Financing local development

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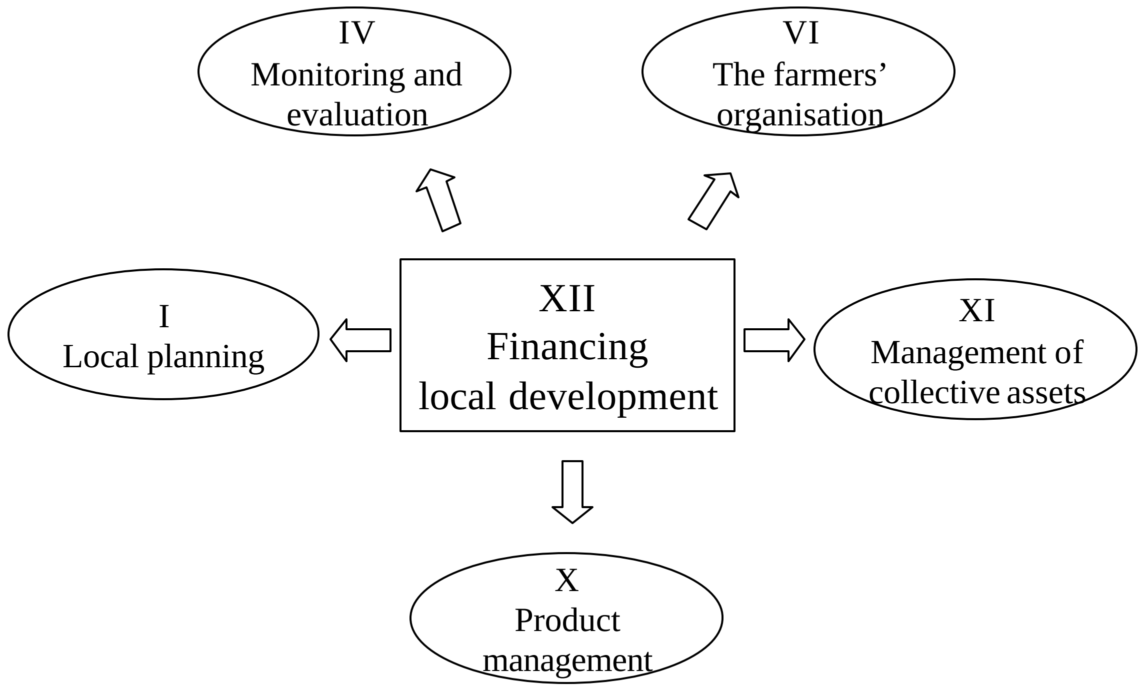
The following chapters are connected to Chapter XII:



Any local development process needs financial support. The nature and means of this support could be varied, as well as controversial. This chapter strives to present the different experiences, pinpoint the major issues and draw some methodological orientations that seem applicable to most situations. The chapter concentrates on financial services and its role in rural entrepreneurial development.

1. Typology of rural finance systems and history in western Africa

1.1 Agricultural credit through national banks and credit funds

Attempts to set up "modern" agricultural credit systems are actually as old as the colonial era. These attempts consisted of duplicating French models of agricultural credit funds in the colonies. These systems took the form of massive and lax credit provided by local companies during the 1910s, or of mutual funds (solidarity collateral) since as early as 1956 in Cameroon.

The main problem of credit in Africa has always been collateral, since the usual guarantees existing in Europe (land, residential or industrial buildings, livestock, stocks of goods, heavy equipment and machinery, etc.) are hardly applicable. This has accounted for the most failures of classical banking schemes. Therefore, other forms of guarantee (moral guarantee, solidarity) have been resorted to and these are referred to as collateral substitutes.

With independence, development banks were created though they were not interested in agricultural credit (despite offering traditional services supporting some commercialisation campaigns).
National agricultural credit banks and funds were then created: CNCA in Niger (1967), CNCA in Togo (1967), BNDA in Cote d'Ivoire (1968), CNCA in Benin (1975), CNCA in Burkina Faso (1980), BNDA in Mali (1981), CNCA in Senegal (1984).
These banks granted loans either directly to the beneficiaries (individuals, companies or farmers' groups, co-operatives) or through development projects or development companies. A review of these different experiences in west Africa in the early 1990s highlighted a variety of problems: bankruptcy (in Niger) and critical situations in many banks (Togo, Cote d'Ivoire, Senegal), volatile balances and a quasi-exclusive concentration on cotton areas (in the case of Burkina Faso and Mali).
The causes of these situations have been numerous: loans granted according to political rather than technical criteria, project managers lacking professionalism, burdensome and ill-adapted procedures, exaggerated operation costs and salaries in the banks, over-centralisation, inadequate strategies in the event of low yielding crops and certain farmers not repaying loans. Almost all of these banks were also characterised by heavily subsidised loan policies and ignoring other financial products, like savings facilities.

> Farmers show solidarity (as groups) and for several reasons farmers often did not repay these loans. Thus, it becomes socially acceptable not to pay back loans provided by government banks and therefore difficult for banks to recover their money.

Two situations where recovery rates have been high are worth mentioning:

- In cotton areas, the loan recovery rates have reached nearly 100% over the past 30 years. This exceptional situation can be explained by the organised and monopolistic nature of the commodity chain (from seed supply to processing and sales on the world market) and by a sound knowledge of the producers and their needs (either directly or through village associations).
  A direct levy at the commercialisation level is very efficient since the debtor can sell only on a controlled basis through the cotton company. Any attempt to bypass the system (for example selling elsewhere) results in the cessation of further supply and credit for the farmer from then on. Such conditions do not exist for many products (another example is sugar cane).
- In areas where groundnuts are grown, particularly in Senegal, integrated credit systems worked well on a large scale for more than ten years up until the 1980s. Credit was granted to co-operatives, which were also in charge of commercialisation. Unlike the situation with cotton, the relationship between credit and commercialisation was indirect. At the end of each planting season, profit and loss accounts would be issued by the co-operatives, showing benefits and arrears (outstanding payments). Should a co-operative show a 300 000 F.CFA profit and 100 000 F.CFA unpaid, the bank where both accounts were held would consider only 200 000 F.CFA as profit. Shareholders of the co-operative would then be liable and share together the loss incurred owing to outstanding payments (principle of joint and several guarantees). This guarantee was not merely a moral guarantee as the profit resulted from commercial activities. Unfortunately, this system became perverted and faced degradation. Local influential people and board members systematically covered the loss with ever-decreasing benefits to

the shareholders. For the system to work, profit would have had tobe much higher than the amount of outstanding payments. If the latter was high (owing to a bad yielding season, or the farmers' lack of willingness to pay back loans), an overall non-payment movement was quickly triggered along with a series of rebates and moratoriums, which ultimately resulted in bankruptcy (Senegal in the 1980s).

Transparency and strictness may help:

In Niger during the early 1970s it was clearly demonstrated that perversion of the system is avoidable if there is transparency and strict application of rules. Equally, the level of solidarity (joint and several guarantees) must be socially manageable (one village or one ward, and not several distant communities involved in one co-operative). A total blockade (and not simply reduction) of the shareholders benefits must be implemented until repayments are fully recovered.

Solutions that can make the situation worse:

Rebate is a cancellation of part of the debts, for example, it could be enacted in a low yielding season. Usually, if the next season is also mediocre, the farmers will demand another rebate and may stop repaying (payments strike).

Payments may also be postponed to the following years (moratorium). Often, farmers facing regular payments plus moratorium payments are inclined to think that they will never be able to pay the entire debt. This may lead to them not repaying at all , as they may be facing other problems. There is always the hope that the government will decide on a general write-off. Psychological and political issues as well as the concept of threshold are important in the field of credit.

1.2 Agricultural credit through projects

Projects or regional development structures often play an important role in rural credit, either as intermediaries for the national banks and credit funds, or as independents (with the aid of external funds). The problems discussed earlier do occur, and are often aggravated by a number of factors:

- Lack of competence on the part of project managers (who are usually agricultural operators interested in credit distribution rather than in loan recovery).
- Lack of independence on the part of the credit officers vis-à-vis extension and supply.
- Lack of concern about the long-term sustainability of the credit system. The objective is to distribute inputs and equipment and then exhaust a fund rather than to find a financial equilibrium. With such a perspective low loan recovery rates are not a concern.

