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ACCION's Experiences with Rural Finance in Latin America and Africa

With rural poverty accounting for 63 percent of poverty worldwide, the importance of making microfinance services available beyond city limits is clear. The rural poor constitute both the greatest unmet need and the largest unserved market for microfinance services. Providing financial services to the rural poor can address problems associated with high levels of poverty, low levels of production, and rural-urban migration. ACCION's objectives in rural microfinance are to extend the frontier of sustainable microfinance beyond urban areas by overcoming cost barriers, mitigating risk, and exploring technological and methodological innovations.

Facing stiff competition and market saturation in some urban markets, urban-based microfinance institutions (MFIs) are increasingly finding that rural areas offer significant business opportunities. In high-competition countries, especially in Latin America, rural areas are generally characterized by lower levels of competition.

Yet MFIs are also aware of the challenges rural areas pose in terms of costs and risks. As these microfinance leaders systematically, profitably and on a large scale penetrate rural areas, they offer a roadmap to other urban-based microfinance institutions.

In the past two years, ACCION has worked with several institutions in Latin America and Africa to institute or expand rural lending programs. These efforts have resulted in successful rural penetration as well as a range of microcredit products adapted for rural areas. This InSight provides a brief listing of the experience of ACCION's affiliates and partners in rural areas and relates lessons gleaned from that experience on how urban, commercially-oriented microfinance institutions can enter rural markets.

Defining Rural Microfinance

Rural microfinance is generally defined as financial services provided to the economically active poor – including small scale producers, store and business proprietors, as well as those involved in farming, animal husbandry, and other agricultural concerns – who reside in rural areas. Yet, the definition of rural area depends on the specific context of each country as well as each institution. In Mexico, for example, the government defines rural as everything outside the federal capital, and in Paraguay cities with fewer than 100,000 inhabitants are considered rural. Some institutions define “rural” according to activity, implying that clients pursuing agricultural activities are rural, even if they operate in larger cities. Most ACCION partners have adopted a geographic definition that generally includes all areas outside principal cities, regardless of the activities pursued by clients. Market towns become important focal points for rural finance.

Rural Finance Experiences

Banco Solidario – Ecuador

Banco Solidario, a commercial bank based in Quito, Ecuador, was the first social mission-bearing financial institution in Latin America established with 100 percent private capital. As of March 31, 2004, Banco Solidario was serving 87,000 microfinance clients, through 14 branches, with an active portfolio of over \$74 million. In September 2001, Banco Solidario and ACCION International began implementing a rural lending program, which included adjusting Banco Solidario's individual working capital loan product to rural conditions. Once the pilot of the individual product moved to a roll out phase, ACCION and Banco Solidario began developing rural group loan products. By the end of 2003, the rural lending program was reaching nearly 4,000 individual and group borrowers with a portfolio of nearly \$5.4 million. Banco Solidario's strategy has been to move gradually into rural areas and to provide a wide range of rural loan products from which clients can choose.

El Comercio – Paraguay

El Comercio Financiera is a Paraguayan finance company offering a broad range of products. It has been offering microenterprise loans since 1998. There are nine branches nationwide, four of which are in rural locations. As of March 31, 2004, El Comercio was serving a total of 6,900 microfinance clients with an active portfolio of nearly \$3 million.

In 2000, El Comercio and ACCION successfully launched a rural lending program, based on individual loans. By March 31, 2004, El Comercio had more than 4,000 active rural clients with an active portfolio of \$1.9 million. The portfolio at risk of the rural program is lower than El Comercio's total portfolio at risk. ACCION and El Comercio are currently preparing for the launch of a rural group loan pilot to complement the individual rural loan product.

Initially, El Comercio focused its rural loan product on the Paraguayan Mennonite community. Because this is a close-knit group, the benefits of El Comercio's products were advertised by word of mouth, enabling the rural loan portfolio to grow rapidly. More recently, El Comercio has expanded its rural loans to other communities. Furthermore, El Comercio has had success by partnering with input providers, organizations that offer in-kind credit to farmers while simultaneously acting as buyers for their goods. Because the buyer is already in place, this arrangement allows El Comercio to provide loans to single-crop farmers, despite the higher risk.

