Successful Rural Finance Institutions

JACOB YARON

BURDENED with low collection rates, heavily dependent on subsidies, and lacking innovative management, rural finance institutions (RFIs) as a group have not turned in a sparkling performance over the last decade. Yet a few successful RFIs have demonstrated that these institutions can be effective in providing creative financing to rural populations.

In order to receive credit for agricultural operations, low-income farmers in Thailand form small lending groups whose members are collectively liable for each farmer's loan. The group members typically live close together, know each other well, and decide among themselves who will be admitted. Borrowers are effectively screened, and peer pressure keeps default rates low because the group's access to future loans is conditional on full and prompt repayment.

Joint liability and other nontraditional techniques have been adopted by four of the most prosperous Asian RFIs: the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, the Grameen Bank in Bangladesh, and the Badan Kredit Kecamatan and the Bank Rakyat Indonesia Unit Desa in Indonesia. Like all RFIs, these four were originally established in developing countries to promote growth in low-income rural sectors by providing local farmers with affordable credit. While other RFIs have foundered, seemingly unable to meet their goals of servicing the rural poor, these institutions are well on their way to becoming self-sustaining, full-service "banks" for rural populations.

The key to their well-being lies in their innovative financial policies and delivery mechanisms, which respond to the very issues that have stymied other RFIs—dependence on subsidies, a low level of outreach, and lackadaisical administration. Recent World Bank research has developed new methods of measuring RFIs' success that help explain exactly how this has been done.

Why RFIs fail

The failures of most RFIs demonstrate why innovation is the key to the success of these institutions. Using traditional banking methods, RFIs in general have been unable to mobilize the voluntary savings necessary to offset their sizable loan portfolios. This has occurred in part because inadequate and depressed deposit interest rates—the result of easy access to cheap funds from state and international donors—have discouraged savings. Compounding this problem have been the administratively capped on-lending interest rates that are widespread in developing countries. These rates have not compensated RFIs for the risks and administrative costs of lending to small agricultural operations.

Faced with these dilemmas, RFIs have tended to favor large entrepreneurs, crowding out small farmers in an effort to minimize risk and transaction costs. The result has been institutions that are often little more than disbursement windows rather than balanced, full-service banks. Further, because RFIs are not under the same pressure as private banks, managers have not been motivated to introduce credit evaluation and follow-up procedures that would improve loan collection performance. Shoddy financial reporting practices make it almost impossible to determine when payments are overdue and what part of the loan portfolio is nonperforming or beyond recovery.

These are the primary issues the four Asian RFIs have addressed, and the World Bank's newly formulated measures indicate that these efforts have been highly successful.

Measuring performance

Given the widespread deficiencies and unique objectives of RFIs, finding adequate ways to measure performance has not been easy. Just as traditional banking methods have not served the RFIs well, traditional indicators, such as accounting profit, do not take into consideration the RFIs' goals or the subsidies required to keep the institutions afloat. The World Bank research proposes two primary criteria for judging the success of RFIs—level of outreach and degree of self-sustainability.

Outreach. The types of clients RFIs serve and the variety of financial services they offer determine the level of outreach. The four Asian RFIs serve the rural poor or low-income farmers, but with distinct definitional differences. For instance, Badan Kredit focuses on off-farm activities. Grameen Bank, on the other hand, hopes to improve overall economic conditions by financing all income-generating activities. It also provides nonfinancial services in the areas of education, health, and sanitation and supports other socially oriented programs. Unit Desa and the BAAC have directed their efforts toward low- to medium-income clients. Unit Desa has aimed at serving the rural population as a whole, while the BAAC has confined its lending to agricultural producers.

Other indicators of outreach help give a clearer picture of an RFI's success. They include the value and number of loans and savings accounts, the types of financial services offered, the number of branches and village posts established, the percentage of total rural population served, the annual growth of RFI assets over recent years (in real terms), and the participation of women. All of the thriving RFIs did well in at least two of these areas.

Growth is also often assessed as a component of outreach, but any measure of growth must take into account an RFI's stage of development. An established RFI may have a low growth rate, yet still be quite successful. In 1989, the newest of the four RFIs, Grameen Bank and Unit Desa, had real growth rates over three years of 34 percent annually. The more established RFIs, the BAAC and Badan Kredit, had significantly lower growth rates (around 15 percent and 4 percent, respectively, in 1989).