1.3 Savings and credit co-operatives (COOPECs and Credit Unions)

These institutions have different names: "*caisses populaires*" (Burkina Faso, Cameroon, Zaire), "*caisses rurales d'épargne et de prêts*" (Côte d'Ivoire), "*banques populaires*" (Rwanda), and so on. In western Africa COOPECs started to appear during the 1970s. They were introduced earlier in eastern Africa (known as credit unions). The motivation was to introduce self-help financial institutions, to decrease transaction costs and to ensure that people that normally would have no access to financial services do get access.

New local co-operatives were created during the late 1980s (Mali, Burundi, Senegal, Congo, Guinea) in response to the degradation of centralised systems for agricultural

credit (CNCA, BNDA). International sponsors also became increasingly interested in alternative ways of organising savings and credit.
The use of such alternative systems have demonstrated the following:

- Promoting savings has been successful: despite past scepticism concerning the possibility of promoting monetary savings by smallholders with limited revenues, all experiences have proved that savings activities have been significant.
- There is a diversity of needs:
    - The need to set some money aside to protect oneself firstly against hazards and losses (theft, fire, termites, etc.), and secondly against excessive personal expenses or external demands (parents, friends, neighbours), which are is easier to resist when no money is immediately available
    - The need for available liquidity to face life's necessities and shocks (disease, death, ceremonies, etc.)
    - The need for small loans (house improvement, social needs, inputs for production, etc.)
    - The need to earn interest on this saved money, even though such remuneration is often modest
- The link between savings and credit varies according to experience: credit can be quasi-simultaneous with savings, or it can come only after a long preparatory phase (often 1 or 2 years). It can represent only a small part of savings (10 to 20%) or conversely more than 50%.
- Loan recovery rates have been satisfactory where savings were part of the programme (often higher than 90%), although there have been increasing delays and outstanding payments (as well as embezzlement, as has been the case in certain co-operatives in southern Cameroon) even when it concerns the farmers' savings.
- Requests for credit often prioritise social needs (housing, health care, education), rather than productive investments.
- Co-operatives with a non-homogeneous social base, where there is a tendency to use the farmers' savings to generate credit for local businesses, often result in outstanding payments. Farmers generally ask for small loans.
- A large part of savings can ultimately be injected into classical banking systems, which favour urban areas. The money is rarely injected back into the rural economy through credit.
- This type of organisation is often proposed from the outside. Original members tend to lose control, while only economic criteria are applied along with an increasing gap between the central organisation and local groups.
- Training often favours a transfer of models rather than support for the invention of new types of organisations.
- It is difficult for COOPECs to achieve financial equilibrium, even after 10 or 15 years of operation. Although commendable in that there is more autonomy vis-à-vis external funds, the search for such balance may have undesirable effects such as limitations to both training and control costs, and a search for security with non-risk investments and loans.

The COOPEC model also raises some concerns:

- National organisations (unions) are costly and heavy.

- There is a tendency to favour development at top levels, for example, through the creation of a second tier or federative bank which is actually a commercial bank. In many cases these institutions resulted in top heavy structures and in a way did not adhere to the essence of co-operative ventures, thus, that it should be member driven.
- It seems difficult to recycle local savings into credit, which would benefit local projects.

Popular banks of Rwanda

These are typical examples of a successful savings function. About US$ 30 million have been saved, and about 150 popular banks created in 25 years and more than 33% of all Rwandese families are involved.

This success can be explained by

- an enthusiastic welcome by the population to the creation of popular banks in 1975 (people being very interested in a secure saving system);
- a favourable institutional environment: the state, the central bank and the administration supported the action and the approach used without interfering, which guaranteed independence and management autonomy.

In addition, some simple methodological principles were applied:

- The first banks were created in a region with a history of co-operative development (church initiatives, local savings co-operatives, etc.).
- Some simple principles of management were applied, which promoted the dissemination of information, and the participation of the people in the elections by the general assembly of an administrative body (management board), the control board and a local manager (from the area).
- There was an internalisation of the practice of co-operative democracy with the support of the central bureau of popular banks (promotion) and the union of popular banks.
- There also was a focused system of coaching and control by regional representatives and decentralised development units as well as strict management (monthly and quarterly financial statements to be submitted to the central bank).

1.4 Informal finance in rural areas

In the absence of organised credit systems, rural people resort to two main types of other systems:

- Informal interpersonal credit systems through family and friends (low or no interest rates, based on kinship or neighbourhood solidarity and reciprocity), or through moneylenders or loan brokers (quick, short-term credit, high interest rates, up to 300% per annum), credit merchants and traders (goods supplied on a credit basis), pawnbrokers (material collateral basis) or landlords (credit for production inputs to a sharecropper).
- Various systems of rotating savings and credit associations (ROSCAs), savings groups, "*tontines*". Such systems have been widely developed all over the continent with many variations.

ROSCAs (known as "*tontines*" in western Africa, "*stokvels*" in South Africa) are especially popular among women. Various forms and levels of contribution exist (from US$ 0.2 per week, up to more than US$ 1000 per month, as seen among Bamileke merchants in Cameroon). The system relies on reciprocity: each member contributes on a weekly or monthly basis, at a fixed date, and each member receives alternately (fixed, or after a toss or a draw) all the contributions. Other systems consist of a money keeper collecting and giving back money on an individual basis, according to his needs.

Despite a certain willingness to incorporate ROSCAs into the COOPECs, it seems preferable to let both structures function separately. According to the farmers, they provide different services and are subject to different operational rules.

Savings groups are also very popular in developing areas. A group will be formed with a common objective (be it ultimately for individual or communal purposes). Funds are deposited with a money keeper or directly in a bank. Communal purposes include building a clinic, a school, water services, and so on. Some groups may even invest collectively in a business run by the group or by an appointed manager. Savings groups also provide the mutual motivation to save, something which may be difficult to do as an individual.

Burial societies are very popular in rural South Africa (Coetzee, 1993). In certain communities, almost every household belongs to a burial society, which uses the money to cover burial costs of members who die.

1.5 Example of the Grameen Bank (in Bangladesh) and its application to Africa

The Grameen Bank experience in Bangladesh is well known. Its basic idea is to support rural populations, especially the poorest of the poor with an emphasis on credit rather than on savings.

The Grameen Bank system has managed to develop

- in a context of precarious livings conditions (low employment, rural small-scale trading and craftwork activities, meagre revenues, great dependence vis-à-vis local usurers, rural exodus, urban unemployment and poverty, marginalisation of women and regular natural calamities).
- through the initiative of a scientist working on action research based on local solidarity and organisation; the first objective was to create self-employment. Subsequently it developed into a banking institution for the poor, especially women (85% of the members); the system relies on the so-called "strength of the poor": solidarity, a vivid experience of the value of money, tenacity and the struggle for survival.
- with an approach which clearly departs from classical banking systems: no forms are filled in, no collateral requested, there are no tills or tellers but a staff of well-trained agents work with the villages.
- based on a set-up of joint and several guarantee groups made up of five people who are socially and economically homogenous, who know and trust one and other and generally with men and women in separate groups.
- based on the credit activity at the outset and later on savings; the credit includes
    - individual productive activities (one year loan, at 16%) redeemed in 52 weekly payments; the interest is paid at the end (51st and 52nd payments).
    - collective productive activities (under the same conditions); the credit ceiling is multiplied by the number of members (but granted only to previous beneficiaries who have paid back their loans).
    - housing loans, for 12 to 18 years, granted only to good members.
    - emergency aid, in the case of disaster (floods) payable according to the same conditions as the productive activities.

- a rescue fund (in the case of death, disability, unexpected problems), fed by a contribution of 25% of interest paid on credits.

Loans are first granted to two members, then to two more and finally to the fifth member (if the first ones have been paying back). The whole group examines the demands for loans and decisions are made collectively.
The economic impact of the Grameen Bank system is first measured by the magnitude of the credit activity (year-1995 figures):

- There are about 1 million beneficiaries (of which about 85% are women) from about 20000 villages.
- There is about US$ 170 million in credit.
- About US$ 17 million has been transferred to the rescue fund.
- There is a high loan recovery rate (over 98%).
- The Grameen bank system employs 6000 persons.

At the beneficiaries' level, the impact is measured through

- the accumulation of productive capital by the households,
- increased income (20 to 50%),
- job creation
- a decline in usurious rates and an increase in agricultural salaries owing to pressure for higher wages.