Uganda Microfinance Union – Uganda

Uganda Microfinance Union (UMU) has become one of the most important microfinance institutions working in Uganda today. By the end of 2004, UMU plans to transform into a Micro Deposit-Taking Institution (MDI), a microfinance company regulated by the Bank of Uganda. At March 31, 2004, UMU was serving 30,500 active borrowers through its network of 18 branches located throughout Uganda. With an active portfolio of \$7.1 million, the outstanding average loan balance is \$235.

Since it began in 1997, UMU has focused on serving rural and peri-urban clients, with six branch offices located in rural areas. It follows a policy of alternating urban and rural branch openings in order to maintain its commitment to rural areas while meeting its financial goals.

In 2004, ACCION and UMU are working on an initiative sponsored by USAID and Hewlett-Packard to use point-of-sale device technology to reach deeper into remote areas. The POS devices will be installed at third party transaction sites, such as retailers. Instead of having to travel to UMU branches, clients will be able to visit select local merchants to make loan payments or deposits, to receive loan disbursements or to withdraw savings. In this way, the technology will allow UMU to reach more remote clients more efficiently.

Compartamos – Mexico

Compartamos is a regulated microfinance institution based in Mexico City, with operations in 78 locations throughout Mexico, particularly in the rural states of Chiapas and Oaxaca. Using a village banking methodology, Compartamos has achieved high rates of growth and reaches nearly 220,000 clients, making it the microfinance lender with the largest client base in the Western Hemisphere. Nearly all of its clients are women, and the average loan size is approximately \$280. Many of these clients are the heads of their households; some are employed in basic income-generating activities such as trading food and crafts, while others work in agriculture. The majority of Compartamos' clients live in rural communities with limited access to education, public services and financial services. Unlike most of ACCION's other partners, Compartamos began as a rural-based institution and has more recently moved into urban areas.

Banco do Nordeste – Brazil

Banco do Nordeste is a public development bank covering northeast Brazil, the poorest region of the country. It has a large network of 165 branches that reaches deep into the small towns and which had traditionally been underutilized due in part to the failure of traditional rural products. Beginning in 1998, ACCION worked with Banco do Nordeste to create a microfinance product, CrediAmigo, using the solidarity group methodology. CrediAmigo was able to achieve scale and profitability very quickly because it capitalized on underused infrastructure and personnel. Today it is one of the largest microfinance operations in Latin America, with over 140,000 clients. In order to reach more deeply into rural areas, Banco do Nordeste is now considering adapting a village banking methodology based on the methodology of Compartamos.

Génesis – Guatemala

Génesis, one of ACCION's longstanding partners, is one of the leading microfinance NGOs in Guatemala. It has a largely urban-based clientele, but also reaches rural women through a small village banking operation. Currently, 64 percent of Génesis' clients are women. At March 31, 2004, Génesis was serving nearly 35,000 clients through 39 branches. At year-end 2003, its rural village banking program, had 15,246 clients and a portfolio of \$4.2 million, with an average loan balance of \$274 and portfolio at risk of 2.8 percent. Genesis' individual loan program reaches 14,178 clients with a portfolio of \$8.4 million and a portfolio at risk of 6.7 percent. The average individual loan balance is \$590.

Lessons Learned from ACCION's Experiences in Rural Finance

The success of a rural lending program is dependent upon a wide range of variables. The following section describes these variables and the lessons learned from rural lending programs at ACCION's partner MFIs. First, MFIs must be operating in a political and economic environment conducive to microfinance in general and rural lending in particular. The MFI must have a realistic understanding of a rural portfolio's earnings structure and its relation to the institutional mission. Furthermore, MFIs must account for the increased cost of serving far-flung clients with little collateral, and must be prepared to deal with human resource issues unique to rural areas.

