APRACA FinServAccess Programme

Rural and Agricultural Finance Development in Asia and the Pacific: Challenges, Opportunities, Threats and Future Directions

An APRACA FinServAccess Publication with the Special Sponsorship of
the International Fund for Agricultural Development (IFAD)

APRACA FinServAccess Publication: 2014/5

Rural and Agricultural Finance Development in Asia and the Pacific: Challenges, Opportunities, Threats and Future Directions

Ganesh Thapa

An APRACA FinServAccess Publication with the Special Sponsorship of
the International Fund for Agricultural Development (IFAD)

Published by: Asia-Pacific Rural and Agricultural Credit Association (APRACA)

Distribution: For copies, write to:

The Secretary General
Asia-Pacific Rural and Agricultural Credit Association (APRACA)
Room A303, Bank for Agriculture and Agricultural Cooperatives (BAAC)
469 Nakhonsawan Road, Dusit, Bangkok 10300, Thailand
Tel: (+662) 280-0195
Fax: (+662) 280-1524
E-mail: apraca@apraca.org and marlowe@apraca.org
Website: www.apraca.org

Secretary General: Chamnong Siriwongyotha

Project Manager: Marlowe U. Aquino

Layout Credit: Sofia Champanand

E-copy: The report in PDF can also be downloaded from the APRACA website.

ISBN 978-616-394-264-7

This report is published by APRACA under the auspices of the IFAD-supported APRACA FinServAccess Project.

Opinions expressed by the expert/researcher do not necessarily represent the official views of APRACA or of IFAD.

This report is published during the incumbencies of Mr. Shitangshu Kumar Sur Chowdhury (APRACA Chairman) and Mr. Maha Prasad Adhikari (APRACA Vice Chairman), Mr. Chamnong Siriwongyotha (APRACA Secretary General) and Dr. Marlowe U. Aquino (FinServAccess Project Manager).

Foreword

Over the years, the Asia-Pacific rural and agricultural situation has been considered very dynamic, evolving and innovating through the test of time. Several significant and important events happened in response to the socio-economic, political and environmental conditions. Because of these, most to the rural people especially those engaged in agriculture and fishery activities cope with the changing climate and natural landscape to be more resilient.

Under the IFAD-APRACA FinServAccess Project, a review of the present condition of the Asia-Pacific rural and agricultural development particularly on the rural finance was done to provide a comprehensive up-to-date scenario of the challenges, opportunities, threats and future directors to all key players and stakeholders.

Through this document, we hope that this will serve a very good information and reference to those institutions and individuals wanting to work and understand further the context of rural finance development in a regional perspective.

May this excellent piece of work backed by comprehensive analytical study done by Dr. Ganesh Thapa, former regional economist of the Asia-Pacific Division of the International Fund for Agricultural Development (IFAD) in Rome, Italy serves to improve, strengthen and enhance the sector as it drumbeats increased production, profit and sustainable efforts by the different institutions and individuals of rural and agricultural development.

In addition, may the members of APRACA and its partners find this document useful as financial reforms and institutional as well as individual transformations are undertaken in this changing time. Also, we hope this could encourage and trigger more related and applied researches responsive to development-oriented, client-oriented, systems-based and resource-based rural and agricultural development for rural people and communities.

Executive Summary

Asia and the Pacific rural and agricultural development are fast transforming due to the growing population and the continuous changes in natural landscape brought about by the ill-effects and impacts of climate change. Through the effective and efficient works of institutions and individuals, development strategies are formulated to address and respond to these ill-effects and impacts leading most people to cope with and adapt to challenges and changes they face.

The rural and agricultural finance sector is an interesting area where support to people and communities is necessary. Several challenges, opportunities and threats are studied and identified as basis for improved and comprehensive sustainable financial development.

The financial development, growth and poverty in the region are essentially an important aspect to work on particularly on the basis of productivity, profitability, security and sustainability. Several studies have documented on the positive impacts of financial development on poverty reduction; its effects resulted to two channels: aggregate growth and changes in the distribution of income showing poverty reduction and reduction in income inequality. However, financial development does not always have positive effect on income inequality.

Specifically, microfinance development posts a strategic and innovative area where financial institutions play crucial roles in the formulation and delivery of products and services. Its macro and micro impacts helped people particularly the poor who are deprived of financial access and access to finance.

Among the emerging challenges related to the provision of services to rural households include product design for rural poor and smallholders; appropriate use of subsidies; rigorous evidence of impact; over-indebtedness among poor borrowers; adequate replication and scaling up initiatives; institutional development interventions; ensuring sustainability; governance and regulation of financial sector to ensure client protection.

The opportunities for rural and agricultural microfinance include advances in institutions; presence of apex institutions which channel funds to retain financial institutions; changing landscape for stronger international partnerships; development of innovative financial products; utilization and application of technological advance; and integration on the usage of strategic alliances to offer new financial products.

With respect to the threats, future financial crises are recognized; occurrence of climate changes; and political/policy backlash must be taken into account. Finally, the future directions must include massive promotion of financial inclusion activities and responsible finance by institutions and for people and communities to be adaptive and responsive to financial accessibility and utility.

