the risk of rural credit; second, and this is perhaps the most important lesson, the adaptation of credit technology to achieve solid financial results and high rates of recovery. Calpiá has not developed any particular technology for rural lending, but has adapted technologies that tested successfully in urban lending to the needs of rural loan applicants. It should be pointed out that Calpiá has always sought to emphasize ability to repay and not crop production, as is traditionally the case in agricultural loans. The Calpiá experience also shows the importance of selecting and training loan officers, and providing them the proper performance incentives.

In Chapter 5, Javier Alvarado and Francisco Galarza present the case of Bolivia's Agrocapital Foundation. This institution has developed a risk diversification strategy different from Calpiá's, but fairly effective. Agrocapital only grants a small fraction of loans to rural micro businesses and lends mostly to larger, well-capitalized farmers. The larger share of long-term investment loans enable it to reduce average operating costs. It is important to point out that, although credit technology for micro businesses and investment demand thorough screening and feature some

common characteristics (such as the analysis of payment sensitivity in critical situations) given the scale of these loans (on average, more than US$10,000) greater emphasis is placed on requiring real guarantees and the analysis of the economic and financial feasibility of the project. On the issue of collateral, it would appear that over a certain amount, the greater risk involved makes lending imprudent and requires conventional guarantees.

In the next two chapters, Javier Alvarado and Francisco Galarza present two programs that explain how to establish successful links with the commercial banking system in Peru. In Chapter 6, a semi-informal institution, the NGO Solidaridad Social Studies Center (Centro de Estudios Sociales Solidaridad), acts as an agent for a commercial bank, the Wiese Bank.In Chapter 7, the agent is a private firm, Critecnia S.A., which works with the Bánex Bank. These cases show how, by making use of the comparative advantages of each of these organizations, profitable credit services may be offered to small-scale farmers, many of whom have had no prior experience with the formal financial sector. The banks have more funds available and greater capacity to handle risk because loans to farmers represent a small percentage of their portfolios. Solidaridad and Critecnia display clear informational advantages because of their proximity to farmers, which enables them to adequately select loan applicants and monitor their activities. In this fashion, problems related to adverse selection and moral hazard, which are particularly common in rural lending, are reduced. Solidaridad and Critecnia carry out the basic tasks of selection, monitoring and recovery, and receive a commission as payment in the first case, and a share of the profits from trading the farmers' products in the second.

In Chapter 8, Mark D. Wenner and Rodolfo Quirós examine an innovative technique involving agricultural credit cards issued by Financiera Trisán, a finance company in Costa Rica, which operates profitably and self-sufficiently. This case shows it is possible to make use of state-of-the-art technology to finance small-scale farmers. Financiera Trisán, part of the Trisán Group, which has several agricultural business interests, issues credit cards intended for agricultural suppliers and rural producers. Through this a mechanism, users can buy on credit products distributed by the Group's companies as well as other affiliated companies. For rural producers, the credit card is a substitute for supplier credit. It affords the advantage to retailers of receiving payment 24 hours following the sale, while farmers obtain a line of credit enabling them not only to easily acquire Trisán products but also others, thereby reducing transaction costs.

Savings are one of the least available financial services in rural areas, despite the fact that there is a great deal of demand for them. One of the few institutions that has moved into this long overlooked area of microfinance is the Workers' Bank of Jamaica. In Chapter 9, John Owens takes a look at a large-scale savings product offered by the Bank to low-income workers. The Workers' Bank has a tradition of drawing savings from low-income residents, many of whom lived in rural areas, by using post-offices throughout the country. However, its, the most innovative prod-

uct is the so-called Partner Savings Plan, which was inspired by the informal savings made in ROSCAs.[3] The Bank identified the characteristics that explained the popularity of this kind of savings method among low-income people and created a product that had its main features, including their terminology, which, along with the heightened security involved in saving money in a bank and a proper marketing strategy, was well received, as reflected by an increasing coverage.