Strategies to reduce risk, such as portfolio diversification, and to attract clients with new and adjusted products are also explored. Finally, this section addresses strategies to make rural products viable such as standardization of methodology, the development of technology to increase efficiency and the formation of alliances with other institutions to defer costs.

Context Factors

The success of rural financial intermediation is heavily dependent on the socio-economic as well as legal, regulatory and supervisory environment. In Mozambique, for example, the environment may still be too adverse to implement successful and sustainable rural finance programs: rural areas are characterized by low population density, poor infrastructure, limited diversification of income sources among and within rural households, and restricted participation of the rural poor in the cash economy. Under these circumstances, rural finance is extremely difficult and financially unsustainable, at least in the short run.

In other countries, ACCION partners found that there were no simple hypotheses about poverty level and rural location of clients. For example, both Banco Solidario in Ecuador and El Comercio in Paraguay learned that poverty does not necessarily increase by distance from urban centers. In Ecuador, some of the poorest clients live on the outskirts of urban centers but still engage, at least partly, in agricultural activities. Both in Ecuador and Paraguay those clients further away from the cities tend to have larger land holdings. Banco Solidario discovered that in nearly all of the areas it operates there are all types of clients. It has adjusted its lending approach accordingly, offering a range of loan products in all areas.

The legal, regulatory and supervisory environment can greatly affect the performance of MFIs operating in rural areas. Interest rate caps, a reality in many Latin American countries, may restrict financial intermediaries from fully recovering their costs, a particularly formidable issue in rural lending. In some cases, regulations constraining interest rates, methodology or security of regulated MFIs give a comparative advantage to NGOs.

Mission and Profitability

While all ACCION partners have a clear social mission, earnings are also highly valued. These dual goals of reaching the poor while turning a profit can be difficult to balance. It often takes time for management to accept rural expansion as a valid business strategy and even more time to implement the necessary changes associated with this strategy. Yet, rural lending will only become truly successful if MFIs are fully committed to it, which may mean accepting lower profit margins and pursuing volume instead.

Several of ACCION's urban-based MFI partners have discovered that moving into rural areas comes with considerable advantages: there is usually less competition, clients are more open, and tend to have a higher willingness to repay than in urban areas. El Comercio even found that rural clients can be more profitable than urban ones, primarily because loan sizes are larger. The recent financial performance of Compartamos has also been outstanding, in spite of its focus on peri-urban and rural clients. Yet, for other ACCION partners, rural activities have proved less profitable than urban loans, mainly because costs are higher and margins are lower in the rural areas.

Widely-dispersed Clients

The wide dispersal of rural clients means that loan officers have to travel longer distances and work more autonomously than their urban colleagues. Some ACCION partners, such as *Compartamos*, maintain only a minimum number of branch offices, with loan officers regularly traveling to the rural communities and performing all loan and savings activities in the field. At *El Comercio*, loan officers often stay for several days in the communities they serve without going back to the branch office. Other strategies to both lower transaction costs and assure good client service include the use of mobile branch offices or small satellite offices in markets or low-density locations.

Effective decentralization also requires decentralized decision-making. This includes clearly established approval limits for loan officers, with more experienced and well performing loan officers having the authority to approve loans up to a certain amount without higher levels of approval. However, decentralized decision-making requires adequate checks and balances. Effective management information and internal control systems are a pre-requisite in this respect. As will be discussed in more detail in the following section, increased demands on the capacity of rural loan officers means that human resource management and training should be at the center stage of any rural expansion strategy.

Collateral

Rural low-income individuals often lack the physical assets required as conventional bank collateral. ACCION partners have therefore developed innovative approaches using a wide range of non-conventional securities, including household appliances and furniture, farm equipment and machinery, livestock and future crop. The effectiveness of most of these securities is based more on psychological pressure than on their market value. Based on the observation that honesty and solidarity is usually stronger in rural than in urban areas, some ACCION partners offer group loans with different forms of joint liability guarantees to the rural clientele. Most MFIs combine the different forms of collateral, some even individual and group guarantees, depending on the profile of the client and the risk level.