Self-sustainability. An RFI is said to be self-sustaining when its income equals or exceeds its expenditures, including imputed factors such as the opportunity costs of its equity. Traditionally, RFIs have been dependent on various types of implicit or explicit subsidies, including differences between market rates and rates paid on concessional borrowed funds, losses on foreign currency-denominated loans absorbed by the state instead of the institution, obligatory deposits made by other financial or public institutions in the RFI at below-market rates, direct reimbursement of some or all operating costs, and exemptions from a reserve requirement or forced investments. The subsidy dependence index (SDI) measures the extent of an institution's reliance on such subsidies (see box).

The subsidy dependence index

Financial self-sustainability can be viewed as the inverse of subsidy dependence. A subsidy dependence index (SDI) is suggested for tracking the progress of an RFI in reducing its dependence on subsidies and for comparing the subsidy dependence of different RFIs providing similar services to a similar clientele. The SDI allows for a sensitivity analysis that measures the percentage increase in the average, on-lending interest rate required to compensate for complete and immediate subsidy elimination. For example, an SDI of zero indicates that the RFI is fully self-sustainable; an SDI of 100 percent means that the average, on-lending rate used by the RFI must be doubled if operations are to continue without subsidies.

For simplicity, this interpretation assumes that an increase in the lending rate is the only change made to compensate for the loss of subsidies. However, the index does not imply that adjusting the interest rate is required or even feasible in all cases. The subsidy is measured against the interest the RFI earns on its annual average outstanding loan portfolio, since lending to a targeted clientele is the primary activity of a supply-led RFI.

Data indicate that the four RFIs under discussion here have differed substantially in their levels of subsidy dependence. Unit Desa was marginally dependent on subsidies in 1987 (a 3 percent SDI) and reached subsidy independence in 1989 with a remarkable SDI of - 8 percent. The speed with which Unit Desa reached financial self-sustainability may be linked to its ability to build on existing infrastructure at the village level and its tremendous success in mobilizing voluntary savings. A similar strategy helped Badan Kredit avoid large start-up investments. Both the BAAC and Badan Kredit had moderate SDIs that improved over time.

In contrast, the figures for Grameen Bank indicate a high level of dependence on subsidies. With its 1987 SDI of 180 percent, Grameen Bank would have needed to increase its on-lending interest rate 180 percent (from 13.3 percent to 37.2 percent) to compensate for an immediate elimination of all subsidies. Grameen Bank made significant progress in reducing its SDI to 130 percent in 1989 but is still far from financial self-sustainability. It is unique among the four RFIs in providing nonfinancial services to its poor clientele. These activities clearly contribute to its relatively high level of subsidy dependence. In spite of its high SDI, Grameen Bank's overall financial performance has been significantly better than that of other formal credit institutions in Bangladesh, which lend to a generally wealthier clientele, do not provide additional services, and yet are burdened with huge loan defaults.

Losing access to subsidies in the form of cheap funds often forces RFIs to increase their interest rates on loans or decrease their lending volume. This clearly would have happened to Grameen Bank, which relies on significant subsidies to support the free nonfinancial services it offers its members. On the other hand, the BAAC and Badan Kredit might have been less severely affected, while Unit Desa would not have suffered at all because it was clearly subsidy-independent.

Successful policies

The financial policies that played an important role in the success of the four Asian RFIs focused on savings, lending and deposit interest rates, loan repayment, and traditional loan security and collateral requirements.

Mobilizing savings. Although initially established as supply-led credit institutions that emphasized rural credit delivery rather than savings, all four RFIs have developed some savings services. Voluntary savings mobilization has been a significant factor in Unit Desa's growth and ability to achieve self-sustainability. The financial ratio of the value of savings to the loan portfolio and the changes in this value over time are indicative of how well an institution is doing in substituting savings for state and donor funds. Unit Desa, which reported 110 percent savings in terms of its loan portfolio in 1989, has clearly been the most successful of the RFIs in backing its loan portfolio with voluntary savings; at 20 percent, Badan Kredit has been far less successful.

Interest rates. All four RFIs charged positive real interest rates ranging from 11 percent to 130 percent annually (the highest amount was charged on only a small number of Badan Kredit's short-term loans). Real rates have generally been above 20 percent annually for Badan Kredit and Unit Desa and below

10 percent for the BAAC and Grameen Bank. Although the rates were positive and in some cases relatively high, they were significantly lower than those in the informal money markets, the sole borrowing alternative for the RFIs' clients.

