

Microcredit and Agriculture: How to Make it Work

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Introduction

This paper discusses the challenges to and factors affecting the success of institutions providing financial services for agricultural activities. After clarifying terminology, the first section will give the reader an overview of recent research on rural economic development and agriculture finance. Subsequent sections will then focus on the rural finance sub-sector of agriculture credit and explore the challenges faced by micro and rural finance institutions (RFIs), present what is working and what lessons are being learned. Within each of these sections publications useful to practitioners will be referenced and examples will be given to demonstrate practical experiences. In most instances the examples will be based on the experiences of the Mennonite Economic Development Associates (MEDA) and its partners in rural microfinance. The remaining part of this introduction will present MEDA and clarify terminology.

While the scope of the paper does not permit an in-depth discussion of all methods of agriculture financing nor all specific local factors affecting success, it is hoped that it will generate discussions and enable practitioners to improve the services and products they offer to rural clients. A suggested reading list of useful resources is presented for further information.

MEDA

MEDA has been involved in the delivery of economic development and microfinance for the past 50 years. The organization targets the poorest of the economically active in developing countries and accomplishes its mission of improving livelihoods through five key areas: Microfinance, Production and Marketing Linkages, Investment Fund Development, Community Economic Development, and Member Services. The first three departments are internationally focused while the last two operate within North America.

Given its broad economic development focus, MEDA's approach to rural and agriculture finance has not been limited to the provision of financial services alone. Rather it has worked at rural finance and linkages from three separate angles: through targeted financial services, through agriculture and market development programs, and through integrated programming (combining the first two, often with direct financial investment at the outset). MEDA's projects have circled the globe from Paraguay, Bolivia, Nicaragua and Haiti to Tanzania, Tajikistan and Afghanistan. The models of financial intervention in rural areas have changed over the years, beginning with the provision of seed capital for the development of a dairy, to the building of community banks in rural areas, to loans for agriculture activities, product storage and processing often linked using a value chain approach involving different partners in related sectors.

Although this paper will not cover all of MEDA's past and present experiences in rural economic development and more specifically agriculture credit, it does draw on these experiences to present examples for the section topics. Needless to say, the duration of MEDA's involvement in its own rural economic development projects as well as the range of countries it has worked in with partners has resulted in both positive and negative experiences, successes and some failures and without a doubt many, many lessons.

Terminology

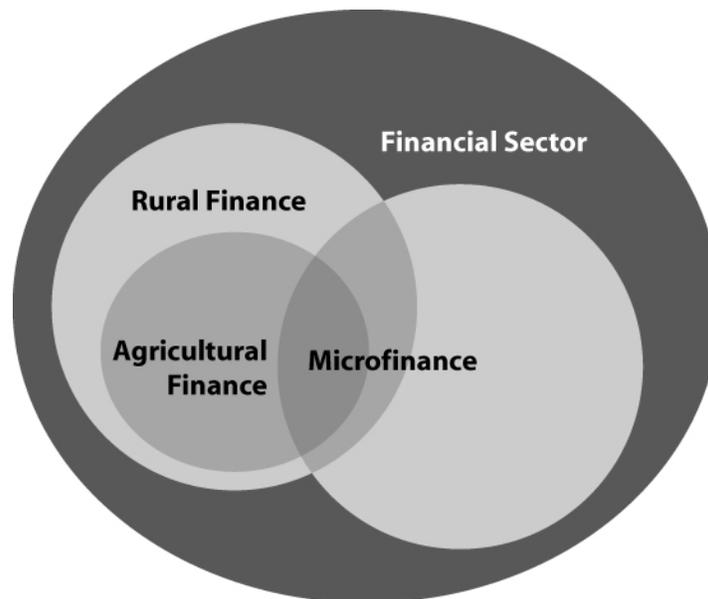
In an attempt to be clear with terminology, this paper uses the following definitions for the financial sector to differentiate agriculture finance from rural finance. The diagram below demonstrates the location of each sector relative to the others.

Rural finance, as defined by the World Bank, is the provision of a range of financial services such as savings, credit, payments and insurance to rural

individuals, households, and enterprises, both farm and non-farm, on a sustainable basis. It includes financing for agriculture and agro processing.

Agricultural finance is defined as a subset of rural finance dedicated to financing agricultural related activities such as input supply, production, distribution, wholesale, processing and marketing.

Microfinance is the provision of financial services for poor and low income people and covers the lower ends of both rural and agriculture finance as seen in the diagram below.



Source: CGAP Donor Brief No. 15 October 2003

Section 1: Overview of Recent Rural & Agriculture Finance Research

There are a number of recent publications¹ on the topic of rural finance and, more specifically, agriculture credit. Some discuss approaches used during the past decades, what worked and where failures occurred. Others present new approaches developed in response to the acknowledged failures of the past and attempt to incorporate lessons learned for the better provision of services in the future. Others still provide useful guidelines or suggestions for practitioners involved in serving rural populations with agriculture credit and other financial products.