This success story should not lead to this system being merely copied in Africa. One of the reasons for its success is that the Grameen Bank system has developed its own type of organisation adapted to the very conditions of the country after a relatively long phase of experimentation. Beneficiaries form heterogeneous socio-economic groups, who experience rapid individual turnover rates (small-scale entrepreneurs) and pursue diverse activities, thus generating different financial needs. Unlike farmers, who are all bound to the same planting schedule in a given area, Grameen Bank group members do not have credit needs simultaneously, and do not all pay back at the same time. Thus risk is diversified across different sectors.
Recent experiments in Burkina-Faso and Guinea have drawn their inspiration from this example. In Guinea, the following principles have been applied:

- A joint and several guarantee group is formed with five members: these members choose one another freely; they are from the same village and share a common socio-economic situation; women and men form separate groups; traditional authorities (village wisemen) have a controlling and supervisory function in these groups.
- Credit is based on the needs expressed and takes account of the multiple nature of rural activities (agricultural inputs, labour, small-scale businesses, etc.); it gives priority to economic criteria (e.g. profitability of the activities supported by the credit); each member presents and justifies his/her credit application before the group and the credit agents.
- It is based on rotating credit: two members are served, then two others and then the fifth member (who is the head of the group).
- There is regular and close monitoring of the beneficiaries both at their homes and workplaces;
- Management procedures are simplified and flexible (the credit ceiling may be increased if the previous loan was reimbursed without problems; medium-term collective credit may be granted after a successful short-term experience); monitoring-evaluation and dialogue with the beneficiaries determine adaptations.

- An interest rate higher than the inflation rate is fixed to preserve the value of both the invested capital and the credit.
- A 100% loan recovery rate is required, with strict adherence to due payment dates, otherwise no further credit will be granted.

Note that many Grammen Bank replications in Africa failed or incurred internal problems that led to high drop out rates. Graham and Von Pishke (1995) argued that the context is so different that it is unsurprising that the Grameen replication in Africa was not that successful. They refer to the more dispersed profile of African rural areas, the practice of migrant labour systems and more. A few examples do exist that are successful (for example the Small Enterprise Foundation in South Africa), but in general Grameen replications have met with extensive problems in Africa.

1.6 Besides COOPECs and ROSCAs, what else?

COOPECs, ROSCAs and informal credit systems are not the sole instruments for credit and savings in rural areas. Other systems do exist as briefly described below.

1.6.1 Seed stocks as savings and credit systems at community levels

For the past 30 years in Madagascar, Niger and Mali, a successful collective savings system has existed through seed storehouses. The norm for an individual loan is the reimbursement of two bags of seed harvested for each bag of seed borrowed during the sowing period. However, farmers have collectively adopted a 50% interest rate (1,5 bags paid back for 1 borrowed). Even if a small part of this interest is used for storage fees (seed treatment, possible loss), the initial stock is tripled in three years.

Given an initial stock of 100, and annual storage fees of 10, the following progression occurs:

First year: Seeds borrowed = 100; Seeds repaid = 150; Available final stock = 140

Second year: Seeds borrowed = 140; Seeds repaid = 210; Available final stock = 200

Third year: Seeds borrowed = 200; Seeds repaid = 300; Available final stock = 290.

In practice, the community uses part of the stock for sowing. The rest can be sold inside or outside the community and the money is then invested for community purposes. This operation reduces the costs for borrowers and makes it difficult for money to be stolen (money is handled and stock usually located right in the middle of the village). This allows for collective investments and enhances the quality of the seeds (which are stored and treated under good conditions, with the possibility of stored seeds being renewed with improved seeds).

1.6.2 Savings and credit from grain banks

There is a wide variety of grain banks with diverse purposes (e.g. food security at community level), and with as many successes as failures. A grain bank is a community or inter-community organisation that manages a stock in kind. This stock may be pooled through purchases among members, purchases from other areas with excess production or from external inputs. The stock is either resold or lent to members during harsh periods (e.g. dry season, low-yielding years). It can also be kept in total or in part to form a safeguard.
In all cases, an important factor of success is the adoption of a differentiated policy, which depends on the results of the growing season (surplus or deficit). To generate

revenue, it is essential to buy the products at the beginning of the harvesting period so that the bank may benefit from the difference between the price at that time and the increased prices during the "hungry gap" before the next harvest. Then loans in the form of bags of grain can be considered throughout the year, with the option of having different interest rates depending on whether it is for a member or a non-member.

1.6.3 Initial donations of capital to farmers' organisation

In situations where it is impossible to initiate savings or where loan repayments are uncertain, the solution may be an initial donation (initial capital), in the hope that this will reproduce itself in the long term.

> An example in the Gao area (Mali) after the harsh 1973 drought that dramatically affected fishermen's activities:
>
> A consortium of NGOs released capital in successive packages to fishermen's co-operatives in order for them to re-establish their means of production (pirogues and nets). All modes of credit as well as borrowers' choices (nature of credit, period of repayment) were carefully discussed and decided on in a general assembly. The first package was earmarked for about 20% of the fishermen. The second package was granted only after the first group had paid back 100% of their loan. There was therefore social pressure from the group of future borrowers, which in turn resulted in a high loan recovery rate. When all the fishermen interested had been served, the money from the repayments was used in different ways depending on the co-operative. (E.g. to set up workshops for the manufacture of pirogues; to buy stocks of grains; to set up a shop for the commercialisation of salt fish; to buy a motorised pirogue for faster transport of fresh fish to the nearest towns; etc.).

The World Bank has financed small-scale rural projects (e.g. FONADEC in Senegal) through initial donations (e.g. a motor pump for a small-scale irrigation scheme). In this case a bank account is opened and managed by the farmers. Farmers' payments are calculated taking account of the equipment's maintenance and renewal. The basic assumption, based on past experiences especially in Senegal, is that farmers are not very motivated to pay back any parastatal organisation or development project. Conversely, they are eager to contribute to their own accounts, especially when it comes to protecting their own activities and making them sustainable in the long run. When inter-community solidarity exists, an alternative solution may be a rotating system whereby the repayment of the first investment realised in the community serves to finance a new investment in a neighbouring community. This principle has been adopted with the mills in Yatenga (Burkina Faso).

In Niger, agricultural credit to co-operatives has been initiated by USAID (USA co-operation and aid agency) and other sponsors. Their approach combines credit, and training and support to farmers' organisations through low initial capital. Other organisations combine subsidies on credit for initial investments with compulsory savings. These approaches have proved relevant and efficient in certain situations.

1.6.4 Development funds

The objective of such funds is to promote savings at the village level and to make use of the savings in productive community investments. The community members themselves decide on the modalities of the loans. Another objective is to get the community acquainted with local financial systems and then to promote further self-managed systems for credit, savings and investment.

One village development fund is located in Segou (Mali) and supported by IFAD (International agency for food and agriculture development). Each village was requested to pool and to manage a fund to be used for the community's needs and to serve as a guarantee of the debt's recovery.

Village people can use the credit for diverse activities, for example, for cash crop fertilisation, improvement of small stock herds, domestic industries, rural small-scale industries such as forges, handicraft activities, woodworks, and the like. The high percentage of loan recovery (104% in Segou, Mali, which means a total loan repayment plus additional contributions) shows the extent to which the villagers feel responsible for the village funds.
In many cases, small shops have been established to generate additional funds. IFAD's long-term objective is to make these shops into real development centres at the community level, where farmers can obtain production inputs, credit and technical advice.

These are only a few examples showing that, over and above the official structures for agricultural credit, there are many modalities for financing rural development; savings; credit; subsidies; contributions in cash, kind or labour; investment; ROSCAs and the various combinations of all these modalities. Secondly, experience shows that in each situation the farmers and rural people should lead the discussions and make the decisions themselves. It is also clear that not one single institutional format is the solution to rural finance problems. No, each situation calls for a different solution and therefore practitioners should always be lead by the local people, their systems and their vies and perceptions when designing intervention methods.

2. Some issues for debate

Part one has clearly shown that there has been more failure than success in the field of rural credit. There are of course some success stories but they are either linked to very specific situations (cotton) or they are too recent to allow conclusive lessons to be drawn. Many points remain controversial, and different practices with different philosophies can still be observed. The views expressed here are not unanimously shared.