This apparent willingness to support even high interest rates suggests that for poor rural borrowers, access to credit—not low interest rates—is the most important aspect of financing. In fact, the returns on the investments made with the borrowed funds were high enough to sustain most loan repayment schedules, as the high rates of loan collection demonstrate.

An RFI's ability to charge positive interest rates often hinges on the repeal of interest rate ceilings and the liberalization of financial markets. In the 1980s in Thailand and Bangladesh, respectively, the BAAC and Grameen Bank operated with legally imposed ceilings on loan interest rates. In Indonesia, however, Badan Kredit and Unit Desa were free to adjust their lending rates.

Loan collection. For RFIs, self-sustainability frequently depends on loan collection, since costly loan losses are the principal cause of insolvency, illiquidity, and increased reliance on state bailouts. The four RFIs discussed here reported high annual loan collection rates of 80–98.6 percent, and belated repayments significantly reduced potential losses. The RFIs used an array of incentives to instill financial discipline and build lender-borrower relationships. For example, both Badan Kredit and Grameen Bank, the RFIs targeting the lowest-income clientele, required borrowers to put aside at least 5 percent of the face value of the loan as obligatory savings. This exposure to financial services helped new customers accept financial discipline and reduced the lenders' credit risk.

Another method of promoting financial discipline involved interest rate rebates. The two Indonesian RFIs offered a monthly interest rebate of 0.5 percent (Unit Desa) and 1 percent (Badan Kredit) of the original loan value as an incentive for prompt repayment. Instead of providing a rebate, the BAAC imposed an annual penalty rate of 3 percent on arrears, or about one quarter of its nominal loan interest rate.

Collateral requirements. The four RFIs' solution to the loan security problem was a vital element in their overall success. Because strict collateral requirements usually put loans out of reach of low-income borrowers, three of the four institutions departed from traditional loan policies. Grameen Bank and Badan Kredit, which make small loans, offered credit without collateral. Badan Kredit now relies on character references exclusively and Grameen Bank on the joint liability of borrowers.

The BAAC has also implemented joint liability for its small short-term loans, relying on the peer pressure inherent in small, homogeneous borrower groups. Unit Desa requires cosigners (usually the applicant's spouse), but borrowers are also required by law to provide collateral. Although it is often not cost-effective to collect collateral on bad loans, the threat of collection has probably acted as a deterrent, since defaulters attract unwanted attention if legal processes are instigated.

Delivery mechanisms that work

Delivery mechanisms have turned out to be just as important to the RFIs' success as financial policies. These mechanisms have been aimed at resolving the two most common problems RFIs face in developing countries: weak loan administration (screening borrowers, processing and monitoring loans, and mobilizing and servicing voluntary savings efficiently) and ineffective loan collection procedures.

Jacob Yaron
an Israeli, is Rural Finance Advisor in the Bank's Agriculture and Natural Resources Department. He was educated at the Hebrew University in Jerusalem.

Loan administration. All four of the RFIs reviewed process loans efficiently, so that first-time borrowers typically receive their money within one or two weeks of submitting their applications. In part, this improved efficiency is due to incentive programs that tie RFI employee bonuses to quantifiable performance criteria. Badan Kredit, for instance, has distributed as much as 10 percent of a branch's profits to staff, and Unit Desa awards a yearly bonus of up to one month's salary for outstanding performance. Grameen Bank promotes staff members based on branch profitability and also distributes up to 10 percent of annual branch profits to employees. In addition, all four RFIs consider staff training crucial to success.

Another reason these RFIs are able to process loans quickly may lie in their incorporation of existing social structures, or peer groups, into the lending process. For example, because determining the creditworthiness of potential borrowers has been one of the principal problems facing RFIs, the two Indonesian institutions have relied on the social cohesiveness in rural Indonesia and the authority of the village leader to provide adequate information on loan applicants. A sound collection record enhances not only the status of the village head but also that of his community, increasing the chances that more members will be able to borrow in the future. The penalty for poor repayment is strict: additional future borrowing is prohibited.

Lending to small groups formed by potential borrowers who are collectively responsible for repayment serves several purposes. Small groups (Grameen Bank prefers 5 members, although the BAAC permits up to 30) that are both socially and economically homogeneous generate a sense of belonging and a clear perception that each individual's performance is crucial to the group's overall success or failure. Motivated group members tend to monitor their more lax peers, for no group member can receive further credit until the entire group's debts are repaid. These groups therefore eliminate or drastically reduce the "free rider" problem.