Recruitment, Training and Motivation of Staff

As the most important link between the financial institution and the client, loan officers are institutions' most valuable assets. In the case of some rural loan products, such as village banking, loan officers are often the only link between the MFI and the client. Loan officers are often in charge of all of the stages in the lending process, from promotion to client selection, loan assessment, monitoring and recovery.

Some ACCION partners expanding from urban to rural areas have initially resisted building a separate rural loan officer force, holding that a unified corporate identity should be maintained and staff should be able to move from one department to the next. Yet experience has shown that urban loan officers transferred to rural areas have not performed as well as loan officers that have been hired specifically for rural areas. In fact, often successful rural loan officers have an entirely different background and skill set than urban loan officers. In many cases, educational backgrounds in agronomy have proven to be more valuable for rural loan officers than formal education in finance or business administration, primarily because financial skills can be taught more easily to agronomists than agronomy can be taught to graduates with finance degrees.

MFIs expanding to rural areas also need to take precautions that rural loan officers do not feel less valued than their urban colleagues, who may seem to have a higher social status, with more expensive clothes and more time spent in the office. To minimize the feeling of inferiority among rural loan officers, management should clearly convey its full commitment to rural expansion. Appropriate incentives, such as a performance-based system for rural loan officers that enables them to earn as much or more than their urban colleagues, are effective. Yet given the cyclical nature of rural activities, an effective and fair incentive system is typically more difficult to prepare for rural loan officers than for urban ones.

The required skills and desired attributes of loan officers offering rural group products are very different from those for individual loans. Group loan officers operating in rural areas must not only possess agricultural and financial skills, but also act as facilitators, conflict managers and motivators. Group loan officers should come from or have close ties with the communities they work in, and importantly, they should speak the local languages. Because of these qualifications, recruiting, training and retaining is generally more difficult for group loan officers than for individual loan officers. In addition, ACCION's experience has shown that office staff of MFIs accustomed to urban clientele tend to find it difficult to adjust to rural clients who may be less educated and less proficient in financial matters. It is thus essential that branch offices attending rural clients actively promote an open attitude of all staff vis-à-vis rural clients, preferably by recruiting customer service staff from the communities served.

Reducing Risk through Portfolio Diversification

The unpredictable impact of weather, pests, price volatility and natural calamities on farm production means that rural lending is inherently risky. Loan portfolio diversification is the most important strategy to protect the rural lender from such covariant risks. ACCION partners moving into rural areas have tried to diversify their portfolios by financing a mix of loans with different purposes, loan terms and repayment schedules. The rural portfolios of all ACCION partners contain a large percentage of loans for trade activities and small-scale off-farm production, with agricultural finance comprising only between 20 and 50 percent of the entire rural portfolio. In addition, these MFIs recruit borrowers who are located in different agroecological zones. To institutionalize this risk mitigation strategy, some MFIs have set ceilings on the share and volume of total agricultural loans by zone. Diversification of the rural loan portfolio in terms of location and lending purposes also helps to balance the uneven workload due to the seasonality in agricultural lending. It also improves the match between MFI assets and liabilities. Finally, on a broader scale, institutions diversify risk through the balance of urban and rural activities.

Most rural lenders associated with ACCION do not accept single crop farmers and require their clients to have a diversified income base in order to increase the chances of repayment. The relatively long time period between the decision to plant a crop and harvest means that market prices are unknown at the moment a loan is granted. Risk is too high if there is no other income source to fall back on in case the single crop fails to generate the expected income. This limitation means that the lending techniques currently available are only appropriate in rural areas where families have a mix of activities – conditions that prevail in much of Latin America, and parts of Africa, such as the highland areas of East Africa. Diversification of income sources is of course an important risk reduction strategy for client families.

Nevertheless, experience among ACCION partners has shown that under very special circumstances the financing of monocultures may be viable. *El Comercio*, for example, has financed soy production, but only because international market prices for soy have been stable for some time, the repayment willingness of the communities served has been outstanding, climatic and soil conditions are excellent, and special agreements with agricultural input providers have been established. To further reduce risks, *El Comercio* prefers to finance only the final stages of the soy production, i.e. the last three or so months of the six month production cycle. *Banco Solidario* is financing single crops if an experienced client in a highly productive zone has several plots with the same crop but at different production stages, which is possible for only a few types of crop.