A review of these recent publications on agriculture credit and the wider topic of rural finance revealed some commonly held opinions regarding the current state of financing agriculture, including:

1. The economic development of rural areas lags behind that of urban ones;
2. Rural areas have not been well served by the microfinance industry nor have they been effectively reached by financial services during the past decade primarily because institutions and donors were focused on the urban markets;
3. Financial institutions that do provide services to rural populations face significant and real challenges;
4. The provision of agriculture credit is inherently risky, and it is difficult to do effectively given geographic dispersion, weak market linkages, higher costs, lack of extension support services and inherent risks;
5. Donors and governments are returning their attention to the rural poor and their needs with respect to a range of financial services;
6. Providing effective agriculture credit and even rural finance remains a challenge to the donor community and development finance sector;

¹ The primary resource documents used for the writing of this paper are the recent publications by Nagarajan and Meyer (2005), Christian and Pierce (2005), Steel and Charitonenko (2003)

7. Although rural areas remain underserved, with respect to financial services, more providers are entering the market;
8. There is recognition of the need for access to a range of financial services, as well as a belief that access to other financial services (savings, insurance, remittances) may be more important to rural populations than credit and should perhaps precede it².

The literature indicates that over the past few years, donors have begun to express a renewed interest in rural and agriculture finance. This is partly due to a recommitment to poverty reduction internationally and a recognition that the majority of the world's poor live in rural areas³. Zellar, in his paper given at conference on rural finance in 2003⁴ identified three principal motivations for the renewed interest:

1. The agriculture sector remains the most important economic sector, especially for the poor in many developing countries;
2. Improved financial markets accelerate agricultural and rural growth, leading to greater economic growth and less poverty and;
3. A growing sense of optimism that donors might learn from the failures of the past⁵.

During the last few decades, despite the lack of donor community focus, organizations have been working in rural areas to reduce poverty or provide access to some form of financial services. In fact, there are a number of examples often used in the literature of successful interventions in rural and agriculture finance. Specifically, BRI in Indonesia, Calpia in El Salvador, and Prodem in Bolivia among a handful of others are described as being successful providers of agriculture credit (in addition to other services) to rural populations. In addition, ROSCAS, SACCOS, self help groups, in-kind credit programs, agriculture banks as well as other micro and rural finance

² Nagarajan & Meyer, 2005.

³ World Bank Global Monitoring Report identifies 1.1 billion people as extremely poor with 75% living in rural areas.

⁴ Zellar, 2003. *Paving the Way Forward for Rural Finance – Conference*

⁵ USAID RAFI Notes Issue 1. January 2005

institutions worldwide have continued to provide access to financial services aimed at the rural populations with varying degrees of success. The view of some authors, however, is that despite the efforts by these numerous providers, the overall effects and impacts have been limited, actual successful interventions have been few and far between, and it is time to refocus efforts through the identification of new approaches based upon lessons learned from past failures⁶.

Nagarajan and Meyer recently produced a comprehensive paper on recent advances and emerging lessons in rural finance⁷. Within this paper they discuss a new “rural finance paradigm” based on the principle that a commercial, market-based approach is most likely to reach large numbers of clients on a sustained basis⁸. It recognizes that financial services are part of an interactive system of financial institutions, financial infrastructure, legal and regulatory frameworks, and social and cultural norms. They further state that government has a role to play in establishing a favourable or “enabling” policy environment, infrastructure and information systems, and supervisory structures to facilitate markets, but it should play a more limited role in direct interactions.⁹

This new rural finance paradigm takes a financial systems approach with three strategic priorities:

1. Creating a favourable policy environment including macroeconomic stability as well as a reduction in the historical bias against the rural sector;
2. Strengthening the legal and regulatory framework so that rural financial institutions which are performing well can provide a variety of financial services to low-income households;

⁶ Nagarajan & Meyer, 2005.

⁷ Ibid.

⁸ A detailed review of the proposed paradigm is beyond the scope of this paper as it deals with the whole sector of rural finance.

⁹ See Nagarajan & Meyer, 2005. pg. 5

3. Building the capacity of RFIs to deliver demand driven credit, savings, and insurance services in a self-sustaining manner.

In the same paper, Steel and Charitonenko¹⁰ are cited as stating that the new paradigm recognizes that financial services may need to be augmented by complementary investments that help rural populations build assets and skills by:

1. Developing economic and social infrastructure at the community level;
2. Undertaking social intermediation to facilitate the formation of solidarity groups or cooperatives and to build social capital;
3. Training in both technical and management skills;
4. Supporting business development services.

Although discussing the feasibility of the proposed approaches on a practical level is beyond the scope of this paper, there is value in examining specific aspects of the frameworks that relate to providing effective, efficient and sustainable financial services and specifically credit for agriculture based activities in practical experience on the ground. In addition to giving them insight on possible new directions the rural finance sector may take, Practitioners might find these documents helpful for their own day to day field work as they have many useful ideas and suggestions as well as examples from different regions and organisations.

Section 2: What are the Challenges?

Other publications have explored more narrowly defined aspects of rural finance and specifically agriculture finance. The remaining sections of this paper will utilize some of these publications for discussing the challenges, what is working, and the lessons being learnt in the provision of financial

¹⁰ Steel and Charitonenko, 2003. This publication is an extensive discussion of rural finance and is beyond the scope of this paper.

services to rural communities in order to extract some of the valuable practical aspects of the research.

It is recognised that rural areas and populations remain underserved, yet economic development for these areas and populations are key components in the overall development of a country. The donor community and providers entering the market have shown a renewed interest in economic growth leading to poverty reduction within rural populations. In spite of their renewed commitment, significant challenges to the successful implementation of effective delivery of services and outreach remain. Given these facts the question remains: what are these challenges and what can institutions do to respond to them to make agriculture credit work?

