CHAPTER 7

Rural finance

Summary

This chapter considers the link between rural finance and inclusive rural transformation. Rural transformation is defined here as long-lasting economic, social and institutional change, where rural societies diversify their economies to high-valued agriculture and non-farm activities, interact and trade with distant places, move from dispersed villages to towns and cities, and become culturally more similar to cities. *Inclusive* rural transformation ensures that conditions are in place for everyone to exercise their economic and political rights, develop their abilities and take advantage of opportunities. It leads to a marked improvement in the economic position and quality of life of small-scale farmers, the land-poor and landless, workers, women, young people, marginalized ethnic groups and victims of disaster and conflict.

Inclusive financial systems are critical in such transformations because they offer the capital needed to generate widely based and equitable growth. In transitioning countries, rapid economic growth often coexists with an extraordinary inequality in the distribution of economic gains. Rural financial inclusion is one important ingredient for stimulating local production and processing of commodities, encouraging more intensive use of productive inputs (such as improved seeds and breeding stock), promoting investment in modern technologies and providing financial opportunities to marginalized groups.[102]

Strengthened financial intermediation can provide low-income households with more consistent cash flows and better access to market opportunities, with options for mitigating risks and improving resilience to unforeseen shocks, with mechanisms for securely transmitting payments and receiving remittances at affordable cost and with reliable savings instruments. For rural enterprises, financial intermediation expands entrepreneurial options for aggregation, adoption of improved technologies and other activities that reduce transaction costs and expand value addition.

The corollary is that a lack of access to appropriate financial services is likely to hinder rural development, particularly for the rural poor. But different transformational paths – and different policies, regulations and public expenditures – affect the degree to which financial systems reduce or exacerbate income inequality. The implications for the outcomes for rural households are direct and profound.

In spite of their importance, and notwithstanding progress during the past two decades, financial systems in developing countries still exclude large segments of rural households. An estimated 2 billion working-age adults globally (38 per cent) have no access to the types of financial services delivered by regulated financial institutions, and 73 per cent of poor people are unbanked (IFAD and World Bank 2015). This amounts to more than half of the adults in the poorest 40 per cent of households in developing countries. Many of these are smallholder farmers and landless workers who rely for their cash flow on agriculture, on low-skilled wage labour, remittances and a few productive assets (such as small livestock holdings), and who often earn little or no income from capital and savings.

How can policymakers ensure that financial development accompanies structural and rural transformation and lessens inequality? Until recently, institutions have concentrated on access to credit and other financial services, which are important determinants of livelihood outcomes. When Chinese and Indian farmers were asked how they would respond to increased credit constraints, around 90 per cent indicated they would substitute family labour for wage labour, about 76 per cent would reduce agricultural inputs, 55 per cent would reduce health care and education expenditures, and 21 per cent of Chinese and 52 per cent of Indian farmers would reduce food consumption. The sale of productive assets would be a last resort (Kumar et al. 2013). Thus not only do credit constraints affect optimal input use, productivity and incomes, but the coping mechanisms that come with a lack of credit have steep impacts on social welfare.

In promoting inclusive rural finance, policymakers and funders must consider the needs of different groups and how they use services. Smallholder farmers, on- and

off-farm micro- and small businesses, female entrepreneurs, young business start-ups and wage labourers each have different needs for financial services, different preferences and behaviours, and specific constraints and risks. In addition to an affordable and reliable credit supply, crucial issues include gaps in coverage of other financial needs – payment systems and remittances, safe and affordable savings and deposits, term or seasonal loans (working capital, advances, etc.) and micro-insurance, all tailored to the diverse financial characteristics of prospective rural clients.

Navigating the links between inclusive rural finance and transformations requires particular attention to the position of informal finance, the dominant source of rural finance in a number of countries. A recent report from the International Finance Corporation (the World Bank's private-sector investment arm) contends that informal financing arrangements are insufficient to enable farmers to access better technologies and agricultural inputs (IFC 2014). Though informal finance has some advantages, such as lower transaction costs and better information, it faces limits in leveraging resources or pooling risks. For example, informal finance is normally unable to offer current accounts, versatile money transfers or risk-management facilities. These limits are costly to small-scale farmers and agribusinesses, checking their ability to compete in larger markets.

The next section presents a brief overview of developments in rural finance since the early 1980s and explains the concept of inclusive finance. The chapter then considers the gaps in outreach of rural finance and its link to structural and rural transformation. The subsequent section presents promising innovations that expand access to financial services, followed by a review of appropriate policies and investments.

Conceptualizing inclusive rural finance

Changes in rural finance since the 1980s

Since the 1980s, rural finance has shifted from state banks and subsidized credit to a pluralistic system offering a broad range of services. Until the 1980s, support to smallholder agriculture came from state-owned agricultural development banks using subsidized lines of credit. Few of the development banks were financially sustainable.

As financial sectors were liberalized, most countries retreated from ownership and management of financial institutions and from the provision of subsidized credit. With the demise of most specialized and state-owned agricultural financing institutions – and a growing realization that interest rate subsidies help the well connected more than the intended targeted borrowers – a consensus emerged in the 1990s for liberalized interest rate regimes, reduced support for state banks and cost recovery in financial services provided to poor people. New financing models were sought with increased attention to pro-poor outreach and sustainable interest rates. This was followed during the 1990s by the founding of many microfinance institutions (MFIs), not all of which have been successful.

The more successful MFIs have controlled their service costs and lending risks, integrated with the formal financial sector and adopted more sustainable business models. They stressed developing a wide range of financial services firmly built on savings. In expanding outreach, they extended their client portfolios to lower-income and mainstream rural borrowers and savers, which helped to mitigate risks, but also diffused their intended orientation to poorer households.

Early proponents of externally promoted microfinance focused more on a sustainable supply of microfinance and less on its actual uses. While microfinance initiatives generally defined target groups, institutional development was seen as a goal in itself because it filled a critical bottleneck in inclusive finance. The type of demand and the planned loan use were not the central focus, which was ensuring a reliable incentive structure for repayments. The viability of microfinance thus relied on ensuring incentives for previously excluded borrowers to repay small loans (for example, to improve their future access to financial services) and drew on group-based lending to leverage joint liability as a comparatively effective enforcement mechanism.

Proponents of a demand-centred approach emphasized the difference between what poor people in developing economies may *consider* their need for finance and the portion of the demand for loans and other financial services backed up by *realistic* financial propositions of the applicant ("effective demand").[103] This view thus continued to emphasize the need for robust demand analysis as normally applied in formal banking services. For example, first generation MFIs, such as FINCA International, ACCION, the Grameen Trust, BRAC and many others, still offer very small and peer-secured loans to small groups, but have developed increasing portions of their credit portfolio to individual small borrowers, who are "graduated" group members, and other micro and small entrepreneurs. For these individual loans, lending policies require an individual loan applicant analysis that takes the intended productive loan use as a major criterion.

The academic perspective on these policy challenges was likewise broadened. Modigliani and Miller's work (1958, 1963) had sensitized finance practitioners to the challenges of the debt-equity mix for funding firms or other small and microenterprises. Behavioural economics probed household or firm financing strategies that cannot be explained solely through traditional *"homo economicus"* perspectives. Most important, neo-institutional economics brought clarity on mechanisms, beyond price parameters, that incentivize or discourage market participants. The crucial value of information, and of quick and uncompromised access to it, constitutes one cornerstone of this school, which emphasized the role that asymmetries of information and moral hazard play in impeding or compromising financial market optimization. Many recent initiatives are built on the insights of neo-institutional economics, and address challenges related to transparency, consumer protection and moral hazard.

Already in the early 1980s, a new school of economists had started to offer a different mix of analytical tools that emphasized the importance of information and risk, and the need to consider other incentives/disincentives and market imperfections to better understand the decisions of market participants. Leading proponents, like Stieglitz, identified information asymmetries as a key variable leading to market distortions. They suggested that policymakers should promote transparency and the free flow of information as a pathway to improved credit allocation – better-informed financial institutions serve clients better. Moreover, given the absence of tools to tackle information asymmetries, better-informed village members are often in a position to capitalize first on rural finance services, excluding those who are not well connected and informed.

One approach to redress information asymmetries has been based on the principles used in community-based financial cooperatives of the Raiffeisen type. Ordinary loans, even when high in relation to the debt service coverage ratio of the loan applicant, are assessed locally on the merits of the applicant's character, capacity, capital and security, and guarantee arrangements that can be put in place by borrowers. Locally managed, founded on members' savings and extending loans based on informed assessments of each individual loan application, these community cooperatives and credit unions provide comparatively high quality services at lower cost. Indeed, they boast positive track records in many parts of the world. Their main limitations, however, may be in the scale (and scope) of their financial service provision – unless they can leverage complementary actors in the financial sector.