Product Mix

Expanding services into rural areas has fostered innovation among ACCION and its partners – particularly in terms of product development. *Banco Solidario*, for example, offers an adjusted rural individual loan product, solidarity group loans, enlarged solidarity group loans, and village banking. In addition, savings and money transfer products are offered to all rural clients. Other ACCION partners offer both individual and group loans to their rural clientele as well as savings services. ACCION partners have found that it is important for clients to have access to alternatives and to have the possibility of graduating from one loan product to the next. A broad range of products helps institutions provide good client service and thus retain clients, as well as to expand outreach, diversify portfolios, exploit urban-rural flows, and reduce overall lending risks. This broad range also helps to generate a larger client base from a given geographical area, increasing the productivity of rural branches.

Taking this one step further, the approach of UMU in rural areas is to serve everybody within a certain distance from the branch office. While most MFIs only finance microentrepreneurs, UMU, as an integral part of its rural penetration strategy, also serves rural schools, health posts, and different types of associations. Point-of-sale devices for rural merchants and savings and money transfer services further complement the strategy to turn every rural branch into a viable and profitable unit.

Product Adjustment to Meet Rural Client Needs

Most ACCION partners have learned the value of client focused lending in their urban contexts. The advantage of urban-based MFIs moving into rural areas is that they can transfer their know-how about client service to the rural setting. In particular, individual loan products can be adjusted to the specific needs and preferences of each client. The loan amount and repayment schedule should be set according to the repayment capacity of the client, taking

into account all household income sources as well as business and household expenses. When financing agricultural production or livestock enterprises, repayment schedules are adjusted to the projected household cash flow, accommodating fluctuations month by month. ACCION partners usually do not set minimums or maximums for individual loans, even for first loans, and try to be as flexible as possible with regard to collateral options. While balloon payments, in which the entire principal is paid back at the end of the loan term, but interest is paid monthly, are usually considered to be very risky, some ACCION partners have adjusted their lending mechanisms to serve clients that request such repayment schedules. Another innovative response to the idiosyncrasies of rural conditions has been the provision of seasonal credit in peak months.

Group lending does not offer as much room for flexibility as individual lending. Most ACCION partners do not view group loans as adequate mechanisms to finance agricultural activities, primarily because of limited loan sizes and regular repayment schedules. Clients prefer to use group loans to finance their secondary income activities or to bridge short-term liquidity needs. Typically, the solidarity group loan products offer greater flexibility to clients than village banking products, and ACCION partners such as UMU are continually making adjustments to the methodology to increase flexibility, for example stretching the range of loan sizes and repayment terms within a single group.

Customer service also means immediate response to client needs. Especially in agriculture, investments can usually not be postponed and delays in access to finance can endanger an entire crop. ACCION partners generally have very strict standards for loan approval times, from less than a day for repeat loans to a maximum of four days for first loans.

Standardization

To counter-balance the costs of responding flexibly to client needs and preferences, a high degree of standardization is necessary. For most rural lenders this means offering only one or very few loan products. However, some ACCION partners have focused on reaching a high level of standardization within products as well as across organizational processes, while still offering a wide range of loan and savings products. Standardization usually includes very clear and strict loan policies and procedures, which outline every step as well as the overall rules of the lending process, from promotion to recovery, for every actor involved. The development of the generic ACCION rural credit manual has played an important role in this respect. A standardized system for data collection and analysis of market trends, in particular regarding yields, prices and costs by location, also helps in standardizing loan assessment and approval procedures as well as managing risks.