Well unfortunately, there is no simple answer to that question nor single approach or method that will work for all practitioners in all areas or countries. As with urban microfinance, there are some general best practice guidelines that can be followed, some common challenges that most organizations will face at some point and some general practices that agriculture credit providers can follow to offer good services and loans.

However, program and institutional design, methodology, products and delivery of services need to be modified to fit the specific country, region, cultural context, operating environment and even the challenges affecting an institution. Institutions must consider the particular factors present in their different areas of operation and understand that what works on Latin American farms may not be applicable in Sub-Saharan Africa on small holder plots of land. What is successful in highly populated rural areas of Bangladesh is not easily replicable in the more remote rural environments of Nicaragua, Peru, or even Afghanistan.

Identifying the challenges facing an institution providing agriculture credit is the first step in figuring out how to make it work effectively. The literature

reviewed presents a comprehensive list of challenges affecting rural finance institutions and also offers interesting and innovative ideas to address them. The various authors categorized their lists differently but they identified challenges both external and internal to the institution. Some challenges faced by rural institutions are similar to those facing any microfinance organisation while others are specific to rural institutions offering loans for farm-based activities. Different lists have been amalgamated in the list below and the focus here is on the challenges specific to lending for farm-based activities.

Some factors unique to rural and agricultural markets that constrain both the supply and demand for finance in those areas include:¹¹

- High transaction costs for both borrowers and lenders
- Generally lower population density and dispersed demand
- Often limited economic opportunities available to local populations
- High risks faced by potential borrowers and depositors due to the variability of incomes, exogenous economic shocks and limited tools to manage risk
- Seasonality – potentially affecting both the client and the institution
- Heavy concentration on agriculture and agriculture related activities exposes clients and institutions to multiple risks, both idiosyncratic (one household) and covariant (entire region or country)
- Lack of reliable information about borrowers
- Lack of market information and/or market access
- Weak institutional capacity – including poor governance and operating systems, low staff and management skills
- “Crowding out” effect due to subsidies and directed credit
- Increased risks associated with the concentration of a portfolio on agriculture activities that are most prevalent in the area

11 USAID RAFI Notes Issue 1; For more detailed comments on these items see Nagarajan and Meyer, 2005. pg. 2, and Christian and Peck, 2005.

- Lack of adequate or usable collateral (lack of assets, unclear property rights)
- Risk of political intervention, which can undermine payment morale through debt forgiveness and interest rate caps
- Inhospitable policy, legal and regulatory frameworks
- Undeveloped legal systems, inadequate contract enforcement mechanisms
- Undeveloped or inadequate infrastructure
- Land held may be too small to be sustainable or located too remotely to be reached efficiently
- Individuals may be dependent upon only one crop with no other external sources of income¹²

Unfortunately, financial services providers in rural markets are not able to choose which challenges they will face. More often than not the various challenges reinforce and compound each other. For example, the high risk inherent in agriculture means increased importance in screening and monitoring of clients and therefore higher transaction costs for both clients and institutions, which are exacerbated by the dispersion of the client base and small loan sizes¹³.

The boxes below describe some of the challenges affecting operations as identified by MEDA's own agriculture lending project in Nicaragua and by institutions in Afghanistan.

Challenges Example 1: MEDA Nicaragua - MiCredito

MEDA Nicaragua's microfinance organization, MiCredito was launched in September 2004 in two areas, one urban and one rural. A primary part of the organization's strategy is to lend in the rural areas of its country. However, acknowledging the risks and challenges associated with this strategy, the MFI decided to also offer microcredit services in urban areas in order to smooth the cash flow for the organization. The urban

¹² Dorward, 2001.

¹³ Ibid.

activities are not intended as a subsidy of the rural ones. MiCredito opened its second rural branch in July 2006. The MFI is also connected to a separate MEDA project focused on the sesame production value chain. This project, which provides extension services and strengthening for marketing and exporting associations as well as linkages to finance institutions, is in its second year.

Through MiCredito, agriculture loans are available for use for any crop but in the primary areas of operation most farmers are growing beans or sesame. In an attempt to reduce risks associated with lending predominantly for two crops, the organization also offers products to serve the credit needs of clients operating rural enterprises and raising cattle. This is a reflection of both the activities which exist in the rural areas and part of the organizations strategy of portfolio diversification.

MiCredito's management team identified the following list of key challenges that they face:

Weather related:

- Rainfall patterns vary by region resulting in some areas with one growing season and others with three
- Susceptibility to earthquake and hurricanes which can cause sudden and severe devastation to livelihoods

Geographic challenges:

- The rural population is highly dispersed presenting challenges of monitoring, follow-up and outreach

Cultural challenges:

- History of poor repayment culture – Many in the rural populations historically associate poverty reduction efforts with charity from NGO's and view the MFI's in the same way making it a challenge to developed good repayment behaviour
- It is sometimes difficult to gain access to the communities and to get the community to accept credit terms (many farmers are used to making one final payment at the end of the loan at harvest time and are reluctant to change or de-link loan repayments from the crop results)

International challenges:

- Bean and sesame as commodities are highly susceptible to international price fluctuations potentially increasing the repayment risk to the organisation

Challenges Example 2: Afghanistan

In Afghanistan the microfinance industry is quite young with most institutions being less than three years old and the oldest around five. While most institutions began lending in the urban and peri-urban environments some have been able to expand into lending for

agriculture, other rural lending or to more remote locations. Rural finance and agriculture lending in Afghanistan not only has to face the typical challenges but the added ones of insecurity and violence and a significant lack of infrastructure as well.