2.1 Agricultural credit or rural credit?

Up to now, official programmes which are linked to different operations undertaken by various governments have been preoccupied with agricultural credit in its narrowest meaning, that is with supporting access to inputs, seeds, agricultural equipment, and so on. When a free choice is given to the farmers, it becomes obvious very quickly that their credit priorities concern a wider range of activities: small stock production; fattening and feed-lotting of pigs, sheep, goats; domestic food processing; local trading; handicraft; storage; labour hiring; spare part supply; and the like.
If one wants to respond to the farmers' needs, thereby increasing the diversification of activities by rural people, financial support should undoubtedly not be limited to agricultural credit. Free choice and direct involvement by the farmers helps to prevent misappropriation, heavy procedures, low recovery rates, and mistrust of credit monitoring.
Ensuring the availability of efficient rural finance services (including saving) rather than extending credit to finance exclusively agricultural production is a preferable

approach when rural development is pursued. There is nothing “sacred” in income generated from agriculture compared with income generated from any other rural activity. Furthermore, given the high co-variant risk associated with agriculture, often other non-agriculture activities would mitigate such risk. Rural Finance Intermediaries have often obtained a more balanced and less risky arrears “contaminated” loan portfolio when launching credit in an indiscriminate manner to all segments of the rural economy, thereby considering the creditworthiness of the borrower and the merits of the investments financed.

2.2 "Hot money" vs. "cold money"? Is the mixture possible?

“Hot money” is money which comes from the farmers who control it and which deserves both attention and social control. The rural people look negatively upon and even apply social pressure or ban people who fail to pay back a fellow farmer or the local farmers’ co-operative.

“Cold money” comes from the government and external sponsors. “Cold money” is often stolen, misappropriated, or not paid back. The communities do not necessarily see this in a negative light.

The social value granted to both types is obviously different, as are the ways to manage them. These distinctions explain the significant differences of loan recovery rates between the COOPECs or ROSCAs and the official credit institutions.

The mere idea of farmers putting their savings back into the rural areas may result in improvements. However, this is not sufficient to respond to all the needs, especially those of the most disadvantaged with low savings potential (resource-poor farmers, women and youngsters). Financial input from outside is almost always necessary. This input can have an initiating and multiplier effect on savings. The most important thing is that this input should not be perceived as easy or cold money. The farmers’ involvement in the setting up of the system (selection of the borrowers, modalities of repayment, types of guarantees, etc.) is critical to the sustainability of the system (through high loan recovery rate).

2.3 Different financial technologies

In essence the experience under the new approach can be classified into projects or programmes that use savings first or credit first approaches and those that provide services to individuals or to groups (or to both). The real test for efficient strategies is whether a correct assessment of prevailing circumstances in the project area leads to the application of the appropriate financial technology. In this section short overviews will be provided on the savings first, credit first and group approaches. An understanding of these approaches is essential when applying policies differentiated according to the circumstances in specific settings.

2.3.1 Savings first approach

The savings first strategy indicates that a financial intermediary provides savings facilities before engaging in loan activities. The first observation is that any intermediary using this strategy grows much more slowly than one using a credit first strategy (Graham & Von Pischke, 1995). Several variants of the savings and credit co-operative (or group based) venture serve as examples of institutions following this approach, including savings and credit associations, credit unions, co-operative banks, and in a much more informal version, savings clubs and burial societies (Coetzee, 1988).

Graham and Von Pischke (1995) argue that the savings first strategy is time consuming in that quite some time is spent in initiating these activities. However, village level activities benefit from a wealth of information on members and potential members. Earlier we also argued that poor rural people have several incentives to save and that savings propensities in rural areas are normally relatively high (see the discussion in section 5.4). Group based savings activities may, therefore, take longer to build volume when starting at the village level, but the institutional base is normally strong and sustainable.

Graham and Von Pischke (1995) argue that savings are typically mobilised from 6 months to a year before loans are made. In some South African village bank examples it takes up to three years before loan services are considered (Coetzee, 1997; Schoeman, 1996). The village banks in South Africa deposit members' contributions and savings with commercial banks during the portfolio building period (Coetzee, 1997).

In normal institutional evolution village level savings based institutions generate enough volume to start with loan activities. As soon as a number of these institutions start in the same geographic area one would also expect a second tier institution that intermediates between the first tier or primary institutions. This is the path that was followed by the German co-operative banking movement (Howell, 1980) and the Canadian co-operative banks (Von Pischke, 1991).

The problems inherent in credit first strategies (see next section) centre on issues of moral hazard and principal agent problems. These problems are very uncommon in savings first strategies, though they do occur. Hard earned money deposited in savings accounts have often vanished among the management or staff of financial institutions. These problems are not common in member managed and operated village based settings.

Some other disadvantages are present in savings first strategies (Schmidt & Zeitinger, 1995). Firstly, it can be costly and demanding to manage a large number of deposit accounts, especially the high turnover of accounts without fixed maturities for small savers. One way to decrease these costs is not to try and recover purely on the differential between return on deposits at commercial banks for the institution and what depositors earn (in the beginning phase), or the spread between interest income on loans and interest paid on deposits in later phases. Charging a fee for each transaction can generate income. In the village banks in South Africa this is common practice (Coetzee, 1997). Secondly, depositors are at great risk in institutions that are not capable of managing their funds carefully. Emphasis should be on starting small and being member driven. Graham and Von Pischke (1995) argue that where these institutions increase in size to numerous members, each with a small account, it is not in the interest of any one small group of savers to incur the transaction costs of organising themselves to monitor the management of the institution. This problem has manifested itself from time to time in credit unions in which the one-person-one-vote ownership principle, regardless of the ownership of shares or deposits held, weakens the vigilance of the widespread ownership base (Chaves, 1994). In short, there are trade-offs between the virtues and the costs and limitations of the savings first path to institutional development. However, experience indicates that if these institutions operate with high member involvement and the ability to reach second and even third tier organisation, they can become formidable financial institutions. One example is the German co-operative banking system, which grew over a period of 100 years to 2600 co-operative banks which have 19500 outlets and formidable assets and are organised at the second and third tier level (DGRV, 1996).

As a general rule, a savings first approach is preferable to other approaches in order to encourage self-reliance and to lead people to become more independent (Gentil, 1993). This should not be a dogmatic rule, however. In certain circumstances (for example a prevailing climate of distrust where there were earlier failures in the financial system and people lost savings) and for certain social categories and spatial settings (the real destitute and poor, especially women in this category) there is every justification for starting with credit or providing both credit and savings services. The lesson is that dogmatic rules lead to the application of inappropriate models in certain settings.

2.3.2 Credit first approach

Credit-first strategies are common in NGO and specialised credit institutions. These programmes are mostly funded by outside donors and governments. Credit-first programmes expand much more rapidly than savings-first as they avoid the time-consuming task of first mobilising local savings (lending is funded externally) and frequently employ group loans as part of their lending technology, thus multiplying the clientele (Graham & Von Pischke, 1995).

In contrast to savings first strategies credit first strategies are riddled with moral hazard problems. These institutions are mostly financed and operated by external agents without the benefit of adequate local information flows. They cannot use the local social structure to monitor clients. Historically (as was argued in chapter three) major default situations arose in these institutions due to the cold money/warm money syndrome[1] (Gentil, 1993).

Programmes addressed moral hazard by designing contracts that reduce opportunistic or irresponsible borrower behaviour (Graham & Von Pischke, 1995). This has been

[1] "Warm money comes from the farmers themselves, is controlled by them and seen by them as deserving careful husbandry…cold money is money from the state or foreign financiers, which can therefore be used for unauthorised purposes or need not be repaid. Defaulting on cold money loans is considered a cunning thing to do and is not frowned upon by other farmers" (Gentil, 1993).

done typically in three ways: using local agents, employing local people as loan officers and using a group based strategy. In the case of local agents and employing local people as loan officers the institution would want to ensure that their remuneration and incentive packages are structured in a way that will decrease moral hazard amongst the staff (or agents).