Acronyms

ADB	Asian Development Bank
AFD	Agence Francoise de Developpment
APRACA	Asia-Pacific Rural and Agricultural Credit Association
BAAC	Bank for Agriculture and Agricultural Cooperatives
BRI	Bank Rakyat Indonesia
CGAP	Consultative Group to Assist the Poor
CSFI	Center for the Study of Financial Innovations
EU	European Union
GDP	Gross Domestic Product
GIZ	Deustsche Gesellschaft for Internationale Zusammenarbeit
IFAD	International Fund for Agricultural Development
IPOs	International Peoples Organizations
MFIs	Microfinance Institutions
MIX	Microfinance Information Exchange
MRCP	Maharashtra Rural Credit Project
NEPAD	New Partnership for Africa's Development
NGOs	Non-governmental Organizations
OEDC	Organization for Economic Cooperation and Development
PARM	Platform for Agricultural Risk Management
PKSF	Palli Karma Sahayak Foundation
POs	Peoples' Organizations
SHGs	Self-Help Groups
SPTF	Social performance Task Force
UNCDF	United Nations Capital Development Fund
USAID	United States Agency for International Development
USSPM	Universal Standards for Social Performance Management
WFP	World Food Programme
WRMF	Weather Risk Management Facility

Table of Contents

Page

Foreword iii

Executive Summary v

Acronyms vi

Chapter 1 Introduction 1

1.1 Financial Development, Growth and Poverty 1

Chapter 2 Microfinance Development 3

2.1 Microfinance and Poverty: A Macro Perspective 3
2.2 Microfinance: Micro-level Impacts 3
2.3 Impact of Microcredit on Poverty: An IFAD Project Experience 4

Chapter 3 Financial Inclusion 5

3.1 Coverage of Microfinance in Asia/Pacific 6
3.2 Institutional Credit to Rural and Agriculture Sector 7
3.3 Microfinance in Agriculture 8

Chapter 4 Challenges of Rural/Agricultural Finance 10

4.1 Challenges related to provision of services to rural households 10

Chapter 5 Emerging challenges in microfinance for agriculture 12

5.1 Product design for rural poor and smallholders 12
5.2 Appropriate use of subsidies 12
5.3 Rigorous evidence of impact 13
5.4 Over-indebtedness among poor borrowers 13
5.5 Replication and scaling up 14
5.6 Institutional Development 14
5.7 Ensuring sustainability 15
5.8 Governance 16
5.9 Regulation of financial sector to ensure client protection 17

Chapter 6 Opportunities in Rural/Agricultural/Microfinance 18

6.1 Advances in institutions 18
6.2 Apex institutions 19
6.3 International partnerships 19
6.4 Innovative financial products 20
6.5 Technological advances 21
6.6 Strategic alliances to offer new financial products 22

Chapter 7 Threats to rural/agricultural/microfinance 23

7.1 Future Financial crises 23
7.2 Climate change 24
7.3 Political/policy backlash 24

Chapter 8 Future Directions 26

8.1 Promoting financial inclusion 26
8.2 Promoting responsible finance 27

References 28

List of Tables

Page

Table 1 Global Unbanked People in 2011 5
Table 2 Microfinance coverage, 2012 7

List of Box

Page

Box 1 Microfinance in Agriculture: The Experience from an IFAD-Supported Project in Bangladesh 9

CHAPTER 1 Introduction

1.1 Financial Development, Growth and Poverty

There is a vast literature on the impact of financial development at the macroeconomic level. The degree of financial intermediation is not only positively correlated with growth and employment but it is generally believed to causally impact growth (Pasali 2013, Levine 2005). Financial development impacts growth positively through two mechanisms: lower transaction costs and better distribution of capital and risk across the economy. However, in economies with weak institutional frameworks, this positive relationship disappears (Demetriades and Law 2006). A special case is the model developed by Greenwood and Jovanovic (1990), which shows a non-linear relationship between financial development, inequality and economic development. At all stages of economic development, financial development improves capital allocation, boosts aggregate growth and in turn benefits the poor. However, the distributional effect of financial development, and thus the net impact on the poor, depends on the level of economic development. At early stages of development, only the rich enjoy access to and benefit directly from better financial markets. At later stages, as access becomes more extensive, a higher section of society benefits directly from financial development. Improved access to finance also leads to greater financial stability (Han and Melecky 2013).

Several studies have also documented the positive impact of financial development on poverty reduction. Beck et al. (2007) have examined the effects of financial development on poverty through two channels: aggregate growth, and changes in the distribution of income. More specifically, their research shows that 60% of this effect on poverty reduction is through aggregate growth and the remainder through the reduction in income inequality. Financial imperfections, such as information and transaction costs, may affect the poor more as they lack collateral and credit histories. So, relaxation of credit constraints would benefit the poor more. Moreover, credit constraints hamper efficiency of capital allocation and aggravate income inequality by restricting the flow of capital to the poor with high expected returns.