A list of identified challenges commonly faced by institutions in Afghanistan is given below:

- Security - On going and potentially worsening conflict situation – expansion in to more remote areas is difficult and potentially dangerous. In some cases institutions have faced robbery, fire, threats to and even the killing of national or international staff.
- Drought and flooding – Long term drought in many areas affects the ability to plant and grow crops and has also resulted in the decay of traditional irrigation systems thus worsening the situation.
- Geographic isolation – access to many remote areas becomes impossible during winter or flooding seasons.
- Lack of infrastructure – roads, lack of regular electricity, supply of goods, irrigation
- Animal diseases
- Government belief that poor farmers are incapable of repaying loans and need subsidies
- Human resources and staff capacity - Need to build capacity in all positions
- Product development challenges due to Islamic lending principles
- Lack of flow of funds delaying program expansion
- Adapting to a quickly changing operating and regulatory environment

These examples clearly illustrate a number of the challenges listed above and although they have been listed as separate challenges they do interplay. The drought problem is compounded by the destruction of infrastructure, which also serves to compound the isolation of areas already separated from economic centres by geography.

Although the challenges presented in the research are well known, they all may not be present in every area, region or country. It is important for a provider of agriculture credit services to be able to effectively identify those challenges it will face in the areas where it operates as well as work to develop mitigation strategies. From a practical perspective it is useful for an

organisation to be able to systematically analyse the specific challenges and risks that it faces and be able to modify its responses to fit the local operating environment. It is also important for both management and staff to have an understanding of the general macro economic environment as well as specific knowledge of the areas of operation, sectors and economic activities and opportunities available to clients to effectively respond to challenges and risks.

To that end, institutions will need to look at all aspects of their own organization and operating environment. They will need to acknowledge where the challenges lie and proactively design strategies and responses to them. One way to begin is to use the tools and research available and analyse their institution within these frameworks and then consciously modify their own systems to improve their products, services and to better serve the rural populations they work with within the environmental constraints they face. They will then need to figure out what they can resolve internally and in what areas they may need external assistance.

One practical approach to systematic analysis of risks and challenges is to use one of the many general lists of challenges as a starting point for discussions and to improve the organisation's level of awareness of the specific risks relevant to its operating environment. The team should also add to the list any additional and specific challenges it might face. Once the issues have been identified the team is then able to systematically discuss both how they might meet these challenges, mitigate the risks associated with them and modify both products and services to better meet the needs of clients.

One useful example of such a list is taken from a brief presented at the Food and Agriculture Organization (FAO) Rural Finance Workshop: SEEP Pre-event by Calvin Miller¹⁴. Miller provides a straightforward identification of key

¹⁴ Miller, "Twelve Key Challenges in Rural Finance", FAO 2004.

challenges faced by organizations providing access to rural finance and then classifies them into categories of constraints. He further elaborates on the four constraints and twelve corresponding challenges with the identification of issues, which arise within each category. The table has been provided in the resource section as a sample tool.

Taking the time to evaluate the external agricultural environment and both the internal and external operating environments gives the organization valuable information about what actually affects it and its clients. In addition, such an evaluation allows for analysis of the severity of the effects and develops an understanding of the level of impact a single issue or a combination of issues brings.

As challenges are rarely faced in isolation, an organization that has taken the time to analyse the actual challenges it has to deal with will have a greater capability to address them or identify what extra resources it may need to locate in order to mitigate the negative effects. Having undertaken an analysis of those which affect the agriculture portfolio, the ability of the institution to combat a sudden shock, lessen its blow or effectively deal with an ongoing issue will be enhanced. The act of doing the exercise itself with the senior management, back office staff and/or field staff strengthens the capacity of the team to deal with challenges as they arise and increases the awareness of all staff in the organisation.

Section 3: What is Working?

As stated above, there is not one clear model or set of guidelines that an institution can follow to ensure absolute success. Every area region and country creates a unique context within which an organization operates. It can be difficult to replicate all the components that made a program successful in one area in another. However, the authors of many documents reviewed indicate there are some basic concepts and principles of microfinance that can be applied to rural finance and specifically to

agriculture credit products, which should assist in the development of a successful institution. Further research proposes some unique ideas specifically focused on agriculture credit that if used correctly and as part of a comprehensive approach should enable an RFI to effectively mitigate some unique challenges and successfully deliver financial services to rural clients. Some of these ideas are discussed below.

Different authors have proposed some strategic steps for institutions that are expanding from urban to rural areas as well as those who provide financial services to rural areas only should take before, during, and after their entry into the sector. Nagarajan and Meyer (2005) for example, discuss similarities that they found in institutions considered to be successful.

Nagarajan and Meyer state that those institutions, which have achieved “success” in providing access to rural financial services, including agriculture credit, to rural populations, have the following similarities:

- the rural finance institution follows the same best practices established for urban microfinance¹⁵;
- the clientele are diversified - the institutions serve those engaged in agricultural activities, non farm households as well as microenterprises;
- the MFIs address idiosyncratic risks by relying on income diversification strategies of the households;
- the MFIs offer flexible terms and conditions to suit the household cash flows;
- the MFIs may require higher borrower equity participation to reduce moral hazards;
- the MFIs assess the loan application on cash flows during the worst periods and future forecasts.