Defining inclusive rural finance

Attention to inclusive finance is rising as policymakers recognize that the earlier focus on *access* to financial services is, by itself, insufficient. Financial inclusion looks beyond access to participation. The IFC and World Bank (2014), for example, use a simple definition – "the share of individuals and firms that *use* financial services" – which is pertinent because of its clarity. The Consultative Group to Assist the Poor (CGAP) Guidelines for Funders define financial inclusion as a state where both individuals and businesses have opportunities to access and use a range of financial services that are responsibly provided by financial institutions (CGAP 2015).[104]

A significant difference between access and inclusion is the latter's emphasis on *behavioural* features. Potential clients may not have difficulties in access (in opening a bank account or taking out a loan), but may hesitate to use these facilities, perhaps because of risk aversion, religion or information asymmetries. In inclusive finance, overcoming constraints to using financial services becomes an important objective of financial development (Beck and Demirgüç-Kunt 2008; Demirgüç-Kunt et al. 2008). Further, the concept of use also considers the capability of targeted clients to benefit beyond the cost of service provision, as well as the degree (regularity, frequency and length of time) to which clients resort to financial instruments.

Inclusion can be defined as fulfilling *effective* demand – servicing needs that feature a higher financial return than a reasonable threshold cost of service provision. In other words, inclusive finance is concerned only with financial demand that is backed up by the realistic prospects of the applicant. Financial services may not be the appropriate way to support every rural person's livelihood. For the poorest households, a different set of policies and investments is often required, so that they can improve their assets and capabilities. The lower boundary of inclusive rural finance can, though, potentially serve as the upper boundary of social protection. Once households reach a stage where they can generate adequate financial returns to make effective use of financial intermediation, they may no longer need continued support or subsidies from social protection programmes.

New technologies continue to lower the costs of service provision and much work still needs to be done to meet the substantial expansion of effective demand over recent decades. This challenge has only partially been met by microfinance. The Reserve Bank of India's regular sector surveys on debtor behaviour and rural banking density, for example, show a clear trend – demand for term financing at reasonable rates, reliably from the same source, over many cropping seasons and for specific production-related loans. This trend reflected perhaps a steady move beyond subsistence farming and a gradual integration of the rural population into the cash economy. In response, banking densities increased considerably, and governments in the subcontinent and beyond promoted rural banks and their branch networks.

These sector surveys also show the diversification of demand, especially for money transfer services (for domestic and international remittances). The importance of deposit keeping has also developed. Other financial services that are in increasing demand include cheque and current account facilities, as well as insurance of increasingly capital-intensive and risk-prone farming systems. As small-scale rural producers integrate into domestic urban and international markets, their need for commodity trade and export finance facilities, such as letters of credit, increases.

CGAP, in its most recent exposition of inclusive finance, added quality of financial services as one further dimension of inclusive finance, in a triangular framework (figure 7.1). Quality is assessed by the extent to which financial services are appropriate for the needs of the intended users and to which service provision is sustainable and responsible. Assessment of inclusion, therefore, also requires contrasting outreach with effective demand and with the quality of financial service provision.[105]

Demand for, outreach and impacts of financial services

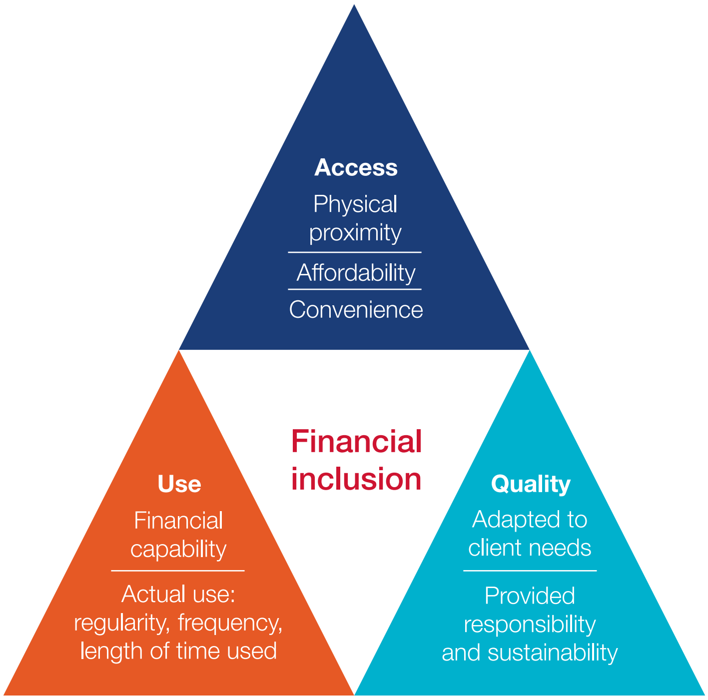
Access and use of formal finance

The theory of transformation suggests that as countries change they have greater access to formal financial services. Using an often-used measure of access to formal finance, we find that there are fewer commercial bank branches per capita in countries with higher shares of agricultural value-added in GDP (figure 7.2). Providing a comparative measure of use, figure 7.3 shows the cross-country relationships between the share of agriculture's contribution to GDP and the percentage of all rural borrowers borrowing from formal financial institutions.

The number of ATMs per capita follows a similar pattern; it is higher in countries with a lower share of agricultural GDP. There is an inverse relationship between agriculture's contribution to GDP and access to formal financial services (see figure 7.3). The data suggest that the share of rural borrowing served by formal financial institutions is higher in countries in more advanced stages of structural and rural transformation. Causality is not suggested, but figures 7.2 and 7.3 indicate that troubling gaps exist.

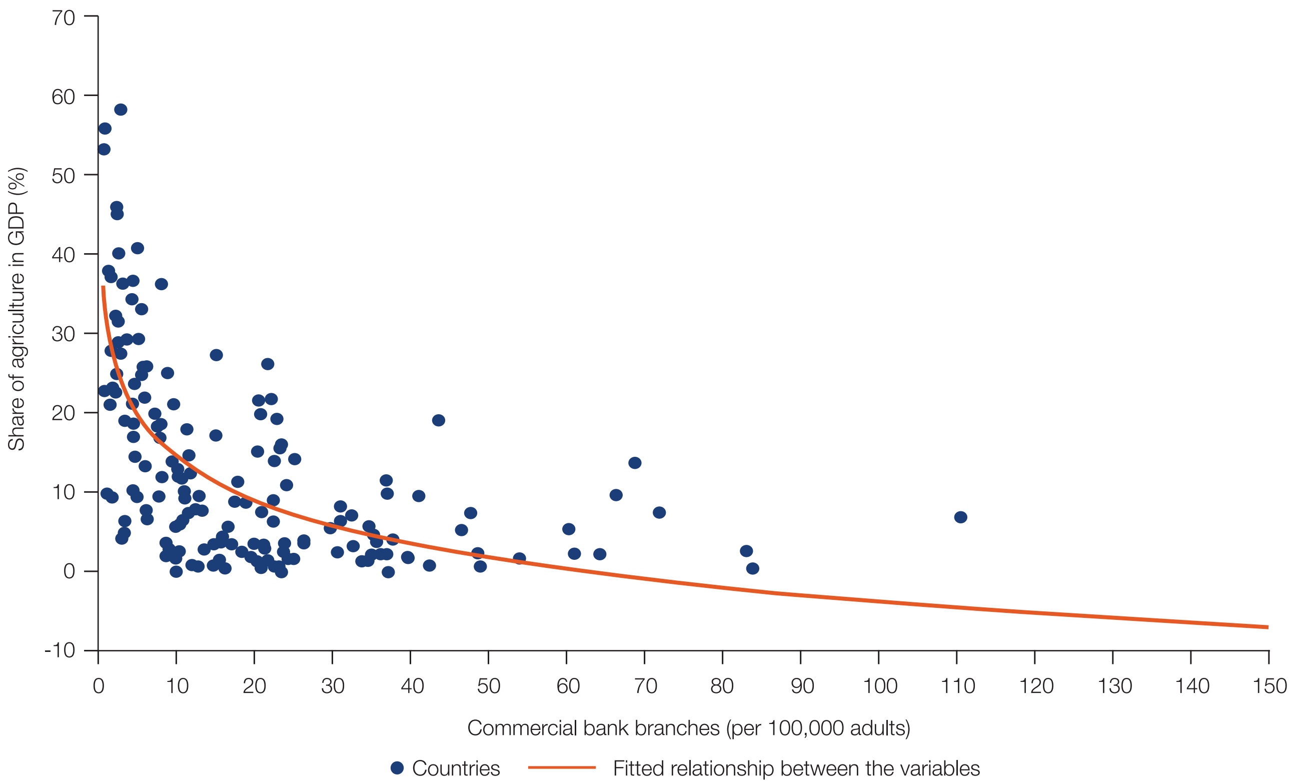
Depicting access and use through national averages is risky, however, as certain segments of society are particularly disadvantaged, an outcome invisible in just rural versus urban access. A study of 200 female farmers in Ghana (Mamudu et al. 2009) found that, while only 26 per cent of rural loans went to agriculture, women reached near-parity within this group (44 per cent). Also, lending to women was higher by volume of agricultural loans granted (54 per cent), though more non-agricultural rural loans wen to men (59 per cent).[106]