Technology

In rural finance, technology plays two key roles: implementing effective internal control when direct supervision is difficult due to distance, and decreasing the cost of penetration into more remote areas. Some partners operating in rural areas are considering the implementation of ACCION's PortaCredit technology, which allows loan officers using handheld computers to take loan applications.¹ PortaCredit has helped a number of ACCION partners in Latin America improve their level of productivity, standardization and risk management. *UMU* in Uganda is currently launching a pilot for a Remote Transaction System (RTS), which is

¹ See ACCION InSight 9: ACCION PortaCredit: Increasing MFI Efficiency with Technology by Barton and del Busto (www.accion.org/insight).

combination of technology and business processes that will enable cash deposits and withdrawals by microfinance clients through a network of accredited third party merchants (e.g. agricultural stockists, traders, gas station managers) in rural and peri-urban areas. The RTS will also facilitate the electronic capture of transaction data at the client level and the creation of an electronic identification system. At a more basic technological level, in some cases, motorcycles have been an important factor for improving the productivity of loan officers working in rural areas.

Alliances with Input Providers and National Banks

Collaboration and strategic alliances with other rural institutions can significantly reduce costs and risks for MFIs. *El Comercio*, for example, closely collaborates with agricultural input providers, who grant farmers in-kind credit. *El Comercio* in turn provides loans to the same farmers, so that they can cover the costs of all stages of the production cycle, including expenses for agricultural labor and transportation. The input providers also act as buyers, thus ensuring loan repayment for themselves as well as the MFI. This arrangement allows *El Comercio* to provide loans even to single-crop farmers. Interlinking the supply of agricultural inputs with credit and output marketing only works well in single-channel marketing systems. Where alternative marketing outlets exist, loan repayment may not be as certain.

Compartamos has established a strategic alliance with one of the largest national banks in Mexico, profiting from its extensive branch network. Disbursements are made by checks and repayments are received at teller windows at this bank, which helps *Compartamos* to keep its own branch network relatively small and costs low. Additionally, close contacts with local organizations and networks, such as government extension services or local NGOs, provide relevant client information, which helps to reduce the time and costs of client selection, loan appraisal and loan monitoring.

Strategies for Reaching Rural Clients

ACCION has learned a great deal in the past two to three years regarding the institutional development requirements for a primarily urban-based and commercially-operating microfinance institution to move into rural areas. It has found that the process should only be initiated when the MFI is ready for it. The minimum requirements for the MFI to expand into rural areas include:

- A clear vision and commitment to rural expansion at board and management level
- Thorough market research
- Sufficient human capacity and financial resources dedicated to rural expansion
- Adequate technology and infrastructure

A thorough market research study conducted by a research company with experience in finance as well as rural areas should be the first step in any expansion process. This research should also include the assessment of whether the minimum conditions for a sustainable expansion are met. Small pilot tests should precede full-fledged expansion. Moreover, products and practices should be continuously reviewed and adjusted as a result of these learning processes.

Urban-based MFIs have the advantage that they usually have well-tested loan products for urban areas. ACCION partners reaching into rural areas have gradually adapted their urban

lending methodology to the rural settings. The general principle has been to begin with the easier challenges and to address the more difficult ones as the former are successfully addressed. Thus, the individual loan product is first reengineered and adjusted to the local context and subsequently a group loan product is launched. Both Banco Solidario and El Comercio have successfully followed this strategy.

Similarly, the selection of areas to start a rural lending operation should be based upon accessibility, client concentration, production risks, diversification of household income sources, and credit culture. Rural lending starts in areas that are more accessible and present low risks, with operations gradually expanding to the more risky areas. This usually means working outward from population centers, such as cities, towns or market centers. In addition, the lending methodology should be more conservative during the initial phase of the pilot. For example, balloon payments or financing of monocultures might only be allowed for in the second year of the pilot. In summary, rural expansion requires a high level of capacity and expertise and MFIs should be given sufficient time to gradually but steadily move into rural areas.

This *InSight* was written by Hannes Manndorff with valuable input from ACCION's Rural Finance Working Group, which includes Susana Barton, Monica Brand, Luis Orlando Cardenas, Mauricio Casteneda, David Dewez, Tiodita Mori and Elisabeth Rhyne. Mr. Manndorff is ACCION's representative in Europe and member of the Africa technical assistance team.

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