15 Gonzalez-Vega, 2003b

Other authors have provided examples of operational approaches used by organisations considered successful rural finance providers. A sample of these product and service modifications is given in the boxes below.

What is Working Example 1: Prodem Bolivia

Manndorff (2004) discusses one approach used by Prodem in Bolivia

Prodem used donor support to research markets and develop products in order to adapt its financial products to better suit the needs of the rural clients it served. The examples of adaptations given include a customized repayment scheme for small farmers allowing different repayment schedules for members within the same solidarity group. Individual agriculture loans are offered with collateral valued at 1.5 times the loan amount. Prodem then reduces its risk further by restricting the final loan payments to a maximum of 60 percent of the loan amount. It also generally limits each office's portfolio to 30 percent in each economic sector (or increases provisions accordingly). In addition to credit it also offers money transfer, micro leasing, and saving products¹⁶.

Calpia, an organization in El Salvador, is often cited in the literature as an institution that is successfully providing agriculture credit, amongst other financial services.

What is Working Example 2: Calpia, El Salvador

Key features of Calpia's success include¹⁷:

- Treating the farm household as a financial unit integrating a variety of economic activities, and basing lending decisions on repayment capacity rather than how funds are utilized
- Managing systemic risk in agriculture by three levels of diversification: (i) across rural and urban branches; (ii) across both agricultural and non-agricultural activities in rural branches; and (iii) across diverse household economic activities;
- Long term relationships to lower transaction costs for both lenders and borrowers;
- Using various types of collateral, including non-traditional collateral from poorer households;
- Delegated and decentralized decision making by well trained loan officers

16 Mandorff, 2004

17 Navajas and Gonzalez-Vega, 2000 CGAP – *Agricultural Microfinance Profile: Caja los Andes* (draft)

- jeopardized, opportunities are realized, and the borrower-lender relationship is strengthened; and
- An effective management and information system (MIS) and a commitment to high loan recovery (including seizure of collateral where necessary as a signal to other clients).
 - adapting it's rural services to become more flexible in timing, amounts disbursed and repayment schedules – (bi monthly, trimester, semester, annual, end of crop cycle and irregular repayment schedules).

As a result, Calpia has created loans that are attractive to a wide variety of clients and which fit a range of agricultural activities.¹⁸

The features or innovations used by Prodem and Calpia are just some of the methods that organizations have used to provide financial services and agriculture credit more effectively and better suited to meet the needs of the rural poor. Christen and Pearce¹⁹ propose, in a new and emerging model on agricultural finance, ten features that are present to varying degrees in successful agriculture finance lenders. While the authors state that success is not contingent upon the presence of all ten features, they have noted that the presence of a combination of these features seem to “contribute to a well performing portfolio, in diverse conditions, in a variety of circumstances”²⁰

The ten features²¹ are:

- 1) Repayments are not linked to loan use – the entire farming household is treated as a single economic unit, with multiple income sources (farm and non farm) and financing needs.
- 2) Character-based lending techniques are combined with technical criteria in selecting borrowers, setting loan terms, and enforcing repayments – e.g. combine group guarantees with knowledge of crop productions and markets in the region.

¹⁸ Buchenau 2003; Mandorff, 2004; Meyer and Buchenau, 2003

¹⁹ Christian and Pearce, 2005.

²⁰ Ibid. Page 4; The authors point out that many of the experiences judged as successful in the paper are relatively experimental or less well tested than those in the general field of microfinance.

²¹ In the main paper the authors explore each of the features in greater detail. See Resource List.

- 3) Savings mechanisms are provided – often with a greater level of utilization than the loan products
- 4) Portfolio risk is highly diversified – institution lends to a wide variety of farming households engaged in different activities and thus is better protected against agricultural and natural risks
- 5) Loan terms and conditions are adjusted to accommodate cyclical cash flow and bulky investments – successful institutions track the cash flow cycles more closely
- 6) Contractual arrangements between producers and sellers and/or suppliers reduce price risk, enhance production quality, and help guarantee repayment – arrangements often combine technical assistance and provision of specified inputs on credit
- 7) Financial service delivery piggy backs on existing institutional infrastructure or is extended using technology – reduces transaction costs for both lenders and borrowers and creates potential for sustainable rural finance
- 8) Membership-based organizations can facilitate rural access to financial services and be viable in remote areas.
- 9) Area based index insurance can protect against the risks of agricultural lending - by providing payouts linked to regional levels of rainfall, commodity prices etc.
- 10) Agricultural microfinance must be insulated from political interference. – it's difficult to survive government moratoriums on loan repayment.

In the paper the authors discuss each of these ten points in greater detail and have also included case studies of different organization offering rural financial services reflecting these features. One of the key components of this proposed model is the understanding that poor farming households are generally engaged in more than one income generating activity, have a number of financial coping strategies, and use a variety of formal and informal financial instruments to manage their affairs. One of the primary

summaries of the paper is that a lot of agricultural production can be financed using standard microcredit principles with some significant adjustments and that traditional agriculture finance institutions can improve their success by adopting good practice microfinance techniques to reduce risk and enable financial sustainability.