FIGURE 7.1 **CGAP's dimensions of financial inclusion**



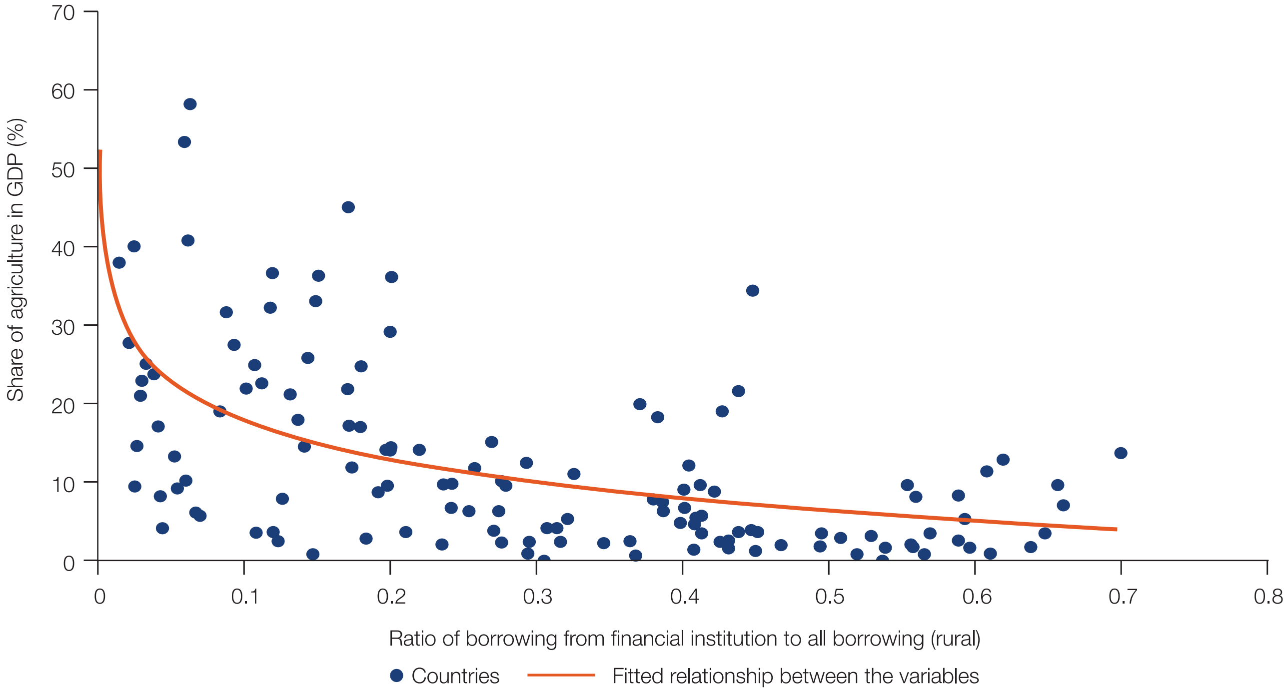
Source: CGAP 2015.

FIGURE 7.2 **Bank branches and agricultural GDP**



Note: The observations on the variables result in a line fitted to the equation y=-7.903ln(x) + 32.597, where y is agricultural share in GDP and x is number of commercial bank branches. The model has a goodness of fit (R-squared) of 0.4605.
Source: World Bank, Global Findex (Global Financial Inclusion Database) 2015.

FIGURE 7.3 **Agricultural GDP and rural borrowing from financial institutions**



Note: The observations on the variables result in a line fitted to the equation y=-7.116ln(x) + 1.3631, where y is agricultural share in GDP and x is number of commercial bank branches. The model has a goodness of fit (R-squared) of 0.2976.
Source: World Bank, Global Findex (Global Financial Inclusion Database) 2015.

But this is only part of the story. Of those women who did not apply for credit, or applied, but did not receive it, a critical barrier was not having a savings account at the rural bank. Thus women (and supposedly men as well) who were not aware of lending processes or who did not have savings were excluded from borrowing. Another factor affecting these Ghanaian women farmers was distance to a rural bank, which highlights how activities such as mobile or agency banking could improve financial inclusion.

It is clear that savings and credits are just one entry point among many for achieving financial development goals. A wider base would include government-to-people payment schemes, small-enterprise finance, digital financial services, remittances and insurance. The need for diversified financial services has expanded rapidly with structural transformation, as evidenced by growing remittances and mobile money transactions. Many countries have huge remittances, 20 per cent of GDP or more in Armenia, Haiti, Liberia, Nepal and Tajikistan. Among the world's 230 million migrant workers, who sent an estimated US$430 billion to their families back home in 2014 (benefiting more than 500 million in developing countries), 164 million are from developing countries, almost half of them women (IFAD and World Bank 2015; UNDESA 2013).

Changing demand for financial services

The scale of mobile money services shows the growing demand for diversified financial services, particularly payments and remittances. In seven of 11 African countries surveyed by IFAD for use of postal networks,[107] mobile money has become the most often-used channel for receiving remittances.[108] Such digital payments have benefited groups that were long excluded from the formal financial system, such as farmers. Mobile money services present promising opportunities for improving inclusion.

Mobile money transactions have been driven by the private-sector's response to technological innovations. Beyond ensuring appropriate regulations, extensive outreach did not require government actions. Although the testing of innovations and other research and development can benefit from public funding, the extent and boundaries of new information and communications technology solutions will largely be driven by the private sector. Such market-driven applications are likely to continue to expand outreach, with major implications for financial-system inclusiveness.

Globally, the scale of remittance flows to developing countries surged to US$430 billion in 2014. Yet this economic engine is largely untapped because the financial sector is not prepared to adapt to the specific needs of migrants and their families beyond offering transfer facilities. A large proportion of remittance receivers remain unbanked or poorly served by regulated financial institutions, particularly in rural areas, which receive 40 per cent of total remittances. Thus remittances (even if usually transmitted through formal channels) are normally associated with informal finance, because of the relationship between the sender and the recipient. Preference for cash-to-cash transactions remains, even though regulations are more stringent and costly for cash operations. The promotion of account-based methods to remit and save money is an important challenge, especially for migrant workers in developed countries.

The IFAD baseline survey found that many different channels are used for receiving remittances. Mobile money is the most prevalent channel in six of the 11 countries (led by Uganda at 93 per cent). Banks are the most frequent channel in Ethiopia (95 per cent), while post offices lead in two countries (Egypt is at 90 per cent) and money transfer operators are the most common in another two. Globally, many migrants (up to 30 per cent of those originating in rural areas) still use unregulated methods to send and save money, in spite of the risks.

The IFAD survey also highlighted that remittances are used primarily for daily subsistence (from 48 per cent in Madagascar to 78 per cent in Senegal), after which come school fees, health bills and emergencies. This illustrates the role of migration and remittances in addressing basic needs and in building human capital,[109] as well as the critical role of intra-household financial transfers in an era of increased mobility and diversified labour allocation.

Other data sources illustrate important differences in the use of financial services between remittance receivers versus others (IFAD and World Bank 2015). Remittance recipients have regular interactions with financial institutions (to pick up remittances in cash) and a higher propensity to save than non-recipients, yet their informal savings habits and their preference for liquidity lead to low use of formal financial services. This suggests that improving access to financial institutions able to provide at least a transactional account to receive and save remittances could open a door to other financial products and, potentially, build long-term relationships between remittance receivers and regulated financial institutions (box 7.1).

Formal versus informal finance

The degree and quality of semi-formal and informal finance must be taken into account when considering the role of rural finance in inclusive rural transformation. In many rural areas, informal finance is available and accessible and is often the first point of call. It is generally in the form of low-volume, short-term, unsecured lending and/or money safe-keeping without formal documentation or language and cultural barriers. It primarily comprises friends and relatives, and the borrowers of today can be the lenders of tomorrow. Friendship and family ties can rather effectively provide financial cushions when a small-scale farmer has a sudden emergency or needs funds for small projects on his farm or beyond. In some countries' rural areas, traders, input suppliers and produce buyers may constitute another major informal source of loans.

Effective demand for loans from suppliers and buyers can be high, though supply is often localized and limited. In such cases, the lending transaction is linked with another transaction in the real sphere and thus features lower information asymmetries and credit risks, and leverages attractive internal returns from the purchase transaction. In contrast, informal finance from traditional moneylenders is

BOX 7.1 Improving access and use of remittances and basic financial services in rural areas

The Asociación Mexicana de Uniones de Crédito del Sector Social (AMUCSS) is a non-profit organization in Mexico formed by a network of rural financial institutions in regions of high migration. Since its inception in 1992, AMUCSS has linked remittances to financial intermediation in the communities of origin. Linkages have a dual purpose, to enhance access and use of financial services by indigenous families in rural migration areas and to boost remittance investment for development.

In 2008, AMUCSS established Envíos Confianza, a remittance transfer company that operates with 13 of the biggest remittance companies and a network of 68 rural financial institutions with 300 points of payment. In 2013, this mutualized platform was strengthened by Red Confianza, a system linking remittance payments and transfers directly to savings accounts. Envíos Confianza complements this with educational marketing and promotion of debit cards, mobile banking and a rural network of points of sale and financial correspondents.