Very few success stories in terms of sustainable institutions with acceptable outreach and development impact can be sited where the credit-first strategy has been used. A number of researchers stated the following criteria for success concerning the financial technologies required to secure sustainability in credit-first NGO programmes serving micro and small enterprises (Christen *et al*; Schmidt & Zeitinger, quoted by Graham & Von Pischke, 1995[2]): Interest rates must be high enough to cover a realistic cost of funds, all administrative expenses, loan losses and a decent return on capital. Furthermore, loan recovery must be well over 90 per cent. Loan officers should plan on serving approximately 200 to 250 accounts each in a densely populated urban or peri-urban environment, to keep total administration costs down to 15 to 20 per cent of the portfolio by the time the programme achieves scale economies in five to seven years. To achieve these goals loan administration must be decentralised with an incentive compatible internal organisation and control structure, using frequent audits and attractive performance based remuneration for managers and loan officers. Character lending is feasible, but loan maturities and repayment schedules must be consistent with the customer's cash flow. Lending should start with smaller, short-term loans to allow customers to prove their creditworthiness before obtaining larger loans. A limited range of simple, standardised loan services should be offered in the beginning. An information management system for timely loan tracking is essential. This implies computerisation. Finally savings services have to be developed to provide leverage for funds and reduce moral hazard once the lending activities achieve viability.

2.3.3 Group approach

Group approaches are based on informal group based financial institutions and have been popularised by the Grameen Bank in Bangladesh (Yunus, 1992). Groups are essentially utilised to decrease information problems and decrease transaction costs of rural financial intermediation (Huppi & Feder, 1990). Decreasing information problems also decreases the incidence of moral hazard. It follows that the group approach was favoured in credit-first strategies. Group approaches are also applied as a collateral substitute, once again based on the flow and availability of information in the group.

There is wide difference of opinion on the relevance of group approaches *versus* individual approaches. In developing countries these two kinds of lending arrangements have a mixed record. This is especially true in Africa. Graham and Von Pischke (1995) summarise the following lessons in this regard:

- Group lending in the Grameen Bank was built on a strong investment in group formation and substantial investment in recruiting committed and well-trained staff before lending began. None of these human capital investments have been

[2] The rest of this paragraph draws on a summary of criteria compiled by Graham and Von Pischke, 1995.

strong in African programmes. One of the more important obstacles in the African programmes is the very high cost of scarce trained personnel compared to Bangladesh where an ample supply of low cost university graduates has been available for the Grameen programme from the beginning.

- Migration is more prevalent in rural Africa, creating more unstable groups, particularly those with male members.
- Weekly or fortnightly repayment schedules are established to generate frequent meetings for the interaction and discipline required to maintain group cohesion and regular repayments. This does not always fit into the cash flow patterns of agriculture. Hence groups made up of farmers in the African programme encounter difficulties. The risk of cash flow interruption is too high as farm groups suffer from covariant risk and the transaction costs of managing a spatially more dispersed clientele are also high. Group lending programmes built on micro-enterprise activity in towns have generally been more successful.
- Joint solidarity has its limits. Once members in a group have made up for the shortfall of their delinquent members on two or three occasions the group collapses on the next default. Intra-group solidarity has been compromised frequently by free riding behaviour. Given the high prestige elderly women enjoy in African villages, it is next to impossible for younger women in the group to deny them group membership or exercise peer pressure or threaten group sanction, against these economically inactive elderly members who delay or refuse to repay their debts. It only takes two or three episodes of this free riding behaviour to destroy the group.
- A common misconception of Grameen replications in Africa lies in the confusion with joint liability that is incorrectly associated with the Bank's institutional design. The Grameen Bank uses group solidarity principles to select, shape and train groups of five clients; however, it merely uses the group as a vehicle to make individual loans. Moreover, in the event of individual borrower delinquency, contrary to conventional wisdom, group liability is not triggered to draw the other members into covering this shortfall. Instead, a contingency fund, built up through an extra charge on each loan, is used for this purpose. In many of the African programmes such as in Burkina Faso, however, the other members of the group are immediately expected to make up for the delinquent borrower's payment. This leads to acrimonious relationships among members and their families. Instead of group solidarity, this leads to sporadic peer pressure with problematic results.
- The practice of holding other groups in a village (i.e., a sector) responsible for the failure of a delinquent group is followed in many programmes, expanding the group solidarity concept into a broader neighbourhood or village sector solidarity strategy. This has frequently proven counterproductive as groups who are current on their loans resist covering for delinquent groups with whom they may feel little solidarity. When this occurs programme directors cut off the credit flows to groups current in their payments to induce them to make up for delinquent groups. This only trigger wholesale delinquency, a testament to the law of unintended, but highly predictable consequences, from the perverse incentives built into this particular group lending institutional design.

Huppi and Feder (1990; Slover, 1991) indicate that successful group lending schemes are difficult to replicate due to the area and group specific characteristics of each group. Graham and Von Pischke (1995) refer to the least documented and least known "black box" of group lending, that is the nature of the group dynamics within these programmes. How does one operationally define and empirically measure such important but slippery concepts as group homogeneity, group solidarity and, in the absence of group solidarity, peer pressure? Answers to these questions could contribute to better institutional design and the measurement of programme performance for group lending programmes.

2.4 Entrepreneurial (productive) vs. consumption (unproductive) credit

Often the tendency is to prioritise productive credit and to distrust unproductive credit (e.g. hunger-gap aid, social credit and credit that supports commercialisation). In fact this tendency is not often relevant, for several reasons:

- The boundaries between unproductive and productive credit are not clear and the farmers express both economic and non-economic needs (credit for production and credit for social needs.
- Most attempts at giving agricultural credit based on offers predetermined by development operators without accounting for the farmers' choices and strategies have failed.
- The implementation of unproductive credit (for social needs or consumption) can be considered acceptable if it is known that the beneficiary will repay it with the revenue derived from profitable agricultural production. Such credit may actually stimulate agricultural production.
- If unproductive credit is discarded the farmers might resort to usury to face their social obligations. The farmers have to pay higher interest rates which makes them dependant (the whole harvest may have to be given as a guarantee to the lender or trader).
- Loans do not always support a sole investment by a farmer; they often cover two or three activities, thus allowing the farmers to minimise risk through diversification (animal husbandry, crop production, off-farm activities, etc.).

2.5 Credit to the rich vs. credit to the poor

Contrary to common belief, rich clients are not always the best payers and low loan recovery rates are found among civil servants, traders and local notables, as well as the poor people.

Can one target only the poor (as in the Grameen Bank experience)? The social and economic structures in Africa differ from those in Bangladesh. Discrimination among potential rural borrowers is not acceptable. Moreover, the poverty criterion (or threshold) is not easy to determine when farmers have access to land and own animals. Discrimination would deprive many farmers who have no credit alternatives. It seems preferable to fix an upper limit for credit (loan ceiling) (e.g. between US$ 100 and US$ 200). Such credit is not likely to interest big, potential rural borrowers. Categories of people that are often excluded from credit (especially women, resource-poor farmers, small-scale entrepreneurs, etc.) would qualify for this type of loan. However, it must be also emphasized that fixing a ceiling often leads to distortions, but no ceiling on an interest rate makes it less enticing for the rich to push the poor aside.

2.7 Interest rates, the cost of credit, and the search for a financial equilibrium

The majority of development operators favour low interest rates for the agricultural sector and higher rates for savings. This viewpoint has been reinforced by the regulations of some central banks. Unfortunately, such an approach seldom allows for the system to be sustainable, and it led to many failures which occur soon after external funding stops (subsidies). Sound management of credit and saving systems for smallholders remain costly, even when the procedures are simplified and when farmers contribute through unpaid labour. Transaction costs are numerous and high owing to the small but numerous operations being treated, the numerous trips, the risks, the time spent in negotiations, the discussions, the information, the training, and so on).

Observations and past experiences show the following:

- The necessity of very low interest rates has never been confirmed during discussions with the farmers. When involved in setting up a credit system, farmers compare the offers with the usurers' rates (100% to 300%) and consider as acceptable any interest rate lower than what they are used to. A recent study in South Africa indicated that the shadow price of small farmer credit is double what they are paying, thus indicating that they could afford and tolerate far higher interest rates than commonly assumed.
- Two credit systems may coexist, different but complementary, as illustrated in eastern Senegal where a cotton growers' association benefited from
    - a formal credit offer, initiated by the cotton processing company SODEFITEX (credit for input supply and animal traction), which was challenged by the farmers owing to ever- increasing input prices and interest rates for medium-term credit for animal traction being considered too high (-15%+);
    - an informal credit offer initiated and organised by the growers' association (financed by the cotton tax, pooled and collectively managed by the association) which supported social and consumption needs at the annual rate of 25%.

In addition, most credit granted is seasonal credit (less than one year) which mobilises small nominal amounts for a limited time (usually from 6 to 8 months). Hence, payments are small, with few variations whatever the interest rate. The major concern of farmers is to access credit under conditions that leave them room for choice in its utilisation.

