RURAL CREDIT FOR RESOURCE-POOR ENTREPRENEURS: LESSONS FROM THE ERITREAN EXPERIENCE

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Abstract

Developing countries' small-scale farmers lack access to financial services. In the Eritrean Savings and Micro- Credit program (SMCP), solidarity groups are jointly responsible for individual members' loans; this reduces transaction costs, improves repayment and substitutes for collateral. Performance of SMCP (1996 to 2002) indicates low arrears and good repayment, but not satisfactory saving mobilization. SMCP service reached many people previously without access to financial services, thus materially improving individuals' economic self-confidence and independence, cash holdings and household living standards. It has had favourable social spin-offs; a well-designed village-banking model can help solve economic problems of the poor.

1. NTRODUCTION

Small farmers in developing countries experience scarcity of capital. Formal financial institutions are reluctant to provide loans to small farmers. This market is perceived as risky and often not viable: Opportunity costs often outweigh expected profits. The causes are small farmers' lack of collateral, high default rates, high transaction costs and high average operating costs involved with large numbers of small loans (Spio, 1994). In most countries the formal financial sector is regulated by banking law whereas the informal sector operates without statutory regulation and supervision. Approximately 60% of financial transactions in developing

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countries rural areas are done within this sector. Relatives, neighbours, professional moneylenders, and rotating saving and credit associations (ROSCA's) are the most important sources of informal credit (Adams and Fitchett, 1992).

Eritrea is a poverty-stricken, newly independent and war ravaged country with serious agricultural development problems (Abubakar and Groenewald, 2003). The Saving and Micro-Credit Program (SMCP) is a system of providing financial services to the poor.

2. THE SAVINGS AND MICRO-CREDIT PROGRAM (SMCP)

2.1. General

The aim of the SMCP is mainly to provide financial services to vulnerable groups, both rural and urban, without access to formal banking services. The SMCP has a two-pronged approach to promote micro-enterprises. Grassroots-based solidarity groups owing and operating "Village Banks" form the backbone of one part of the program, called Tier I. Beneficiaries belonging to this category generally need short-term micro-loans not exceeding Nakfa 10,000 per loan. Most Tier I clients use the loans either to meet working capital needs or to expand business operations; they constitute over 90 % of SMCP clients. Individual entrepreneurs whose requirements cannot be met through the Tier I facility have access to a Tier II window, intended to enable individual and group clients, without recourse to Commercial Bank of Eritrea (CBER) stipulated collateral, to borrow up to Nakfa 100,000. Although they constitute only 10 % of the client base, Tier II clients have absorbed up to 42 % of the SMCP loan fund.

2.2. Collateral/loan security

The SMCP is a Solidarity Group (SG) based lending program, involving groups in which some or all members are jointly liable for each individual's loans instead of individual loan collateral

requirements. No new loans are provided until all outstanding loans of the group are repaid. Solidarity group members moreover become eligible for further loans only after having successfully accumulated 10% mandatory savings within three months. Mandatory savings are normally deposited in a local commercial bank account opened in the name of the village or group and will be used to honour unpaid commitments in case of default.

2.3. Interest rates

SMCP annual interest rates have been 16% for Tier I clients and 14% for Tier II clients, higher than those of most other micro-lending institutions in Eritrea. Real interest rates over inflation ranged from –0.005% to +0.012% (Annual Report of SMCP, 2001).

Financial and institutional sustainability are not always synonymous. Long-term institutional sustainability may be financially costly in the short-term (Johnson and Rogaly, 1997). The operating profit of the SMCP grew from Nakfa 12,409.00 (second half of 1996) to Nakfa 5.2 million (last quarter of 2001). However, this does not necessarily reflect the true surplus, as the SMCP still receives subsidies from donors and the government of Eritrea.

2.4. Target beneficiaries and credit delivery mechanism

SMCP Tier I and II saving and credit services are open to all citizens excluded from access to services of commercial banks and other financial institutions. The potential clients - people in the informal sector - are about 250,000 people (SMCP project document, 2002), supporting over 1.2 million persons. By economic activity, loans distributions have been: Tier I: Agriculture 38.6%, Service 3.8%, Trade 56%, and Manufacturing 1.6%. And Tier II: Agriculture 38.06%, Service 14.04%, Trade 43.27%, and Manufacturing 4.62%. An important target group consists of women farmers and entrepreneurs who have the potential to expand the local economy while at the same time improve their own standard of living.

2.5. Group formation, loan size and term, and loan conditions

Only members of SG‘s consisting of 3 to 7 members are eligible for SMCP credit. Prerequisites for SG’s include:

- The SG has to be formed voluntarily by individuals with the same understanding of the program and who trust each other;
- A SG may not have more than one member from the same nuclear family, but different members of the same family can join different SGs;
- The group has to be formed from the same community/town; and
- When different repayment due dates and loan sizes occur, SG members must decide and negotiate between each other on the ways and means of avoiding complications. Generally, it is preferable for solidarity group members to have a similar capacity to utilize the loans extended.