The main adjustments suggested by the authors in their model are numbers one through five. These are based on standard principles of microfinance and adopting most of these points may enable an institution to improve the services they provide to rural households. However, the authors also point out that there are specific challenges to agriculture finance that require organizations to adopt innovative responses in order to serve the rural people well. Points six through nine were presented as responses that could be used in an attempt to address these agriculture specific challenges. The authors state that while not all of these specific challenges will be applicable to every institution, until an institution is able to address the more difficult challenges specific to agriculture finance in their area they will remain less effective overall. The more difficult challenges include: large and long term investments, price and yield risks, relatively high cost of operating in rural areas with low population density, and the lack of client credit records. They further indicate, however, that the suggested responses outlined are still in the early stages of testing, are not yet fully proven successful and that more institutions will need to test them to be able to determine if they really are appropriate responses to the more difficult agriculture finance challenges.

Organisations wanting to improve their agriculture lending operations would do well to examine the general factors of success as well as any specific to their area and compare these against their own current policies, procedures and operating guidelines. As suggested by the authors, they should strive to adopt good practice techniques utilised by microfinance organisations and after identifying challenges specific to agriculture in their area, they should determine if any of the innovations designed to meet these more difficult

challenges are a) appropriate to the local context and b) that the organisation has the resources, human and financial, to take on the testing process. If it does not then it may be worthwhile to explore funding options aimed at supporting innovation in rural finance to enable to organisation to test the idea but decrease some of the risk associated with innovation.

MEDA projects and partners have identified features of their approaches, which they believe are positively affecting the levels of success of their activities in agriculture lending. A number of these ideas are given in the boxes below.

What is Working Example 3: MEDA Nicaragua – MiCredito

In MEDA Nicaragua – MiCredito has identified the following as critical to the effectiveness of their agriculture credit activities.

1. A skilled, experienced Senior Management team enabled the program to begin its pilot period without delay. *It would have been more challenging with a young or inexperienced team and would have required significant technical assistance and support during the first few years.*
2. The ability to undertake a pilot year with financial support but little risk to the institution enabled the study and analysis of areas of operations, product design, delivery etc. allowing the institution to launch its lending operations with products and services which it knew would effectively meet clients needs and demands
3. Open communications between the program and the clients and delivering a consistent message has led to an improvement of repayment culture. Clients understand what is expected of them and what they can expect from the organization.
4. Good selection of start up areas based upon analysis of data from the pilot period
5. The creation of and strict adherence to policies and operational guidelines early on created a solid foundation from which the program could grow
6. Ongoing credit education for clients
7. Diversification of the loan portfolio between urban and rural clients improved cash flow of the organization and reduces the risks associated with over concentration on a single crop in some areas
8. Limitation of crops in initial period focusing on the more successful / marketable ones
9. Creating a good monitoring team and “branches” close to the clients
10. Qualified staff with understanding and knowledge of agriculture sectors and geographical areas of operation

11. Credit staff that like to work in the country, are good investigators, and have the ability to analyze a business

What is Working Example 4: IMON - Tajikistan

IMON - MEDA's project partner in Tajikistan has identified the following as critical to the effectiveness of their agriculture credit activities.

1. High level of capacity in the local management and staff enabled the organization to expand into new areas without jeopardizing the success of its urban lending activities.
2. A Good reputation in the region as an honest and fair organization
3. Careful selection of start up regions. Areas chosen were areas with strong staff capacity and strong agriculture activities
4. Agriculture knowledge / experience of staff is critical to serving a farming and farm product processing target market. Understanding local and regional agriculture activities, practices and experience enables the staff to adequately evaluate and analyse the loan applications and repayment capacity of the clients.
5. Institutional infrastructure already in place resulting in a lower cost of operations. The organization began its agriculture lending activities based from area offices located near to farming communities enabling easier levels of access and monitoring.
6. MIS, HR, accounting systems in place. As this was not a new microfinance institution but one which was operationally sustainable with all necessary systems in place the management team was able to focus on researching and delivering appropriate products and services aimed to the farming and processing markets and did not have to spend time and resources on developing an institutions from the bottom.
7. Risk reduction by portfolio diversification - by client, type of activity and by region is important to ensure a lower degree of risk in the portfolio. IMON's rural lending portfolio is initially focused on the fruit and vegetable sub sector and lending activities are linked to a MEDA project providing extension services for agriculture as well as processing. Even though many different fruits and vegetables are produced in the region, there is an increased risk to the portfolio due to the focus on one sub sector. This risk is reduced by also offering loans for livestock, other rural based enterprises, storage of products and soon possibly loans for irrigation and leasing services for farm equipment. IMON also mitigates its overall portfolio risks but operating in several different regions of the country and maintaining a healthy urban based portfolio.

MEDA is currently in the process of testing an approach to rural economic development, combining the work of the microfinance and product and

marketing linkages departments. In this approach, MEDA is using some techniques of value chain analysis and sub sector analysis and applying it to rural finance organisation activities. MEDA is testing this approach partially as a risk management reduction strategy and partially to identify potential linkages between producers, markets and financial institutions to promote growth along the whole sector while at the same time enhance the whole chain rather than just one component.

Section 4: What is Being Learnt?

A valuable part of the growth and development of both institutions and rural finance sectors, including the subcomponent of agriculture credit is the sharing of information and experiences of what has been learned, with the failures being as important as the successes. The literature states that those organizations who are considered to be successful in the area of agriculture credit and rural finance have learned many of the lessons from urban microfinance and considered them relevant for rural and agriculture lending. Although modifications to term and collateral requirements can assist in accommodating rural clients, there are similarities with respect to lending methodology, interest rates, and terms structure²². These documents, among others, do provide some useful steps, required conditions and even guidelines that should be examined by practitioners to evaluate their own programs and status of operations.