All told, AMUCSS now serves 30,000 migrant families annually, benefiting more than 60,000 people. It has also reduced remittance transaction costs by about 20 per cent, and helped seven out of every 10 remittance recipients open a savings account, every month mobilizing savings of US$1.5 million.

Source: AMUCSS 2015.

normally associated with advance funding at high interest and without related transactions.

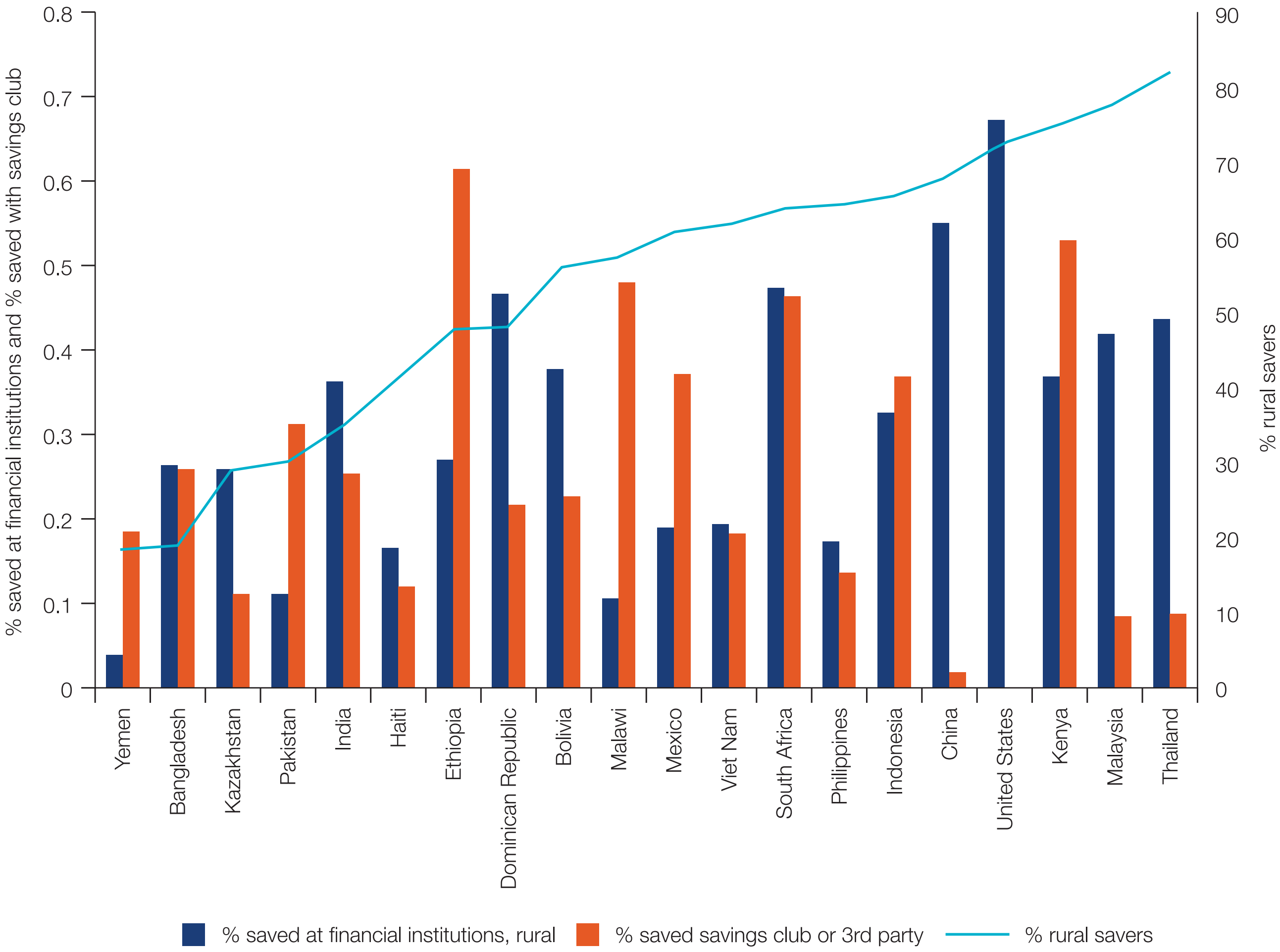
Community-based informal financial services are at least as important as traders and moneylenders in many remote agricultural areas of SSA and in parts of the Indian subcontinent. Purely informal arrangements comprise rotating savings and credit associations (ROSCAs), systematically described first by Ardener (1964) and later by Bouman (1979). Such associations rotate fund allocation by lot, auction or group consensus. Less common are accumulating informal savings funds, or *chits*.

Figures 7.4 and 7.5 illustrate some measures of inclusive finance for a subset of 20 nations. Figure 7.4 shows savings activities at formal institutions and/or savings clubs, such as ROSCAs. It suggests that in the absence of formal institutions, rural households have found alternative mechanisms for savings and borrowing. Figure 7.5 shows equal diversity in terms of sources of credits, with rural borrowing in the Dominican Republic and India relying substantially on informal sources. In many other cases, borrowers relied primarily on friends and relatives. In only five of the 20 countries (Bolivia, the Dominican Republic, Haiti, Kazakhstan and the United States) is the ratio of loans from family and friends to total loans less than 50 per cent, indicating that family borrowing remains high, no matter what the stage of structural or rural transformation.

Ghate (1990) was the first to systematically analyse and discuss the limits of this expansion of institutional finance versus the existing informal finance systems. He contends that even in highly developed rural economies, informal finance will maintain a certain market share, partly because demand for certain financial services may be too specialized, quickly required, short-term or unsecured to attract formal or semi-formal financial institutions.[110] This holds true in particular for small loans, but also for rural insurance mechanisms, such as the informal funeral assistance societies and similar rapid and flexible arrangements (Ghate 1990; Bouman 1990; Zander 2015a).[111]

The same argument for limits in the transformation of the rural finance landscape is pointedly made by Bouman (1990), who also cautioned against the notion of linkage of formal and informal finance that prevailed at the time. Again for rural India and based on empirical research in the Maharashtran

FIGURE 7.4 **Savings mechanisms for rural savings, including formal financial institutions and savings clubs/third-party individuals**



Source: World Bank, Global Findex 2015.

sugar belt, he observed that "linkages (with the informal financial sector), whenever they occur, happen automatically and without outside interference to this effect."