The BAAC and Grameen Bank have relied heavily on this type of self-help group to promote and deliver loans and to provide a link with individual borrowers. Grameen Bank's groups hold routine meetings that allow members to review loan applications. The open, face-to-face dialogue used in these meetings encourages and builds accountability. In addition, the meetings touch on social, educational, and health-related issues, generating a stronger sense of solidarity that reinforces pressure on members not to default.

The RFIs have also utilized components of "mobile banking" as an innovative means of providing low-cost saving and lending services to very poor clients. Badan Kredit staff visit a different village each day of the week (often market day), collecting deposits and weekly loan repayments and greatly reducing transaction costs for both client and bank. The BAAC offers assistance in filling out loan applications at the village level, although disbursements and repayments are handled at central branch locations.

Loan collection. To encourage borrowers to pay back their loans on time, the four RFIs reward borrowers who adhere to payment schedules with moderate increases in credit eligibility. In addition, repayment is tailored to clients' needs. The two Indonesian institutions offer flexible payment schedules that borrowers can adjust according to cash-flow patterns. Badan Kredit's standard 3-month loan repayment plan makes calculating the 12 weekly payments easy, even for inexperienced or illiterate clients, and contributes to customer confidence.

In contrast, the BAAC and Grameen Bank use a rigid loan repayment structure, which nevertheless has been instrumental in maintaining financial discipline. Grameen Bank introduces inexperienced borrowers to the financial system by requiring them to make regular weekly loan payments for a year. This system suits the cash flow of the various nonprimary agricultural operations Grameen Bank targets and has cut both administrative costs and loan losses. Reflecting the agricultural crop cycle, the BAAC requires borrowers to repay short-term loans 11 months after disbursement in a balloon payment. Interestingly, borrowers facing repayment difficulties have preferred to incur the high financial costs of borrowing from moneylenders rather than jeopardize their borrowing eligibility with the BAAC.

External influences

The environment in which the Asian RFIs discussed here operate has also contributed to their success. All four institutions reviewed have enjoyed stable economic conditions in countries with annual inflation rates of less than 10 percent. This stability has contributed to reduced uncertainty, higher returns on investment, and impressive repayment rates. In contrast, an unstable economy characterized by erratic changes in relative prices and unpredictable austerity programs can abruptly curtail disposable income and adversely affect return on investments. A volatile inflation rate that raises the costs of adjusting repayments and reduces the value of savings can also render lending on a small scale impractical.

Where are RFIs headed?

Programs that have been adequate in a region with one set of social values may not offer the right approach for providing credit services to the rural poor in a different socioeconomic environment. Based on the experiences of the four RFIs presented in this study, it is clear that several critical issues must be addressed in replicating their approaches, techniques, and procedures.

- A social mechanism tailored to the client base can lower transaction costs and effectively use peer pressure for screening loan applicants and collecting loans. Reviewing both the performance record of similar programs in the region and the targeted clientele's perception of the moral obligation associated with loan collection helps define the most useful mechanism.
- Variables such as population density and infrastructure may offer special limitations or opportunities for replication of a specific approach, such as mobile banking. Replication will also depend on the economic and political conditions in a certain country or region, since previous credit experience, lending regulations, and adverse economic conditions can seriously hamper a program's success.
- Eliminating or gradually reducing subsidies helps RFIs gain long-term financial viability. Various methods of reducing subsidy dependence are available, such as applying positive on-lending interest rates that are high enough to cover financing and administrative costs while maintaining the value of the RFI's equity in real terms. Deposit interest rates can be increased in order to mobilize voluntary savings, which gradually substitute for the donor funds that have financed the loan portfolio. Finally, improving loan collection and reducing operating costs will help keep administrative overhead costs low.

However, state or donor support in the form of increased financial resources (not necessarily at subsidized interest rates) during the initial phase of an RFI's operations can contribute to the institution's success. Temporary lending from the state or donor may help close the funding gap between an RFI's savings mobilization and its outstanding loan portfolio. Because savings mobilization can be the driving force behind an RFI's growth, availability of funds, not their cost, is the primary issue. This finding strongly suggests a reduced role for subsidies.

Finally, state and donor support should concentrate on institution building. The lack of emphasis on institution building in RFIs is a common characteristic of ailing supply-led credit institutions: too few resources are devoted to training, mobilizing savings, or creating management information systems and incentive systems for clients and staff. All of these elements are essential to an RFI's transformation into a well-balanced, self-sustainable, independent financial institution.

For further information, see "Successful Rural Finance Institutions," by the author, World Bank Discussion Paper 150, January 1992.