A summary of the lessons from urban microcredit that can be applied to rural areas is given below:²³

- Demand for microfinance exists in rural areas and current microfinance technology can be adapted to provide services to rural clients;

22 Nagarajan and Meyer, 2005 Page 18 Table 1.

23 Nagarajan and Meyer, 2005. Christen and Pearce, 2005. Both sets of authors do qualify the term "successful" stating that many of the organization currently listed as successful have not in fact been operating in the rural environment for a long period of time.

- Flexible disbursement and repayment schedules are important for rural outreach but such flexible terms may increase default risk and present challenges for MFIs in managing liquidity;
- MFIs need to diversify their portfolios with various types of rural and agricultural clients to reduce portfolio risk;
- Economies of scale are important in reducing MFI costs;
- Partnerships and alliances with existing institutions and infrastructure may facilitate increased outreach and provision of diverse services at reduced cost;
- Technology can help reduce the higher transportation and communication costs found in rural areas;
- MFIs need to assess client demand using market research to design appropriate products and services;
- MFIs may need to offer financial products other than credit to achieve sustainability. Access to remittance and deposit services can help both client and MFIs smooth seasonal cash flows and protect against risks;
- Successful MFIs with rural coverage acknowledge that rural operations are expensive and risky, so cross subsidization with robust urban operations may be required.
- Credit may not be the best first approach to reducing rural poverty. In some cases alternative models (savings, remittances, insurance) may be better suited to the local context.

However, it is not always possible to apply the success factors of organizations like Calpia in El Salvador and Prodem in Bolivia to the rural areas of Sub Saharan Africa or Afghanistan. Latin American institutions tend to offer larger loans sizes because borrower incomes are more diversified; there is good infrastructure, good transport facilities, and cash crops. This is not the same elsewhere, and further innovation is likely necessary to effectively reach the smallholder farmer with a single crop or those who operate in more remote areas or countries affected by destruction of infrastructure due to sustained conflict.

Specific examples of lessons learned by MEDA programs in Nicaragua and Haiti are provided below.

Lessons Learned Example 2: MEDA Nicaragua - MiCredito

Nicaragua - MiCredito

1. If possible take the time to investigate the region where you will operate and choose the ones that are the most productive and have the most potential
2. Study the competition and identify your unique traits
3. Prepare good policies and take the time to adequately train all staff.
4. Monitor and reinforce policies regularly especially if rural staff are not often in the office
5. Need to make monitoring team even though the clients are dispersed and have irregular payments
6. Diversify portfolio by regions, products, enterprise activities, rural / urban
7. Understand the crops being funded – gather market information on the local regional national and international level and determine the degree of concentration in each crop and area.
8. Need to be tough to establish the organizational culture
9. Associations may be useful for lobbying the government if necessary

Lessons Learned Example 1: Haiti

Haiti

1. Hiring credit staff with financial or business background and a strong knowledge of community living and rural farming practices
2. Be prepared to invest in appropriate systems to ensure effective accounting, portfolio tracking and internal controls
3. Ensure appropriate human resources, operating policies and procedures and systems for lending and financial management are in place early on so staff can concentrate on clients and portfolios
4. Understanding the areas where you are working is crucial to effective start up and expansion. Take the time to study different regions and consider doing a pilot test.
5. Place full time dedicated, experienced, international staff in the institution from the outset until local management has the capacity

to take over

6. Ensure sufficient funding is made available to the project
7. Growing when systems are not ready or fully in place is detrimental to the success of the organization
8. As much as possible keep it simple (loan products, incentive systems, community bank management)

Other general lessons that MEDA has learned over the years include:

1. Knowledge of the economic environment local regional and even in some cases globally is important when lending for agriculture activities especially in cases where the crops grown are commodities and are possibly affected by world prices;
2. It is important to study the degree of concentration in the portfolio – across clients, branches, and the institution;
 - Take time to identify how heavily invested the client is in one crop, the organization is in this same crop, and then externally how heavily invested or concentrated the region is in one crop. If an institution has many clients in its portfolio all growing the same crop and if for example this crop is the predominant one in the region, then if there is a significant change in the price of this product in the world market due to global competition or some other external effect the risk to the organization due to this level of portfolio concentration is increased and compounded by the concentration on this crop in the region. It is advisable for an institution to be aware as possible about the local regional and global market for the main crops in their portfolio to effectively assess the associated risks and to enable them to determine what if any mitigating actions they can take to decrease their exposure.
3. The skill and capacity of management and staff is a critical component to the successful implementation of any lending activities. There needs to be a solid foundation in day to day operations and to have this running smoothly to be able to grow, expand into riskier areas or activities and to innovate or look beyond functioning at a basic level.

- If staff capacity needs developing it is important that an investment in human resources be included in planning budgets and work plans. Investing too little in capacity building or doing it too late may lead to irreversible problems
4. Investments in the lending program need to be timely and sufficient. Investing financial resources in too small amounts or too late may create significant operating problems for institutions.
 5. If you can't hire in the capacity then you need to spend time and resources to build it and may need to adjust expectations accordingly.