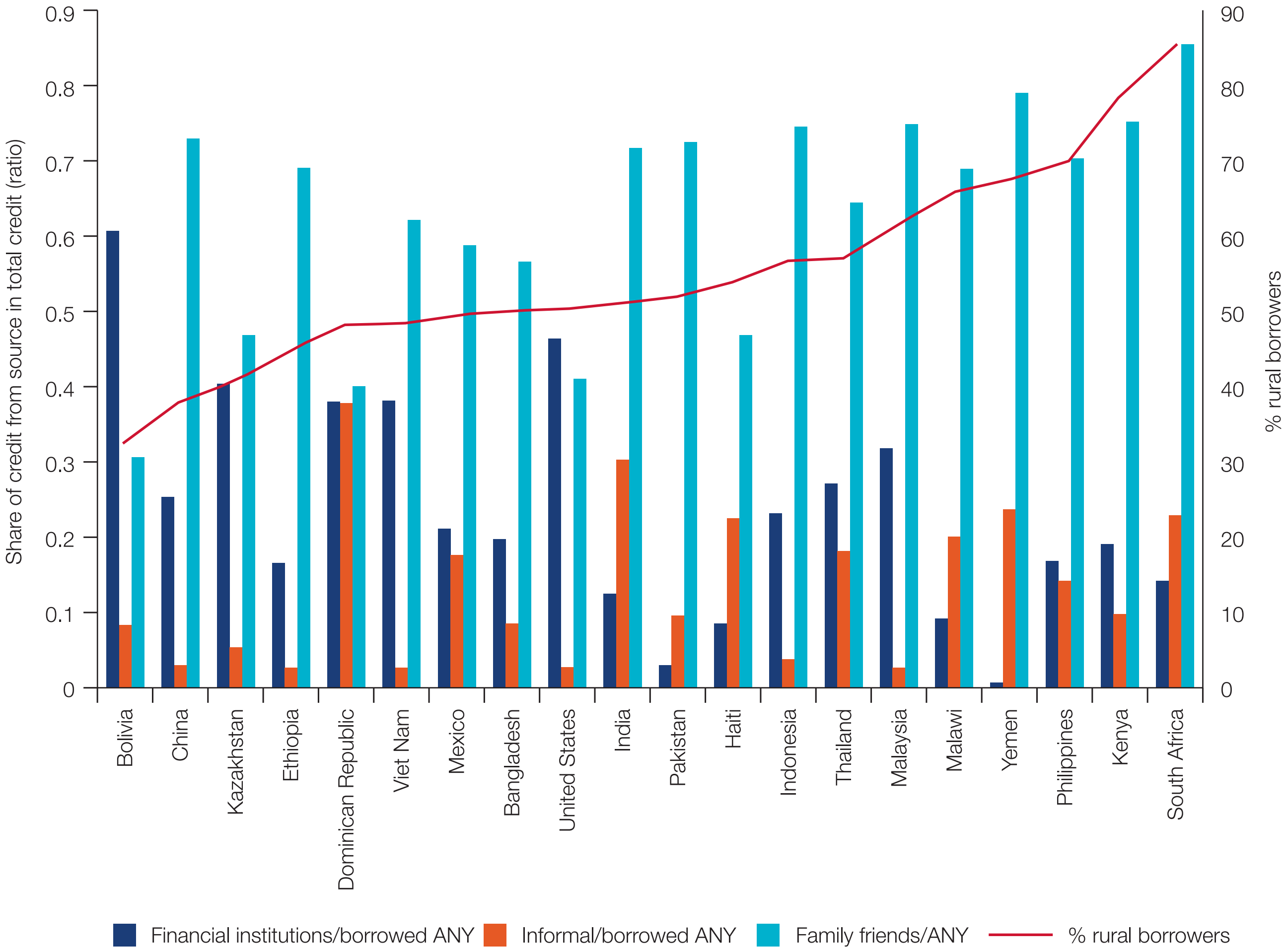
The multiple impacts of rural finance

When discussing the impact of credit on agriculture, the focus is usually on crop outputs or yields and fertilizer demand. However, at a more aggregate level, agricultural credit and the density of commercial rural bank branches can have positive impacts on agricultural investment, on agricultural and non-farm employment and on rural wages. Indian district data over time are very rich and contain data on all the variables needed for such an expanded analysis.[112]

India has long had a well-developed cooperative credit system that finances crop inputs and some longer-term investments. After India's nationalization of the large commercial banks in 1969, the banks were compelled by the government to expand their lending to farmers and agro-industry with targets set both for number of rural branches as well as the proportion of lending to the agricultural sector. Both types of institutions provide subsidized credit to farmers. India also has rich data at the district level for agricultural outputs, inputs and capital, for agricultural prices and wages, for infrastructure variables and for the number of commercial bank branches and the lending volumes. India, therefore, was a good bet for studying the multifaceted impacts of rural finance (Binswanger et al. 1993, 1995).

The impacts of the number of commercial bank branches in the district, the total loan volume

FIGURE 7.5 **Rural borrowers' credit sources – formal and informal financial institutions, and family and friends**



Source: World Bank, Global Findex 2015.

from all commercial and cooperative banks, systems, and the agricultural loans from the cooperative agricultural banks were estimated. Separate equations were estimated for these financial variables on the following dependent variables:

- Aggregate crop output and fertilizer demand
- Investments (tractors, pump sets, draft animals, dairy cows and small stock)
- Agricultural and RNFE and rural wages.

In addition to the financial variables, the equations included a crop price and a fertilizer price index, interest rates and infrastructure and technology variables. The analysis took account of the joint impact of credit demand and credit supply on the amount of credit extended.[113]

The data pertain to a randomly selected set of 83 districts in 13 states for the years 1960/1961-1981/1982. The investment data are derived from the quinquennial agricultural censuses as the difference in capital stocks between census years, which means that they represent net investment. Table 7.1 shows the resulting finance coefficients from the different regressions.

Only statistically significant results are discussed. While cooperative bank credit does not show an impact on aggregate crop output, total rural bank credit does.[114] The impacts of all three finance variables on fertilizer demand and investment in pump sets have large and significant elasticities, varying between 0.25 and 0.46, which imply that both are powerful productivity-enhancing investments. It is, therefore, a question as to why these effects

TABLE 7.1 **The multiple impacts of rural finance on agricultural and rural development in India**

Dependent variables	Independent variables		
	Predicted cooperative credit	Predicted total rural credit	Commercial bank branches
Aggregate crop output	0.063 (2.38)	0.027 (1.92)*	0.020 (1.37)
Fertilizer demand	0.39 (4.55)*	0.31 (6.67)*	0.25 (6.69)*
Investment in tractors	N/A	N/A	0.14 (1.31)
Investment in pumps	0.40 (3.59)*	0.46 (3.63)*	0.38 (3.61)*
Investment in draft animals	0.14 (0.62)	0.40 (1.56)	0.71 (1.96)*
Investment in milk animals	0.58 (4.34)	0.76 (5.09)	0.52 (2.63)*
Investment in small stock	0.84 (3.60)*	0.76 (5.09)*	-0.16 (-0.42)
Agricultural employment	-0.07 (2.51)*	-0.05 (2.07)*	-0.07 (-2.69)*
Rural non-agricultural employment	0.06 (1.48)	0.24 (5.26)*	0.29 (10.94)*
Rural wages	0.03 (1.34)	0.06 (2.93)*	0.06 (2.01)*

Notes: t-statistics in parenthesis. Asterisk refers to significance of 10 per cent or better on a two-tailed test.
n.a. these equations could not be estimated because of multicollinearity.
Source: Binswanger et al. 1993, 1995.

are not visible in the output response. It could be that for most borrowers, credit replaces their own resources to finance the inputs and investments. But the small and poor farmers who do not have their own resources would not be able to borrow much from the formal system and thus are not able to contribute to an output effect.

No impact of rural commercial bank branches can be shown on tractor investment, perhaps because it is a long-term investment for which only little credit is available.[115] An important finding is that all three financial variables reduce agricultural employment, which means that the investments financed are substitutes for labour. However, total rural credit and bank branches increase non-agricultural employment, with an effect that is sufficiently large that they lead to an increase in rural wages. An implication of this finding is that landless workers may be able to compensate for the lower agricultural employment via higher wages.

The rich results indicate that rural finance has profound impacts not only on agriculture, but on broader rural development, including farm and non-farm employment and wages. These far broader impacts are likely to operate via a variety of channels, including credit, savings, payment services and more. This is consistent with the position of this chapter that we must look beyond credit in seeking impacts on rural welfare.

Innovations in inclusive rural finance and inclusive rural transformation

The past decade has produced a wave of initiatives seeking to expand inclusive rural finance at scale. The innovations described in this section use some of the new tools that address information asymmetries as well as the high costs of extending financial services to agricultural areas. The earlier notion that competitive rural financial markets function effectively, with liberalized interest rates acting as market clearing prices that optimize resource allocation, failed to take into account important information asymmetries. Such information asymmetries include:

- Moral hazard – attracting clients that are less committed to repayment or who may use credit for other purposes than the proclaimed investment.
- Adverse selection – attracting riskier clients.
- Assortative mating – attracting borrower groups formed by the association of individuals excluded from other groups because they are most likely to default.

A substantial body of evidence now shows that the market-driven approach does not, by itself, effectively address access problems or resolve quality concerns.

Innovations in agricultural finance

Smallholder farmers, on and off-farm micro- and small businesses, female entrepreneurs, young business start-ups and wage labourers have different needs for financial services. They have different preferences and behaviours, and their own constraints and risks. This variety calls for a broader outlook on rural finance that goes beyond only affordable and reliable credit supply, to include the expansion of financial needs and to address gaps in their coverage. Such gaps might encompass payment systems, safe and affordable savings and deposits, availability of seasonal loans (working capital, advances, etc.) and micro-insurance, all tailored to the diverse financial characteristics and needs of different prospective rural clients.

The quality of financial products has been affected by information and communications technology, which expanded the scope for increased efficiency and scalability. The internet, electronic data management (covering small and more remote financial institutions) and the increasing use of cell phones have altered the financial landscape of developing economies. Further, structured finance transactions, such as value chain financing arrangements, have emerged as more complex, but well-adjusted solutions to increasingly demanding financing requirements of producers and aggregators. *Sharia*-compliant financing is an important sub-group (IFAD 2015a).

The Rome-based UN agencies have also brought forward knowledge and practical experience of agricultural value chain financing. Their efforts show that analysis of an entire value chain means that important opportunities and constraints, which may not be apparent from single production systems or chain layers in isolation, can now be identified and analysed. Recent studies show that looking at the entire value chain offers insights in to how to leverage finance for inclusive rural transformation and how to strategically address financing needs to fit a value chain (Zander 2015a). Finally, specialized agricultural investment funds were set up to increase the transfer of international investment resources to developing financial sectors (FAO 2010). To date, these funds usually offer equity together with debt finance and technical assistance facilities to agribusiness and larger producer associations.

Examples of product innovations that promote inclusive finance include the introduction of an agricultural finance facility in a Bangladesh apex fund (box 7.2). The example illustrates how a new financial service can open up access to formal term finance to small-scale farmers who previously relied on seasonal and term loans from informal sources. Interventions via apex funds are not the only options. Another example comes from The Gambia (box 7.3).

New work-flow or logistical processes (or their automation), as well as greater transparency to different contractual partners, can help farmers penetrate markets that financial institutions previously considered too costly or risky. Examples include process innovations in agricultural value chain financing that promote security of contract in outgrower and contract-farming arrangements, inventory credit and warehouse receipts. The case of inventory credit in Niger illustrates how innovations can address moral hazard and can reduce costs (working through community operators) to meet effective demand, even under the difficult farming conditions of the Sahel.