Tier I has seven loan cycles and loan sizes increase gradually. The first loan cycle starts with Nakfa 1,000. Eligible borrowers may request amounts below the designed ceiling. Receiving the subsequent loan will be contingent upon the repayment of the previous loan by all SG members. SMCP loan sizes and maturities are indicated in **Table 1.**

Table 1

The usual Tier I borrower generally starts at cycle I and works his way up to cycle 7. Fresh borrowers may in some cases enter the program at later cycles. The loan repayment period presented in Table 1 is only indicative. Some flexibility must be built in for repayments terms to reflect reality. A grace period (pegged cash flow) may be allowed depending on the nature of the investment. The loan life should also reflect the nature of the business activity; grain trade and

sheep/goat fattening generate revenue faster than raising dairy calves or erecting a vegetable oil expeller project.

3. PERFORMANCE OF THE SMCP PROGRAM

3.1. Loan repayment

Table 2 shows indicators of portfolio quality, including repayment rate, reserve rate, portfolio at risk, loan loss rate etc.

Table 2

Portfolio in arrears indicates amounts of loan payments past due. These values are favourable, varying between 1.15% and 9.36% this success is attributed to close monitoring of loan performance, a high degree of management autonomy, strong social pressure, incentives for higher loans, as well as innovative and flexible loan terms and conditions. A high repayment rate, varying from 100% to 92.5%, also indicates good performance. The 2002 repayment rate was 92.5% - a decrease of 4.13% from the previous year, caused by severe drought.

3.2. Saving mobilization

To become eligible for borrowing, SMCP requires applicants to save 10% of the proposed loan amount. This compulsory saving is important as it enables SMCP to assess the ability and commitment of the potential client to make repayments. SMCP deposits the savings with the Commercial Bank of Eritrea (CBER) in the village bank's name. The account is administered by SMCP regional accountants and the village bank chairman on the behalf of the clients. The CBER pays 6% interest on these deposits.

Voluntary saving mobilization is an integral part of the program; however, Table 3 indicates limited success in this respect (ECOSOC *et al*, 2000). At December, 2002 mandatory and

voluntary savings amounted to Nakfa 2,963,609.27 - 15.38% of the outstanding loan balance of Tier I. Average saving per client was Naka 262.97. The ratio of savers to borrowers is 1:1. Individual, voluntary, and open-access savings accounts have proved most successful in attracting savers. Mandatory savings have achieved services higher outreach than voluntary deposits. Table 3 shows saving mobilization by SMCP.

Table 3

3.3 The effectiveness of rural credit service

According to a World Bank analysis (2002), SMCP services were provided to 11,800 individuals, 36 % of which being women. Many used loan funds to improve their livelihood and increase their self-confidence and economic independence by 20 %; clients with a cash holding of Nakfa 10,000(US$741) increased by at least 50 %, and average monthly household expenditure of clients increased by 24 %. The SMCP provides a platform for institution building, notably through strengthening the capacity of village administrations to manage village-based saving and micro credit service programs. The organization of the village banking model (with its underlying solidarity group structure) promoted community cohesiveness, highlighted the importance of collective action and accountability by members in servicing and repaying loans, and strengthened the interaction and relations between the village administrator vis-a-vis credit committee members, the village bank membership, and even the rest of the village residences. SMCP credit furthermore contributed towards employment through income generating activities.

3.4. Major operational problems and constraints in rural credit

The following problems have complicated rural credit development, including the SMCP.

War /Border conflict between Ethiopia and Eritrea: The border conflict with Ethiopia aggravated an already difficult situation of reintegrating nearly half a million refugees and

demobilizing over 100,000 since independence in 1993. After May 1998, approximately 250,000 people were displaced and over 64,000 deported from Ethiopia to Eritrea. This compounded the challenges of reintegrating these groups into an already strained economy. Approximately one third of the deported came from rural areas, and must be resettled eventually. The war also caused infrastructure damage in affected areas and a cumulative death of between 50,000 and 70,000 from both sides (Nagan, 2002). Socio-economic infrastructure and services of approximately 200 villages were destroyed and have to be rehabilitated (www.wds.worldbank.org).

Default problems: In some regions borrowers developed the attitude of expecting debt rescheduling or write-offs and of regarding the loans as government grants. If loans are not repaid according to schedule, funds will be tied arrears and the bank will face shortages of loan funds.

Accessibility: From the lenders' point of view the large number of scattered small size applications, the difficulty conducting follow-up visits to each borrower, and the expense cost of loan administration are major constraints in reaching the rural people.

Backward technology: Rural agricultural and non-agricultural production systems are traditional with stagnant technology and characterized by low productivity resulting from lack of knowledge of modern techniques and of improper production practices.