IThe most important aspect here is to really understand the client farmers' needs and design products that suit those needs, and answer to the requirements of the financial institution. These needs will not necessarily be only for farming and farming families have many more needs for financial services which are not met by the conventional formal financial institutions. This is why they quite often resort to a interacting with a multiple of financial institutions, ranging from informal to formal.

Towards sustainable local financing structures

The profitability of a local credit and savings structure is determined as follows:

Gross bank profit = income- expenses

Bank income = interests on the loans + interests on investments + commissions or fees charged to clients

Bank expenses = clients' remuneration

Net profit = gross benefit – standing operation costs – variable costs (risks)

The standing costs are very high owing to the high transaction costs they include (numerous operations with an average deposit/credit operation amount of US$ 40). The variable costs may remain low and constant as long as the loan recovery rates are high.

From the above and from past experiences, the following factors should be considered:

1. In terms of management costs:

- Relying on benevolence, unpaid labour
- Simplifying management to the extreme
- Remunerating clients through savings rather than through quasi-free credit, and granting credit at acceptably high rates
- Maximising profit from available cash and funds (through investments)
- Limiting the role of external organisations with regard to cash management
- Introducing cross-control procedures among the operators

2. In terms of risks:

- Maximising the solidarity of the community associations
- Letting the farmers' groups decide on credits
- Avoiding granting credit to civil servants and local big traders
- Training farmers in active management and risk evaluation

To solve the tricky challenge of long-term equilibrium and sustainability, one should have a banking spirit, and always bear in mind that every cost incurred, every risk taken will eventually impact on the beneficiaries who might then discard the system if they deem these charges to be unexpectedly burdensome.

2.8 Centralisation vs. decentralisation

Many problems facing credit systems are linked to excessive centralisation, that result in long procedures, expensive overheads, gaps between the decision level and the implementation level, gaps between the COOPECs and their local groups, decentralisation of decision making of both local agents and farmers.

One must therefore get the grass-roots structures more involved, and have them take more responsibility for decisions on granting credit and recovery, and for personnel and financial equilibrium. Structures must be geographically and socially close to the beneficiaries (both savers and borrowers) who will in turn consider them as their own concerns. However, these grass-roots structures must also benefit from regional and national support, especially in the fields of training, control and monitoring, in representation vis-à-vis the authorities and in negotiations with the official banking structures.

Part of the support costs must be paid by the base structures, while external financial support (e.g. on training) may temporarily be important. In any case, these services should be implemented by lean structures (e.g. a tenth of staff members at national level) and must truly serve the grass-roots structures, and not become a steering and burdensome hierarchy.

3. Methodological orientations

The diversity of experience and debates shows that there is no universal formula relevant for all situations or one model that takes priority. However, there are some constant elements.

3.1 Several basic principles about rural finance

- Rural credit must respond to the real needs expressed by the farmers (the credit offer must coincide with the demand), and should match the realities and constraints of the rural environment and of the potential beneficiaries.
- Credit should be linked to local savings; experience has demonstrated that credit is better recovered when it mobilises the beneficiaries' savings.
- Credit does have a cost. This is reflected in the interest rate which must include the real costs (e.g. cost of the resource, management costs, cost of the risks incurred), and which is necessary for the system to be reproducible, thus sustainable in the long run.
- Specific agents must carry out credit monitoring and management. They must be trained and be able to make a proper diagnosis. Such a diagnosis should rely on observations and regular dialogues with the beneficiaries and result in procedures being adapted if necessary.
- The structure in charge of credit operations must be autonomous from other development operators (agricultural extension, input supply, etc.). It must also be psychologically and physically close to the beneficiaries (without intermediaries). It must seek the active participation of the people concerned.
- The state and its administration should support the initiation of actions and contribute to their evaluation. But it should not interfere with the operations perse, since the farmers' trust in the system is critical and is more easily gained if the rural people do not feel that the government is intervening.

3.2 Elements of an approach

3.2.1 Starting from a situation diagnosis

Special attention must be paid to defining and ranking the financial needs of the farmers. This process should consider the local diversity (types of farmers) and include any other diagnosis related to other relevant functions. Discussion can lead to a critical analysis of past credit experiences by the farmers and of the current credit conditions (official or informal, interest rates, constraints in getting loans granted, recovery systems, guarantees, etc.). One should also try to analyse past and current ROSCAs' experiences.

3.2.2 Defining a strategy

This stage follows the diagnosis. Several cases may be considered:

- There is no existing financial system or institution in place. In such a case, a model should be progressively designed through experimentation and dialogue with farmers.
- There is a system or a rural finance institution in place (e.g. national agricultural bank, other bank). In such a case, two strategies may be envisaged depending on the situation:

- Setting up a complementary system of rural mutual savings and credit close to the farmers, which takes into account the needs which have not been satisfied (e.g. adapted Grameen Bank system)
- Buying out the rural credit institution with or without mutualisation (such situations currently occur in Africa and Latin America) by farmers' organisations or by a decentralised savings and credit system; this supposes that the buyer has the necessary financial means or that he/she receives external support (e.g. a sponsor may hold the social shares, which will be progressively repaid)

The objective is to adapt the rural finance institution to the needs of the farmers. One must however keep in mind that it is often difficult to change the logic of action. Actually, such experiences have not proved successful. Even when farmers' associations become shareholders (e.g. FONGS in Senegal being represented at the National Bank for Agricultural Credit), such a strategy has been risky and uncertain since it is not easy to induce the changes that are expected by the farmers.

3.2.3 Setting up sound systems

Difficulties arise when a completely new system has to be developed, when a system is new in the area but exists somewhere else, or when a system must be altered or adaptations have to be made. Points for review and decisions are not that numerous. One of the most acute problems is that of guarantees (collateral). The following examples present a rehabilitation process in a co-operative for savings and credit in Benin and the setting up process of a new system inspired by the Grameen Bank in Guinea-Conakry.

Close attention must be paid to the procedures, the forms, the accounting system, and so on, in order to achieve simplicity and transparency in the system and to ensure the involvement of the local people. Finally, one should avoid reproducing the burden of heavy national structures while setting up vertical structures.

In Benin: an experimental credit programme in the regional and local agricultural credit institutions (CLCAM and CRCAM)

Financing credit:

At the farmer level, it has been clearly stated from the outset that money for credit should come directly from the farmers' savings and not from external sources. This creates complications when arranging the conditions for credit granting, the modalities for recovery and the nature of the guarantees.

A proposal to use external funds (same amount as the loan in demand) has been made. This external financing actually correspond to a de-freezing of a part of the debts of the regional banks owed to the national bank (Borgou, Atlantique and Zou regions) and to the reconstitution of the equity capital (Mono and Zou regions).

As far as cash management is concerned, there is a need to grant the first loans in March (for the planting season). These can be covered either by new savings in the Borgou region or by recovering previous loans in the Zou region.

It is therefore necessary that external funds are made available to the different regions in a timely manner.

Modalities of credit:

- The loans granted at the local level are planting season loans (less than 1 year). However, in the Borgou area, the local board can be consulted by the regional branch about loans for animal traction and equipment.

- For the first year, loans are used for agriculture (labour, seeds and inputs), livestock (fattening piglets, poultry and kids), and the women's activities (small-scale trade, products processing, etc.).
- Interest rates are slightly below those usually practised in rural areas (reimbursement of two bags for one borrowed, 10% monthly interest rate, etc.). They must however cover the different charges of the local financial system (manager's salary, running expenses, savings recovery, etc.). Interest rates have been set at 15% yearly for the Borgou area, and at 2% monthly for other regions. These rates cover the interest rate per se, as well as a contribution to the guarantee funds and diverse fees for setting up and monitoring the file.
- Loans are granted exclusively to members, including individuals and co-operative structures.
- The different management levels have established a number of conditions for granting credit. Although these conditions differ according to the variety of structures at the local level (this pinpoints the importance of local boards), they generally have the following characteristics:
- The application must be accepted by the board.
- The beneficiary must be a member of the co-operative, with no outstanding debts.
- The beneficiary must have saved a minimum of 10% of the value of the loan in demand (usually about US$ 15); savings are frozen until the credit is totally repaid.
- A credit ceiling is set up and strictly respected (generally between US$ 150 and US$ 600).
- The beneficiary must produce sufficient guarantees, moral guarantees (seriousness, honesty, hard-working behaviour, etc.) as well as physical or financial collateral (guarantee by a cotton growers' association, personal guarantee of fellow members of the co-operative, turn of ROSCA, agricultural products, house rent, vehicle, etc.).
- The schedule and modalities for loan granting, monitoring and recovery have been established for each local structure (e.g. in cotton areas, direct levying is carried out by local managers when the cotton company CARDER pays the cotton growers' association). The manager and the board play an active role in each of these different areas. In case of outstanding payments, the board should be involved (applying moral pressure and implementing the guarantees stated in the contract). Resorting to police or judiciary authorities must remain absolutely exceptional.