Under the inventory credit system, stored inventory acts as collateral, enabling farmers to receive input loans and thus intensify

BOX 7.2 How to offer term loans to small-scale farmers in a developing country

Although Bangladesh experienced rapid growth in the microcredit sector after Grameen Bank was set up, the sector catered primarily to microenterprises operated by the landless poor. MFIs often required weekly or biweekly repayments in meetings,[116] which were not suitable for farmers seeking to finance their crop season or longer-term investment. The smallholder farming community – 6.4 million small-scale and marginal farmers operating 37 per cent of Bangladesh's agricultural land – had little access to agricultural credit, and were almost completely unserved by sustainable microfinance services.

Recognizing the urgent need for innovations to secure longer-term finance for smallholders, IFAD launched a partnership with a microfinance apex institution, the Palli Karma Sahayek Foundation, to deliver financial services to the farming community through microfinance partner organizations. One initiative, the Microfinance for Marginal and Small Farmers Project, piloted new lending products to small-scale and marginal farmers, notably seasonal loans with lump-sum repayment modalities at crop harvest (10-month loans) and 14-month agricultural sector microcredit products. Loans were complemented with technical advisory services to borrowers, improving the loan portfolio quality of partner organizations.

This partnership reached over 280,000 farmers, 200,000 of whom became active microfinance clients. A total of US$156 million was provided as microcredit, with a 98 per cent loan recovery rate. Women constituted 84 per cent of the programme beneficiaries. Data from an impact survey showed that annual household incomes increased by 63 per cent, while participating households increased their farm sales by 52 per cent on average, or 25 per cent more than the control group.

After the IFAD project, the Foundation has integrated seasonal loans and agricultural sector microcredit within its core programme, with increasing lending outlays through nearly 270 partner organizations across Bangladesh. Disbursement rates continue to increase, reaching over 500,000 seasonal loans in 2014 with a value of more than US$93 million.

The Microfinance for Marginal and Small Farmers Project demonstrated that small-scale and marginal farmers could be creditworthy for MFI lending – as long as the loans had farmer-friendly repayment schedules – and that MFIs could become a viable agricultural finance alternative to rural banks and moneylenders. The apex financing facility promoted lending to a segment of the rural population that had difficulty in accessing formal finance with longer-term maturities, now offered by a host of MFIs in the Bangladeshi countryside.

Source: IFAD 2015a

production, where previously they had to rely on informal tontine-type petty cash borrowing. Inventory credit works with a "double key" system to one lock; one held by the farmers' organization and the other by the financial institution, often an MFI (which would refinance its operations with commercial banks) or a small bank or informal lender. Developed in Niger from 1988 with FAO support, inventory credit expanded access to financial resources from farmers able to provide land and cattle as collateral to those willing to put their produce "under lock and key." Within 10 years, inventory credit provided financing for about 5,000 tons of grains, oilseeds, legumes and dehydrated horticultural products belonging to around 12,500 farmers.

The inventory credit approach has since been introduced to other West African countries, successfully in Burkina Faso (where in 2013 it accounted for about 3,400 tons of commodities belonging to about 4,000 producers), but less successfully in Senegal, where an initial pilot was discontinued. Indeed, the model's scalability

BOX 7.3 How to cope with a bumper harvest

In 2010 the Islamic Development Bank concluded a structured financing deal, which enabled large numbers of produce buyers in The Gambia to access the liquidity needed to market a bumper groundnut harvest. Groundnuts are the country's main export crop and the mainstay of its farming population, which is short of financing in the bank sector to support export facilities. At the government's request, the International Islamic Trade Finance Corporation (ITFC) offered a US$14 million six-month revolving *murabaha* facility. The Gambia Groundnut Corporation, the state-owned exporter, was to act as ITFC's agent for buying groundnuts delivered by farmers' cooperatives, which it would then sell to buyers in the United Kingdom and France. Payments to cooperatives were made once the Corporation confirmed documentation of warehouse receipts and copies of shipping documents and invoices.

The transaction was set up in a *Sharia*-compliant risk-sharing format, which increased acceptance and was a first for the financial sector of The Gambia.[117] Without this facility, some of the crop would have been left unsold or sold below market prices because of inadequate liquidity of the local produce buyer. Instead, farmers were paid as soon as the documents relating to their deliveries were processed – even faster than under normal conditions.

Source: IFAD 2015a

remains an open question. Even in Niger, the warrantage system seems to have reached full maturity by the late 1990s, after which lending volumes appear to have stagnated. In part, this was due to poor harvests, but also a result of financial difficulties with one of the key lenders and some rigidity in the double padlock system. There may have been other reasons. One leading partner organization adopted another financing model, FAO technical support came to an end and a shortage of warehouses limited absorptive capacity (Coulter 2014). Though the warrantage model has potential to be improved, these constraints highlight the importance of the private sector in leading innovations and local adaptations.

The warrantage system may have a unique place in the rural finance landscape of Niger, but its expansion potential is limited by the implementing capacity and managerial requirements of the financial institution. Warehouse receipt financing and techniques with other collateral substitutes that are easier to implement than inventory credit have shown faster growth than the classical warrantage system. Warehouse receipt financing takes inventory credit arrangements one step further. It automates the registration of the commodities to be stored, providing small-scale farmer suppliers with pin codes to make their consignments traceable (such as tobacco in Malawi). Or it can introduce connectivity between different warehouses by installing servers in each facility (such as warehousing in Uganda). These and other models for expanding access to financial services also require action on legislation, inspection and supervision of financial institutions, capacity development and national policies to support new channels, processes and products for rural finance.

For agricultural value chain financing – as for other components of rural finance – the degree of inclusiveness and the real value added of different financial services remain uncertain. Some believe such arrangements are unlikely to be suitable for reaching a large number of farmers, but there is also evidence of spillovers and multiplier effects, as in employment, technology, contract farming and externalities. But the difficulty in providing rigorous evidence illustrates, not that the link between rural financial systems and inclusive rural transformation is absent, but that it is multifaceted and complex.

Linking formal finance with informal channels to expand outreach

There have been many attempts to draw on existing informal finance systems for quick and effective promotion of financial services in more remote and difficult-to-access areas. Moneylenders were used as conduits for credit lines from the formal financial sector in the Philippines and Sri Lanka. Value chain financing uses interlinked credit transactions of buyers of agricultural produce and input suppliers, to reach producer associations more effectively in many countries of Latin America and SSA. The Village Savings and Loan Associations, promoted by CARE International and others worldwide, mimic the workings of the informal non-ROSCAs.

An important innovation in inclusive rural finance that draws on informal financial services is agent banking, of which there are a number of different examples. India and Brazil were pioneers in this area, allowing small-scale farmers in remote and inaccessible forest or mountain locations to get essential savings and credit services for the first time. Earlier examples where financial institutions tried this approach individually (and without the necessary legal backup) include Lanexhang Bank in the Lao People's Democratic Republic and the Rural Cooperative Banks in some of China's provinces.

Examples from Kenya and Peru are particularly illustrative. In 2009, Kenya's Central Bank recommended an amendment to the Banking Act to allow commercial banks to use third-party agents to expand outreach and promote financial inclusion. With the help of the Alliance for Financial Inclusion, central bank officers benefited from knowledge exchange visits to Brazil and Colombia, which helped improve their understanding of agent banking models, leading the bank to issue "Agent Banking Guidelines" that took effect in 2010. By September 2011, the new legislation resulted in authorization of 10 banks to roll out agent banking networks, approval of 8,000 agents, the opening of more than 800,000 mobile accounts that leverage the agent banking model and around 3 million new transactions through agents.

In Peru, access to basic accounts was limited, especially in rural areas, because of the high costs. By the end of 2005, there were only 3,700 service points, including branches and ATMs, serving just 21 per cent of the country's districts. Then the Superintendent of Banks and Insurance issued new regulations to enable and expand agent banking. The initial regulations were replaced by a more comprehensive resolution in 2008, outlining the requirements for using this channel and the operations allowed.

In 2013, benefiting from peer learning and knowledge exchange within the network of the Alliance for Financial Inclusion, the Superintendent of Banks and Insurance updated its regulations for banking agents. It clarified the difference between banking agents, agent operators, and agent aggregators (entities that already exist in the market), simplifying the requirements for operating through banking agents and expanding the operations allowed so they can function as cash-in/cash-out points for e-money services. These regulatory changes began to improve financial inclusion. By the end of 2010, the country had 17,488 service points, while the share of districts with access increased to 33 per cent, covering 81 per cent of the total population.

The prevalence of informal finance in rural areas poses challenges for regulators, who need to ensure consumer protection and to minimize risks when informal finance is linked to formal finance. Such prevalence also has implications at the micro level, primarily on limitations in variety, adequacy and cost of financial services from non-specialized sources.