Most institutions offering financial services in rural areas have designed short-term credit products, but few have attempted to introduce financing methods that could respond to demands for purchasing fixed assets. In Chapter 10, Javier Alvarado and Francisco Galarza analyze one of the few existing experiences in financing agricultural machinery and equipment through the mechanism of financial leasing for small-scale rural producers, implemented by the National Ecumenical Development Association of Bolivia, ANED (Asociación Nacional Ecuménica de Desarrollo). The design of this product resulted from an analysis of the demand for financing by some rural producers in ANED's working area. This new product allowed it to grow quickly and post net profits over the past two years. An important feature of this scheme is the importance of contract design in creating proper incentives for producers to take adequate care of the equipment and purchase it outright at the end of the process.

Finally, the third and final section of the book (Chapter 11) presents the main conclusions and recommendations. The chapter summarizes the lessons learned from the case studies regarding the relevance and interaction of policy framework, institutional design, price-fixing and appropriate technology. The main findings and lessons learned include the following:

(1) A clear and precise conceptualization of how rural financial markets function is crucial in designing appropriate policy actions and in building a financial architecture, particularly in rural areas. Cheap credit is not a remedy to alleviate poverty, and politically imposed interventions do not solve market problems. Instead, financial intermediaries must bear in mind that to carry out a financial contract (whose terms mean that its fulfillment is uncertain) they must tackle and solve three challenges: (i) how to obtain sufficient information on clients' ability and willingness to pay, save and honor insurance contracts; (ii) how to determine and set price risks; and (iii) how to minimize transaction costs to make contracts profitable.

(2) Providing policy factors and context is important, but these do not entirely determine the success or failure of a rural financial institution. The study has found institutions, such as Financiera Calpiá in El Salvador and Agrocapital in Bolivia, that have managed to develop and provide financial services efficiently in rural areas, despite the fact that these countries display the least

3 ROSCA (Rotating Savings and Credit Associations) is an informal savings and credit system widely used in every country.

promising natural factors and human capital and have slower growth rates than Costa Rica and Chile, for example.

(3) In order to be able to attain the goals of profitability, increased client coverage, and steady growth of portfolio and capital, the key to the organizational success of intermediaries is the correct "alignment"[4] of their mission, governability incentives, capacity of their human resources, internal controls, risk management techniques and technology for providing services.

(4) The methodology applied in evaluating loan use tends to "rely on experts"; that is, a local loan officer carries out a subjective evaluation more or less based on the five Cs: (i) character (perception of the applicants in terms of fulfilling their obligations), (ii) capital, (iii) capacity (ability) to pay, (iv) collateral and (v) existing economic conditions. This influences consistency and comparability, given the existence of several levels of loan approval.

(5) The typical interest rate on credit products in rural areas is high: it is 25 percent or more a year in most of the cases studied in this book. It would appear that interest rates on financing commercial activities are inelastic, while they are elastic on financing agricultural or manufacturing activities. However, the sustained demand for loans from rural financial institutions with "high-price policies" indicates that there is indeed the ability and the willingness to pay and that the relevant price reference is the cost of informal lending. To reduce the cost of credit, several improvements are needed: increasing the operating efficiency of intermediaries; encouraging greater mobilization of domestic savings; and, improved macroeconomic policies, particularly regarding the maintenance of low to zero fiscal deficits.

(6) Innovative financial products promise to lower transaction costs and improve risk management, which would allow intermediaries to enter markets that have been unreachable or unattended until now. An important aspect to take into account is that innovation appears to work better when intermediaries have a wealth of experience in a related area and enjoy a solid reputation in the geographic area where they operate. In addition, legal barriers and deficient infrastructure must be surmountable from the start of the process of innovation.

The rural financial organizations and innovative financial products analyzed in this book reveal, to greater and lesser degrees, the fact that rural finance can be profitable and sustainable. This is perhaps the most important lesson arising from this work.

4 It is said that there is correct alignment of incentives, mission, human capital, internal controls and financial technology when they are uniformly oriented and are consistent in their pursuit of determined goals.

However, much work needs to be done to extend rural financial markets and make them more efficient, as well as to promote concrete experiences in rural financing and strengthen existing ones. We hope the results presented in this publication will encourage policymakers and implementers, donor organizations and managers of rural financial institutions to persist in their efforts to build more efficient and more complete rural financial markets in Latin America and the Caribbean.