Implementation:

Procedures, formalities and paper work must be simplified as much as possible. Information about the conditions of granting credit must be distributed as widely as possible (i.e. general meetings). Public notices about these conditions must be displayed at the structure's offices and should include a version in the local language. Members' demands should be collected and submitted by the manager to the board (or to its credit committee).

Monitoring and evaluation:

The sound operation of the programmes is supervised by staff members at regional level, with the part-time support of a consultant. Regular reports (in June and March) should be written, summarising and then evaluating the results.

In Guinea-Conakry: an experience inspired by the Grameen Bank principles

Objectives, elements of procedure	Planned	Achieved
Nature of the credit	Profitable, diversified, agricultural / non-agricultural loans	Yes
Beneficiaries	Resource-poor farmers, men and women, crop and livestock farmers, craftspersons, anyone who wishes to develop current or new activities	Small and medium-scale farmers formed the majority of those interested. Commercial farmers, civil servants and big traders were not interested owing to the low ceiling.
Ceiling	US$ 35 to 45 (depending on the local structures)	US$ 55 for all situations
Duration	Less than one year at the beginning	Yes (12 months)

Interest rate	3% per month on the remaining debit balance (the overall interest rate representing about 20% of the loan)	Yes (+ 5% for file management)
Repayment modalities	10 monthly payments, an 11th one for interest, a 12th one for guarantees (death, accident)	12 equal monthly payments, including capital, interest and guarantees (called a solidarity fund, representing 20% of the interest)
Guarantee	Self co-opted groups of 5 to 10, with rotating presidency Local chiefs check the groups' quality informally The guarantee itself is the social pressure amongst group members in the event of outstanding monthly payments	5 members in all groups. Yes, with complementary control by development operators Yes, there are 2 first beneficiaries, then 2 others after 2 months, and finally the president
Partnership share	Low amount, provided when submitting the application or at loan granting	US$ 0.5, levied from the loan granted
Monitoring and evaluation	Loans are distributed and recovered on each market day (once a week) Regular and frequent visits to the groups to check the loans' utilisation, and to take stock of activities and results Yearly assessment of loan impact and of the level of satisfaction	Loans were distributed for the first time in July 1989. Further distribution and repayments are to take place at markets or at certain convenient locations chosen by farmers. Visits once to twice a month (at market places, farms, plots) Yet to be organised
Training programme	Explanations and instructions provided on the conditions for credit Distribution of documents in written Poular, in Arabic, in French	Yes, generally in 2-3 controlled training sessions

3.2.4 Restructuring of specialised credit institutions

The latest approach on a possible role for specialised credit institutions can be illustrated with the following discussion drawn from the work of Graham (1995)[3]. Attempts to restructure credit institutions must recognise the high social costs and rent seeking behaviour of many of these institutions - qualities that characterised the performance that left many of them insolvent in the 1980s. In many African countries, especially in West Africa most development banks have been closed, or are in the process of closing.

Any restructuring plans should recognise that institutions that specialise in farm finance are frequently candidates for failure since they do not diversify risk in their portfolios (thus high incidence of covariant risk). Hence any reform of agricultural development banks must accept the fact that they should increasingly diversify. In some countries they are the only banks operating in rural areas, giving them a potential franchise value. When their current financial state does not make them sufficiently attractive to investors for immediate privatisation, consideration should be given to improving their condition to the point where they can be sold to private buyers. If this is not possible, a second best alternative may be to restructure radically

[3] The rest of this section is drawn from the work of Graham (1995). Graham and Von Pischke (1995) were of the first researchers to question these extremes in approaches to rural financial markets.

their internal organisation and external mission to survive as sustainable institutions supplying realistically priced financial services earning decent rates of return.

Much of what follows distils the experience gained in reformed state banks in South East Asia (Yaron *et al,* 1996; Yaron, 1992) and in a recent South African study (Strauss Commission, 1996; Coetzee, 1997). "Banks fail because of bad policies, poor banking practices and weak institutional frameworks" (Sheng, 1996). This statement was made regarding commercial banks in developing countries. If we add to these reasons all the additional ailments of state agricultural banks, it is clear that restructuring becomes a formidable task. The question is how to reorganise these institutions so that they do not fall prey to the same vices that largely destroyed their usefulness as financial institutions in the past. Based on the experience restructuring and transformation should attend to the following general areas (Coetzee, 1997; Strauss Commission, 1996; Graham, 1995;):

A. Role of government, clarity of role and functions, and political commitment

Experience shows that government is rarely successful when it tries to engage directly in financial markets. However, government should provide an environment that is conducive to the development of financial markets and set the operational framework for financial institutions that use public funds. Day to day political interference is detrimental. Political support and objectives must rather be embodied in the institution's purpose and policies. Operational autonomy is then the only approach that can be considered.

B. Autonomy and governance

This implies protection against political intrusion, which in turn requires a Board of Directors in which no government official is the chairperson, on which no elected officials should serve, and where members drawn from the private sector carry more weight than those drawn from the public sector. This approach mooted by Graham (1995) has an interesting twist. Consider the approach that one should have a link between ownership and governance, but also would like to get away from government interference. Thus, what we ask from government is to capitalise, but not to govern. If we expand ownership to the private sector, one surely will loose much of the development imperatives. Thus, ensure viable business with the current clientele end convince the government that their commitment is reflected in their hands-off approach!

C. Institutional considerations

South Africa is characterised by a multitude of uncoordinated public sector institutions with overlapping mandates and competencies. The creation of new, additional institutions should not be actively promoted, given existing limitations on human resources and other capacities. There also is a dire need to optimise cost effectiveness in the operations of financial institutions and to rationalise public institutions that serves the same clientele. Where applicable, therefore, existing institutional structures should be transformed to serve the needs of the reconstruction and development process.

D. Flexibility

As different circumstances prevail in different provinces, and due to the dynamic nature of developments in South Africa, institutions should be allowed the flexibility to focus on local circumstances, provided that they do so within a coherent framework. An expansion of this argument is that within the basic guidelines reflect the reality of context.

E. Minimising systemic (DFS) and institutional (individual DFI) risk

The prudent management of systemic risk requires that financial institutions manage diversified portfolios. The stability of the development finance system depends on development finance institutions spreading risk across different types of clients, different sectors and/or different geographic areas. The high potential for covariant risk, especially where institutions are locked into serving one sector (for example agriculture), should be mitigated by diversifying portfolios.

Systemic risk is also related to funding structure (as reflected by balance-sheet ratios) and should be minimised, *inter alia*, by subjecting institutions to regulation and strict commercial principles. Cost recovery is central to commercial principles. Subsidy-dependent entities should not be supported in the long term and subsidy support should be minimised in order to contain government fiscal exposure.

Sound management information systems are critical to minimising institutional risk. DFIs must have accurate, timely and reliable financial information to be able to plan and measure performance and impact under various sectoral conditions and in dynamic financial markets and to take early, appropriate corrective actions. To the extent that DFIs make use of public resources, they need to comply with and report on the basis of specific standards, codes of conduct, disclosure and information requirements.

F. Mobilising financial resources

Commercial principles are essential to the financial and fiscal soundness of a development finance system. Innovative approaches to the mobilisation of funds to ensure less reliance on government contributions are needed. This could be achieved, for example, by an institution that has a strong deposit base, offering a wide range of deposit facilities throughout its branch network. The matching of financial instruments on the mobilisation and application side is part of a sound approach.

G. Capitalisation

Initial re-capitalisation should be done by the government (if necessary), with additions to capital limited to retained earnings and sales of shares to the public. The institution's charter should specify its minimum capital ratio (for example for a financial institution).

H. Allocation of resources

DFIs should preferably function on the basis of pinpointed financial market failures and should design and use appropriate risk-sharing arrangements to maximise private sector financial involvement. They need to develop innovative financial mechanisms to address neglected or emerging markets (for example, the venture capital market).