Community-based savings and credit organizations

After Kenya and Peru, a third example outlines the strength of communities and their capacity to build their own proximity-based financial institutions entirely without the help of outside donors. Many rural-based systems of credit and savings systems operate in this mode. Examples stretch from rural Brazil (SICREDI) to Kenya (SACCOs), Poland, Sri Lanka and India.

The Sanasa network in Sri Lanka exemplifies this people-driven approach and the considerable capacity of financial cooperatives to increase inclusiveness. For many rural households, depositing facilities are offered by the dense network of rural banks, but receiving loans from regulated financial institutions is far harder. The Sanasa primary societies have been filling this gap well. Established as early as 1911, village-based primary cooperatives operate at exceptionally low cost thanks to voluntary management and light overheads. In contrast to informal lenders (who generally use their own capital), these cooperatives advance loans exclusively from mobilized savings at rates and borrowing limits set by the membership. Deposit mobilization and safe keeping are the main financial services provided by these small societies. At district and national levels, Sanasa structures service the technical needs of village cooperatives, including auditing, training and liquidity management. Although the village-level office bearers are volunteers, management skills have come from targeted training programmes of provincial and national umbrella organizations.

The Sanasa network has grown from about 640 cooperatives in the 1980s to more than 8,000, with 1 million members, mainly in rural areas. About 4,000 primary cooperatives are active across the island, most of which continued operating even during civil strife. Close to 1,000 cooperatives operate with an asset base of at least LKR 10 million (about US$72,000), and 200 have an asset base of more than LKR 100 million (more than US$720,000). The network has also established an apex bank (Sanasa Development Bank Ltd.), an insurance arm and a training facility.

Such community-based financial institutions provide an important bridge between the financial sector and remote rural village communities. When communities view member-owned and member-managed financial institutions as their own and can fend off unwanted political interference that compounds moral hazard and adverse selection, these systems can remain a first call for services for many decades to come. With low costs and good risk management thanks to proximity, such institutions offer long-term viability for rural markets.

Helping rural households make effective use of financial services

The earlier study on the use of financial services in Ghana underscores the need to investigate borrowing behaviour and to develop financial education programmes for borrowers and lenders. This and other research and analytical insights on the behaviour of market participants have helped explain financial exclusion and shown that such exclusion in rural areas is not restricted to limited access of formal financial services.

The Soro-Soro Ibaba Development Cooperative (SIDC) in the Philippines demonstrates how migrants and their families could be supported to achieve financial goals and successfully invest back home by combining certain activities, such as financial literacy programmes, followed by financial products and investment avenues (box 7.4).

Including the poorest

The above examples focused on providing access and services to excluded rural households that exhibit effective demand. But many studies have shown that microfinance rarely reaches the poorest. So what of those households whose livelihoods are too meagre to generate sufficient revenues to cover even cost-effective and relevant financial services?

One avenue has been to strengthen the livelihoods of such households through asset transfers, training and coaching. Often termed *graduation approaches*, they seek to provide a push that may not bring households out of poverty, but can help them secure productive livelihoods and generate greater income.

Recent assessments of them include randomized control trials in six countries that provided some of the poorest households with a productive asset grant, training and support, life skills coaching, temporary cash consumption support and access to savings accounts and health information or services (Banerjee et al. 2015). Trial results show that graduation programmes had positive effects on treatment groups across a range of outcome areas, with the most significant effects on household incomes, financial inclusion and household assets. The incomes of the

BOX 7.4 The importance of financial education

Between 2010 and 2012, IFAD financed a pilot intervention, run by Atikha, a Filipino NGO that supported Filipino workers in Italy to invest collectively in their home province through a cooperative group – SIDC – set up in 1979.

Initially, remittance recipients and their families attended financial education seminars, with an emphasis on nurturing savings. Migrants were thereafter given the option of investing in SIDC, which in turn pooled migrants' and families' resources to finance a sustainable poultry cooperative. Investment in SIDC required membership subscriptions for migrants and their family members at home, at a cost of €25 a share, and a minimum contribution of €1,800 over one year (€150 per month). Although the investment is frozen for five years, it provides an annual return of 6 per cent plus dividends based on annual performance.

In total, 1,100 overseas migrants and families invested US$250,000 through SIDC, and around 600 people in rural areas received business and skills training. To date, the SIDC credit cooperative has provided more than US$1.3 million in loans, serving 600 beneficiaries with average loans of US$2,200. Having established a profitable market position and gained the trust of migrant investors and their families, the cooperative is now pursuing an expansion strategy to open to further market outlets.

Source: Atikha 2015.

treatment groups were significantly higher than the controls in every country, while household consumption was higher in every country except Honduras. Though they are lower one year later, household income and financial effects remain positive and significant, indicating that benefits have been sustained in the short term. The effects of per capita food consumption and food security remain at similar levels one year after the project's end, and are thus relatively more sustainable.

The findings suggest that graduation approaches are effective in helping the poorest households improve their self-reliance and gradually increase their income. Thus graduation strategies complement financial services by assisting the poorest in moving out of poverty, so that they may be able to make better use of other financial services.

Options and opportunities to expand inclusive financial services – impact measurement

The impacts of the different models used for achieving financial inclusion are not yet supported by conclusive empirical evidence – microfinance and graduation approaches are the only areas with rigorous evaluation. The following examples *illustrate* that governments, civil society, financial institutions and funders can support financial inclusion, as in the case of agent banking regulations adopted by the central banks of Kenya and Peru. The efficacy of these innovations in changing outcomes has not been rigorously evaluated, nor the degree to which they improve the lives of poor farmers.

Evaluation of microfinance and graduation approaches has found that, while microfinance has varied benefits, take-up rates were more modest than expected and few of those who took up microcredit achieved a transformative impact, whether in household income, consumption, poverty reduction or business growth (box 7.5). There is also some evidence that borrowers substitute other forms of borrowing for MFI loans, but scarce evidence that micro-borrowers are able thereafter to use other sources of credit. Graduation approaches, conversely, as seen, have shown that grants to the poorest, with support services, can have a significant positive and sustainable effect on household income and consumption.

BOX 7.5 Findings of randomized control trials on microfinance

A randomized control trial of agricultural lending (Beaman et al. 2014) illustrates spatial diversity that goes beyond household-level exclusion or rural-urban disparities. The study investigated the relationship between binding liquidity constraints at the village level and credit demand among Malian farmers. It provided cash grants to unbanked villagers in communities without access to credit and, in communities with access to credit, randomized similar grants to borrowers and non-borrowers alike.

The proposition was that in the presence of liquidity constraints, the investment returns from a cash injection in unbanked villagers would be higher than those in banked communities. This would be the case if, in the banked communities, borrowers had already self-selected into the credit market to exploit higher average returns and had to invest the grant in a lower-productivity proposition. Villagers who had achieved their respective opportunities for higher returns on investment through savings or other means, would not borrow. Accordingly, the hypothesis was that farmers in banked communities did not face the same liquidity constraints as those in unbanked communities.

The findings show that relaxing liquidity constraints in unbanked villages induced a small increase in labour and cultivated land, but increased the use of fertilizers by 14 per cent and of chemicals by 19 per cent. This investment response was not found in banked communities, suggesting that, because credit was available and used or not used because of alternative sources of liquidity, farmers were already optimizing input use relative to areas with low borrowing options.

This suggests that rural Malian banks have been effective in providing liquidity that increases returns in those areas where they are operating, that restrictions in access or use of rural financial services have constraints on prospective borrowers and that the improved liquidity has positive spillovers within a village.

Source: Beaman et al. 2014

Strategies, institutional changes and investments

To move the financial inclusion agenda forward at the macro level, the G20 group of countries in 2010 formed the Global Partnership for Financial Inclusion (GPFI) and adopted nine basic principles[118] for innovative financial inclusion (GPFI 2010) – for all economies, not just developing ones. This conceptual framework of the GPFI reflects the need for a more resilient global financial system that fosters growth and confidence. The thrust since has been on concrete commitments for policy measures to stimulate financial inclusion,[119] with a focus on innovation and on collaboration with the private sector.

A first action plan was put in place in 2010 – still reflecting the "crisis mode" that influenced the original creation of the GPFI after the financial crisis of 2008-2009. The second Five-Year Financial Inclusion Action Plan (2014-2019) was subsequently prepared, advocating responsible market development that balances improved access to financial services with stability of the financial system. It identifies 10 action areas in different segments (box 7.6).