Inadequate infrastructure: A country with an area of 124,320 sq. km has only 3,850 km highways; 810 km is paved, the other 3040 km not (CIA, 2001). Due to the lack of transportation and communication facilities in rural areas, branch offices of the banks have been established only in major towns.

Inadequate provision of complementary services: The provision of extension services is inadequate, not only due to shortage of skilled manpower but also due to lack of mobility. Marketing services for output are insufficient, causing farmers not to have bargaining power.

Lack of co-ordination among the Financial Government, Non-Government institutions and line ministries: Coordination among the concerned ministries and non-government organizations involved in development programs and the financial institutions is weak in several regions and non-existent in some others. This renders it difficult to achieve proper utilization of credit and its contribution to development.

Legal constraints and the lack of appropriate regulatory and supervision: Many countries, particularly developing countries, have limited capacity to regulate and supervise the traditional and also the formal financial sector. These Institutions are not regulated and often not allowed to mobilize client savings (Campion, 2000). The SMCP is legally constrained in its effort to mobilize savings from the public; the legal framework governing the rural credit sector (licensing supervision and monitoring) is yet to be developed. There is no uniform registration or licensing procedure for rural credit in Eritrea.

4. LESSONS LEARNED

- The village-banking model can promote community cohesiveness and community driven micro-finance development. Close collaboration with lower level administrative structures also provide a dynamic foundation for strengthening the institutional development of community driven micro-finance development.
- By promoting local governance, transparency, accountability, local capacity building and sustainability of local services, community based projects can contribute to

broader efforts to decentralize the provision of public goods and services in a way that also helps local government to fight poverty.

- Efforts to build on existing institutional structures should be complemented by explicit measures such as greater community mobilization, information dissemination and targeted capacity building to ensure that the institutions function in an effective, inclusive, and participatory manner.
- Clear mechanisms and incentives need to be established up-front to facilitate the achievement of the less visible objectives of institutional development and sustainability. The trade-offs between the physical and more qualitative output targets need to be confronted in the project design stage and the hierarchy of objectives needs to be defined and established up-front. Explicit measures are needed to compensate for the natural bias towards maximizing immediately visible and more easily measurable results.

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Table 1: SMCP Loan Sizes and Maturities (currency is in Nakfa)

Cycle	Loan size (1996-97)	Maturity	Loan size (1998-2000)	Loan size (2001-2003)	Maturity
1	750	3 month	750	1000	3-12 month
2	1500	6 month	1500	2000	3-12 month
3	3000	12 month	2250	3000	3-12 month
4	6000	24 month	3000	5000	3-12 month
5			4000	7000	3-24 months
6			5000	8500	
7			6000	10,000	

Source: Annual Report of SMCP (data base of SMCP)
Eritrea's official exchange rate year 1996:1US$=Nakfa 6.70; year 1997:1US$=Nakfa 7.20; year 1998:1US$=Nakfa 7.40; year 1999 & 2000:1US$=Nakfa 9.80; year 2001:1US$=Nakfa 14.10; year 2002:1US$=Nakfa 14.30(African development indicators, 2002:205).

Table 2: Indicators of portfolio quality

Indicators	1996	1997	1998	1999	2000	2001	2002
Repayment rate	100%	98.85%	97.96%	92.88%	94.04%	96.63%	92.5%
Average of un paid loans (past due)	-	43,495.5	181,194.81	653,974.89	552,187.17	1,073,117.79	
Reserve rate [a]	-	-	0.44%	1.18%	5.61%	2.11%	5.36%
Portfolio in arrears [b]	0	1.15	2.04	7.12	5.96	2.71	9.36
Portfolio at risk [c]	0.00	1.28	2.09	7.48	6.33	3.37	7.5
Loan loss rate [d]	NA	NA	NA	NA	NA	NA	14%
Average of disbursed loans Tier I	1,370,600	6,364,550	13,894,050	9,429,800	7,018,350	19,799,570	
Average of disbursed loans Tier II	-	66,755	635,179	302,263	2,681,145.33	14,695,553	

a loan reserve(Calculated for loans with payments past due/portfolio outstanding)
b payment past due/portfolio outstanding
c outstanding balance with payments past due/portfolio outstanding
d.write offs (cumulative)/portfolio outstanding
Source: Annual report of SMCP

Table 3: Saving Mobilization

As of Dec.,2002

Region	*Saving*			*Total*
	Mandatory	*Voluntary*	*Interest*	
Debub	452,476.25	1,417.00	30,154.01	484,047.26
Anseba	446,464.00		76,374.66	522,838.66
Maekel	472,771.52	61,121.40	61,591.42	595,484.34
Gash Barka	443,330.67	660.40	67,111.13	511,102.20
S/K/B	415,431.21		54,888.92	470,320.13
D/K/B	125,800.00			125,800.00
Total Program of 2002	199,979.88	3,550.00	50,486.80	254,016.68
Total	***2,556,253.53***	***66,748.80***	***340,606.94***	***2,936,609.27***

Source: Annual report of SMCP