I. Loan policy

Interest rate policies should be designed so that the DFI does not crowd out private sector involvement. An emphasis on portfolio diversification is appropriate, especially in rural areas, where non-farm rural enterprises should be regarded as just as important as farming enterprises, in order to decrease risk exposure. Explicit targeting should be avoided. Commercial short-term overdraft facilities should be incorporated into the loan portfolio to balance medium-term lending, along with remunerative government treasury bills up to a specified portion of its financial assets. This gives the institution the means to manage both risk and liquidity.

J. Staffing

A DFI requires an efficient employment policy of creating the right potential capacity, where no government interference is allowed in terms of placements and termination of employment, within acceptable national norms and rules as espoused by the national labour legislation.

K. Decentralisation and incentive measures

A branch-based approach should be followed, qualified by opening branches in phases, from part-time to full time, as the volume of transactions justifies it. Decentralised decision-making should prevail at branch level. Performance based remuneration and related bonus schemes should prevail for branch managers and relevant loan evaluation and collection personnel, based on criteria such as the number and volume of loans, loan recovery, and deposit mobilisation. Bonus schemes should only be triggered after meeting a high loan recovery standard. Transfer pricing incentives would be required to reward deposit mobilisation beyond that used to fund local loans. DFIs should furthermore provide the appropriate incentives and penalties to align the behaviour of their clients with market signals and principally real interest rates. Client-responsiveness is also closely related to incentives and penalties.

L. Transparency, measurement of performance and reporting

State-owned institutions, especially financial institutions, should be at the forefront of disclosure. Accountability should include quarterly and independently audited annual reports issued to the public, specifying financial conditions truly and fairly. Reports should include balance sheets, income statements, source-and-application of funds statements, and additional tables showing the ageing of loan arrears by loan type, write-offs, reserves and the market value of the investment portfolio. Most importantly, subsidy dependence indexes should be carried out yearly and must figure prominently in all annual reports. Price differentials between market prices and the pricing policy of the institution should be included in reports. *Large exposures* and large defaulters should be listed by name and not afforded the confidentiality that is appropriate for private banks and their clients. Specialised government supported institutions should clearly differentiate between those activities they execute as an *agent for government* and for which government should pay them, and those activities on which they should achieve full cost recovery.

Following the private sector emphasis on reporting by companies to a level above financial reporting, e.g. the impact of the company's activities on the environment and contribution to social development, more and more pressure will be exerted on public sector entities to report in even more detail. Several innovative measurements already exist to measure outreach of development finance institutions and reliance on subsidies. The public and government would expect to be able to evaluate the level of investment needed of keeping the institution afloat compared to the resultant development performance of the institution.

M. Co-ordination

Experience in the current system and internationally suggests that the most efficient development impact is generally achieved where development investment occurs within a coherent and economically sustainable framework. This requires linkages between aspects like marketing and production and between investments in, for example, physical and social infrastructure. It also requires co-ordination between different state supported and owned institutions, as well as with the private sector, to ensure that no duplication of efforts and subsidies exist and that programmes are being executed comprehensively.

N. Donor support (external)

Donations (where received) should generally not be used to fund loans, but rather to build up human capital to manage credit risk intelligently. Important here is the implementation of a management information system that permits the tracking of loans on a weekly basis. Thus training, technical assistance and judicious support for computerisation are appropriate. Some of the institution's own funds should be committed to these endeavours as well, to ensure continued investment in management information systems upon donor withdrawal. Support should also not be directed at institutions, but at a sector. Therefore the same assistance should be possible through other institutions serving the same clients.

If such an institution performed well, it could offer through its extensive rural branch network a range of deposit and savings services for the poor (as legitimate a demand as for loans) far better than many NGO programmes (Graham & Von Pischke, 1995). Moreover portfolio diversification and extensive branching would alleviate the covariant risk associated with site specific unit banks or limited reach NGOs. These institutions can serve an agricultural clientele that is rarely included in NGO portfolios. Reformed state-owned banks should be in a good position to serve the input suppliers and output buyers at the wholesale level who play such an important role in lending downstream to micro-entrepreneurs. In short, these banks could positively shape the market environment within which micro-enterprises operate. In the end reformed rural development banks and NGOs (as well as other financial service providers) could complement each other in rural areas.

These reformed institutions would clearly not expand as rapidly as in their heyday of irresponsible portfolio growth. However, it is important that agricultural producers be relieved of any price penalisation and indeed benefit from well-designed government investments in human capital formation, agricultural research and related support services. Otherwise there will be an unfortunate tendency for policy makers to resort to subsidised credit through development banks as a convenient substitute for their failure to provide these services. In short, a threat will always exist for donors and the government to re-colonise these institutions with targeted loan programs and a political agenda, however, this is less likely in countries with intelligent agricultural support services and appropriate price policies (Graham, 1995).

3.2.5 Mastering the system's expansion

Once the system is set up, one of the biggest difficulties is to resist pressure from the farmers, the government or the financial organisations to expand too rapidly, particularly when the first experiences have been successful. First, they must recognise that a successful start does not necessarily imply long-term viability, since many new systems tend to perform well in their first stages. Second, one should make sure that the conditions for long-term success are fulfilled (i.e. complete information about the rural people, training, quality of the staff, control capacity, etc.). It is advisable to establish a realistic plan for further expansion after two or three years of experimentation, which will be re-examined periodically depending on the results.

3.2.6 Monitoring and evaluation

A sound accounting system and a thorough analysis of the credit statistics and figures remain the basics for efficient monitoring and evaluation. The most important indicator of success is the loan recovery rate. Another critical viability indicator is the financial equilibrium of the local structures and of the system as a whole. There are other indicators which should be gathered, presented and discussed with the farmers. As an example, it was proposed in 1984 (during a conference in Lomé) that several simple indicators be systematically collected from COOPECs, as a starting point for national and international reviews. The following indicators still remain valid (data must always be calculated in the same manner to allow for comparisons from one year to the next):

- Number of local credit fund structures and their development
- Number of members, their development (in absolute figures, and compared with the number of potential members) and distinguishing shareholders and beneficiaries (users)

- Total savings, savings development, and contributions according to socio-professional categories, the amounts and the numbers of accounts
- Savings per member (in current and inflation-adjusted currency) according to socio-professional categories and to status (shareholders or beneficiaries)
- Savings compared with monetary revenues or revenues of the main commercialised products (in broad terms)
- Proportion of credit operations compared with savings operations (amounts and number of operations per category)
- Overall outstanding payment rate per loan type and per socio-professional category of the beneficiary
- Credit utilisation (type of activity) per category
- Self-financing of the local financial structures, of the whole system and the management regulations to reach it
- Information on the poverty levels of clients and also the impact the financial services had on their socio-economic circumstances

Collecting simple indicators is but a starting point before the more thorough evaluation. It is important to

- identify and know the promoters of any rural finance experience (the members and the external operators);
- identify the promoters' real objectives (savings security, financial equilibrium, credit distribution, financing local development, etc.);
- acquire an accurate knowledge of the respective roles of the social groups involved in COOPECs or ROSCAs;
- measure the actual autonomy of the members.

These elements allow a real evaluation to be conducted with the members with whom possible new orientations can be considered on and perhaps undertaken.

4. Conclusion

Financing the rural sector is becoming increasingly important. It makes it possible to reinforce the farmers' organisations and their autonomy, as well as to promote agricultural and non-agricultural productive activities, including processing, craftworks, and services.

Following the failures and poor results of both development banks and specialised banks (national banks of agricultural credit), two alternative formulas seem particularly promising:

- COOPECs (co-operatives for savings and credit) in which credit is generated only from savings previously collected by the members
- ROSCAs (informal or formal experiences of solidarity and rotating credit, which have existed for a long time in Africa *tontines*, *stokvel*, and also the Grameen Bank of Bangladesh) in which money may also come from external sources and where credit may precede savings

Other formulas also offer interesting possibilities (seed stocks, grain banks and village development funds).

Such diversity clearly shows that there is no universal panacea. In each situation, a system should be developed with the farmers after a sound analysis of the situation. Three golden rules may be set:

- The system must be socially appropriate and adapted to the farmers.

- Financial equilibrium must be targeted, which often implies relatively high interest rates in order to achieve long-term viability.
- No single institutional format will be appropriate for all circumstances. The market realities will dictate the best institutional solution.

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