With the GPFI and specialized implementing partners, such as the Alliance for Financial Inclusion, progress has been made in pursuing policy targets and achievements at the macro level (GPFI 2014). Further, the work of the G20, GPFI and the Alliance has resulted in a notable shift of initiatives to support financial inclusion towards the actors at the sector level – ministries, central monetary authorities and other standard-setting bodies. The examples cited above show that enabling regulations and flexibility towards developing retail and rural microfinance marketplaces can improve access to financial services. But the opposite also

BOX 7.6 GPFI 2014-2019 Financial Inclusion Action Plan – four action areas, 10 action targets

SME finance

1. Accelerate and replicate successful policy reforms to expand financial services to SMEs
2. Establish the SME Finance Forum as a global centre for knowledge exchange and promotion
3. Improve financial access through the SME Finance Compact, SME Finance Initiative and key development achievements

Regulation and standard-setting bodies

4. Mainstream financial inclusion in the work of standard-setting bodies and other relevant global bodies and increase understanding of the interdependence of financial inclusion, stability, integrity and consumer protection
5. Encourage consistent incorporation of inclusion in financial sector assessments

Financial literacy and consumer protection

6. Improve the capacity of public authorities and other stakeholders to develop and implement financial literacy and consumer protection measures
7. Promote consumer protection and financial education good practices for digitally delivered financial products and services

Market and payment systems

8. Consider ways to address the money transfer operator bank account closure
9. Reduce the cost of sending remittances
10. Expand opportunities for innovative technologies

Source: GPFI 2014.

applies. Where central banks have tightened regulations too strongly they can choke a thriving rural microfinance sector, as the case of Bolivia shows. Similarly, steep increases in minimum capitalization threaten to push many of Tanzania's Community Development Banks out of business.

Strategies for increased access, better financial services and improved financial inclusion for all income segments can be pursued at three different levels in the financial system:

- The micro level, where clients and their financial institutions operate
- The meso level, where sector-wide financial infrastructure is put in place, including credit reference facilities and professional associations
- The macro level where governments enact legislation and create supervisory bodies (IFAD 2009).

Successful models are likely to be as varied as there are countries and implementation environments. None of the new developments, innovations or institutional vehicles has so far been universally successful, and promising practices and experiences are context specific. But these efforts are greatly helped by proper financial management and functioning supervisory structures, by experimentation and continuous adjustment to new circumstances and by a proper reporting and impact assessment system.

National policies that set concrete financial inclusion targets are instrumental in increasing rural financial inclusion, in particular if these policies are accompanied by the introduction of new institutions with better reach to more rural people. But the formulation and fine-tuning of strategies and policies for improved rural financial inclusion need to be based on a sound analysis of access and financial inclusion at the level of the client – the smallholder farmer and other rural clients with their diverse needs.

Much still needs to be done to improve the inclusiveness of financial services at the sector level, particularly with national standard-setting bodies as the key collaborators. When facing specific challenges, such bodies are usually left to their own devices. How can optimal capitalization levels for single-unit rural banks be determined? Up to which asset or turnover thresholds should credit-only MFIs remain unregulated? How should gross earnings of financial cooperatives be treated in a country context? These are just a few of the issues that need to be identified and addressed by policymakers and external financing institutions.

Another dimension is the community. Here it is important to assess the prevalence of informal and semi-formal financial services and their sensitivity to changing conditions. Informal lending may be penalized by usury codes and financial cooperatives may be hampered in their reach by inconclusive laws or regulations.

At the level of financial institutions, meso-level innovations need to be directed towards better management of three key business areas – appropriate services for different client needs (such as farmer loans in the Bangladesh example), service costs and client- and transaction-related risks. There is no general formula or silver bullet for adequate institutional development paths and blueprints rarely bring the required results. The state should not intervene directly in financial service provision, but it has a very important role in creating the enabling framework for it.

Much needs to be done at the macro level, particularly fostering more inclusive and client protection-oriented legislation and implementation guidelines for the inspection, audit and supervision of financial innovations such as agency banks, or entirely new rural finance institutions, such as single-unit rural banks. Central banks face the challenge of balancing financial stability with inclusive financial innovation (BIS 2014). Examples differ widely among countries and often also within different periods within countries. Bolivia regulated the financial activities of MFIs very flexibly in the past, but has now become more stringent. Bangladesh has established a separate supervisory authority for microfinance. Much of the success of savings and credit cooperatives in Kenya and Rwanda is due to delegated supervision responsibilities for their activities. A useful rule of thumb is to regulate large financial mechanisms, leaving smaller ones to be managed by local stakeholders.

The example of the Central Bank of Nigeria (CBN 2005) illustrates how this process can be managed domestically without external donors. When domestic agencies are in charge of policy formulation processes, results are more likely to be better tailored and country specific (box 7.7).

BOX 7.7 Central Bank in charge of the Nigerian Microfinance Policy

A consultative process between the Central Bank of Nigeria on the one hand, and Nigerian MFIs, commercial banks, the wider NGO arena and donors on the other, drew up a Microfinance Policy. It involved several drafts and took five years. It was issued in December 2005.

It provides a uniform development path for the network of community banks and the still informal majority of MFIs. MFIs can remain small and stay unregulated, or can change into microfinance banks with a minimum capital and supervised by the central bank, like all other formal financial institutions in Nigeria.

Larger MFIs had to increase their transparency with ownership patterns that are clearly defined and bring both privileges (dividends and election rights) and responsibilities (for internal supervision and board representation) with them. The trend of treating MFIs just like any other actor in the financial markets and having them supervised by the central bank, therefore, increases their overall exposure and reduces their insulation from financial sector trends, such as interest rate changes and systemic risks (through bank closures, etc.).

Source: IFAD 2016.

Conclusions

The challenges facing rural finance are always changing. While transformation shifts the effective demand curve for financial services, the provision of inclusive rural finance is itself a catalyst that supports rural transformation. Inclusive financial intermediation expands the ability of rural households to capitalize on emerging opportunities and spurs rural growth.

Adaptation, a client-oriented approach, and innovation can make the difference for financial inclusion and institutional robustness, especially in remoter agricultural environments. The key level of intervention remains the micro level, where innovations in financial services can increase inclusiveness. Stiglitz (2011) states that government not only has a restraining role in ensuring strong financial regulations, but also a constructive and catalytic role in promoting entrepreneurship, providing social and physical infrastructure, ensuring access to education and finance, and supporting technology and innovation.

Most innovations to increase the inclusiveness of rural finance are still made at the level of these key actors – the financial institution (supply side) or the client (demand side). But as the examples show, other stakeholders play important roles – rural communities, local and national governments and their different departments, and the private sector. The examples illustrate the wide scope for external supporters to foster inclusive rural finance. But domestic governments, rural people, organized in communities, and different types of civil sector actors are in the front seat whenever promising innovative practices are introduced and propagated.

Fully inclusive rural finance systems can be promoted by external funders and agencies, but will eventually depend on the initiatives of governments and the agility of different types of financial institutions. IFAD and like-minded partners, therefore, assist in developing and strengthening these systems, rather than trying to run them. On this, this chapter illustrates some key principles:

- Provide broader and more holistic policy advice to manage inclusive rural finance within rural transformation.
- Strengthen the financial capability of rural women and men to support their long-term productive capacity.
- Ensure that financing is delivered in a timely and strategic manner.

Some examples showcase the wide range of different support roles that international agencies can play when supporting inclusive rural finance. In each case, governments and people on the ground received support from international agencies in a listening and partnership role. Even in acute crises, international partners should support, but not manage, development processes. Specifically, with respect to rural finance, policymakers and financiers are well advised to consider the following lessons:

- A forward-looking research and academic agenda needs to acknowledge inclusive finance and its interrelations with the wider process of rural transformation.
- The analytical framework of inclusive finance follows a holistic approach. Research and evaluations need to be tailored to fit its broader systems and locally driven dimensions.
- Rigorous methods have been used to assess microfinance and graduation approaches. Other models and approaches still require careful investigation and research.

There are important new entry points for supporting inclusive finance, such as remittances. Leveraging them towards provision of other (additional or new) financial services represents a unique opportunity to create a convergence between the financial goals of millions of remittance senders and receivers, mostly unbanked or under-banked, the commercial strategies of traditional and emerging financial service providers and international development goals. To capitalize on this opportunity, migrants (and their needs) have to be better understood, and offered finance and investment options that fit their profiles. Whether through remittances, savings or investment, migrant workers possess a powerful set of instruments to change their own lives and the lives of those back home.

Graduation approaches have sought to improve the livelihood outcomes of the poorest – who are almost always financially excluded and likely to continue to be so – with targeted grants. There is no intent to use financial services for this group, and perhaps there should not be, as microfinance and other financial services tend to benefit better-off groups. Yet graduation approaches have shown a scope for bridging purely social protection activities on one side, and livelihoods, microfinance or microenterprise development work on the other.

These approaches are, however, very demanding of institutional capacity, and coaching and support services. To successfully engage in this type of programme, governments and development agencies will have to adopt dynamic and entrepreneurial solutions that rely on strong partnerships involving capable organizations from the private sector and civil society.

Further, while the mix of activities that constitutes the graduation model seems sufficient to achieve positive results, the randomized controlled trials discussed did not control for the individual contribution of each component of the model nor the contribution of subsets of these components. This lacuna suggests that more research is needed to identify the requisites for scaling up the graduation model, especially if it requires lower-cost alternatives to be identified.

Finally, while there is room for scaling up several of the innovations described earlier, the empirical evidence of success and lasting impact of many initiatives is mixed. Aside from trials on microfinance and graduation approaches, contributions to wider rural transformation processes are even harder to prove empirically and require similarly rigorous impact analysis.

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