For those institutions currently offering urban microcredit, ACCION, has created a useful list of lessons learned from its experiences in Latin America on the factors it believes are necessary for success. The complete list of lessons learned²⁴ can be accessed on the Microfinance Gateway and the ACCION web site. A summary of their lessons learned includes:

- 1) MFIs must be operating in a political and economic environment conducive to microfinance in general and rural lending in particular.
- 2) MFIs must have a realistic understanding of a rural portfolio's earnings structure and its relation to the institutional mission.
- 3) MFIs must account for the increased cost of serving far fling clients with little collateral and must be prepared to deal with human resource issues unique to rural areas.

Factors affecting success include: context, mission and profitability, degree of dispersion, collateral, HR, group loan officers, portfolio diversification, product mix, product adjustment, standardization, technology, and alliances.

ACCION found that an institution should only begin the move from urban into rural when the organization is ready to do it and that the minimum requirements include a "clear vision and commitment to rural expansion at board and management level; thorough market research (and small pilot

²⁴ Manndorff (2004).

tests); sufficient human capital and financial resources dedicated to rural expansion; adequate technology and infrastructure”.

Although each of these lessons given above are specific to the organisation facing them, some of the lessons presented by the research papers used in this document or in the examples from MEDA’s own activities may possibly be transferable to other organisations and areas. Managers are encouraged to explore the findings of these documents and institutions to determine what may be applicable within their own. It is through such evaluation and analysis of both the successes and failures elsewhere that organisations may be able to improve their own agriculture credit activities, services and products.

Conclusion

There is not one specific easy answer on how to make agriculture credit work in all countries for all clients in all locations all of the time. There are however, general and specific ideas coming from recent research and existing institutions that provide potential frameworks for analysis and practical examples for evaluation. This research and experience may be useful to organisations who are new to the area of agriculture lending (among other rural financial services) as well as those who are interested in improving their own effectiveness, outreach and impact with their rural clients. While there is still a definite need to continue the dialogue between policy makers, donors, governments and practitioners on agriculture credit and the wider topic of rural finance to ensure ongoing learning and effective project design, rural finance organisations by examining what is working and what has been learned in different regions can begin to determine what may make agriculture credit work in their own areas of operation.

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The author acknowledges the importance to rural communities of access to additional financial services such as savings, insurance and remittances as well as to alternative types of institutions including community banks, self-help groups, ROSCAS and in-kind programs. Although it was beyond the scope of this paper and the authors specific experience to explore these services and approaches, the omission was in no way meant to diminish their role in rural economic development.

Tools & Resources

This section is a list of articles, papers or other documents and tools that were reviewed during the course of writing this paper and which I felt may be interesting or useful to practitioners working in rural areas.

Recommended Reading / Resource List

1. CGAP occasional Paper: managing risk and designing products for agricultural microfinance: features of an emerging model
2. CGAP Information Notes: Microfinance institutions moving into financing for Agriculture
3. Christen, Robert P., and Douglas Pearce. *Managing Risks and Designing Products for Agricultural Microfinance: Features of an Emerging Model*. CGAP Occasional Paper, No. 11. Washington, D.C.: CGAP, August 2005.
4. Manndorff, Hannes. *ACCION's Experiences with Rural Finance in Latin America and Africa*. ACCION InSight No. 11, August 2004.
5. Miller, Calvin. *Twelve Key Challenges in Rural Finance*, FAO, 2004. <http://www.seepnetwork.org/content/library/detail/2062>.
6. Nagarajan, Geetha and Richard L. Meyer. *Rural Finance: Recent Advances and Emerging Lessons, Debates and Opportunities*. Reformatted version of Working Paper No. (AEDE-WP-0041-05), Department of Agriculture, Environmental, and Development Economics, The Ohio State University (Columbus, Ohio, USA) 2005.
7. WOCCU. *A Technical Guide to Rural Finance: Exploring Products*. WOCCU Technical Guide No. 3, December 2003. http://www.woccu.org/development/guide/RF_tech.pdf
8. Rural Finance learning centre – documents, manuals and tools
9. Ag production lending toolkit - GTZ

Twelve Key Challenges in Rural Finance – Calvin Miller

<p>1. Vulnerability constraints</p> <ul style="list-style-type: none"> • Systemic risk • Market risk • Credit / financial risks 	<p>ISSUES</p> <ul style="list-style-type: none"> • Weather • Plagues, diseases • Prices • Production • Useable collateral • Demand preferences • Health & family needs
<p>2. Operational constraints due to</p> <ul style="list-style-type: none"> • Low investment returns • Low investment and asset levels • Low geographical dispersions 	<p>ISSUES</p> <ul style="list-style-type: none"> • Low growth potential • Low velocity of capital • Non-competitive technologies • Lack of market integration • Lack or quality of roads and communication • Low efficiencies of business operations • High operating costs
<p>3. Capacity constraints including</p> <ul style="list-style-type: none"> • Infrastructural capacity • Technical capacity and training • Social exclusion • Institutional competency 	<p>ISSUES</p> <ul style="list-style-type: none"> • Lack of business investment • Lack of competitive technologies • Lack of roads • Lack of communication • Lack of education • Lack of technical and management skills • Lack of institutional capacity • Lack of social representation (civil society)
<p>4. Political and regulatory constraints</p> <ul style="list-style-type: none"> • Political and social interference • Regulatory framework 	<p>ISSUES</p> <ul style="list-style-type: none"> • Political interference • NGO “donation” interference • Cultural and gender constraints • Land tenure laws • Financial regulations • Tax policy

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