The focus of Claessens and Feijen (2006) is a specific channel through which financial development impacts on undernourishment. The analysis covers the period 1980-2003. In theory, some specific channels can be identified through which financial sector development impacts undernourishment. First, savings and credit help consumption smoothing when there are income or other shocks. Second, access to financial services eases the financing of productive investment in, say, agricultural equipment, thereby raising yields and incomes of smallholders, and reducing undernourishment. Third, there may be an additional benefit to low income households, without access to financial services, as higher yields translate into higher food output and lower prices. They have shown that private credit has a large negative effect on undernourishment through higher agricultural productivity in general and higher livestock, crop and cereal yields in particular.

Imai, Gaiha and Thapa (2008) examined the experience of 9 Asian countries (Bangladesh, China, India, Indonesia, Malaysia, Pakistan, Philippines, Thailand and Vietnam) over the period 1960-2006, using panel data. The results showed a positive role of finance on the gross domestic product (GDP) and agricultural productivity growth. Financial development also reduced the Gini coefficient of income distribution, thus contributing to reducing income inequality. However, when this measure of inequality was replaced with the share of the poorest quintile in GDP, financial development ceased to have any effect, pointing presumably to the exclusion of the poorest in the sample of Asian countries considered. Undernourishment was also reduced directly by financial growth (in terms of private credit in GDP), or indirectly through agricultural productivity growth.

However, financial development does not always have a positive effect on income inequality. In fact, Greenwood and Jovanovic (1990) predict a non-linear relationship between financial development, inequality and economic development. At all stages of economic development, financial development improves capital allocation, boosts aggregate growth and in turn benefits the poor. However, the distributional effect of financial development, and thus the net impact on the poor depends on the level of economic development. At early stages of development, only the rich enjoy access to and benefit directly from better financial markets. At later stages, as access becomes more extensive, a higher section of society benefits directly from financial development.

CHAPTER 2
Microfinance Development

2.1 Microfinance and Poverty: A Macro Perspective

Most studies on the impact of microfinance on poverty or income have relied on micro-level evidence based on household data (Imai et al. 2010, Khandker 2005, Mosley 2001). Macro-level studies are rather limited due to the scarcity of reliable macro data on microfinance. A recent study (Imai, Gaiha, Thapa and Annim 2012) has analyzed the macro-level impact of microfinance on poverty using cross-sectional data covering 48 countries in the developing regions for 2007. The cross-sectional data was supplemented by a two-period (2003 and 2007) panel covering 61 countries[1]. The study was based on the data generated by Microfinance Information Exchange or MIX (2010) and the World Development Indicators 2011 (World Bank 2011). The results of this study suggest that microfinance not only reduces the incidence of poverty but also its depth and severity. Other factors that contribute to poverty reduction include gross domestic product (GDP) per capita and share of credit in GDP (as a measure of financial development of an economy). The study also points to worsening of poverty in a mild recession scenario with small reductions in gross loan portfolio per capita, GDP per capita, and share of credit in GDP. The simulations made in the study are helpful in adding precision to anecdotal evidence about how setbacks to microfinance institutions (MFIs) hurt the poor. Indeed, sustained flows to MFIs may help avert to some extent accentuation of poverty as a consequence of the slow and faltering recovery of the global economy.

2.2 Microfinance: Micro-level Impacts

A number of studies based on randomized control trials have shown that formal financial services have a positive impact on various microeconomic indicators such as household consumption, well-being, and business activities. Such impacts vary by financial product category. Attanasio et al. (2011) found a significant impact of group microcredit on food consumption in Mongolia. Better monitoring of group loans was seen as the main reason for these results as it ensured discipline in terms of project selection and execution. Another study of expanded access to consumer credit in South Africa found increased borrower well being in terms of income and food consumption, decision making within the household, borrower's status in the community, and overall health status (Karlan and Zinman 2010). Expanded access to credit can also have a positive impact on women's decision-making power in the household (Angelucci et al. 2013).

Many studies have found a positive impact of access to microcredit on various indicators related to businesses, including the income of existing businesses, business size, and the scale of agricultural activities, and the diversification of livestock (Attanasio et al. 2011, Ausburg et al. 2012, Angelucci et al. 2013, Crepon et al. 2011, Field et al. forthcoming). Access to microcredit also increases the ability of micro-entrepreneurs to cope with risk. Some researchers have, however, did not find improvements for longer-term welfare indicators, such as education, health, or women's empowerment because of access to microcredit (Banerjee 2013).

Among the various microfinance products, most studies have focused on the impact of microcredit on well-being of the poor. However, other financial products like savings, and insurance also are important for the welfare of the poor. Studies show positive impact of savings on consumption smoothing,

[1] From Asia and the Pacific region, Bangladesh, Cambodia, China, East Timor, India, Indonesia, Mongolia, Nepal, Sri Lanka, and Vietnam were included in the sample.

working capital formation and women's empowerment. Ashraf et al. (2010) found a positive impact of access to a commitment savings account on women's empowerment in the Philippines. Women's role in household decision-making increased together with a shift toward women-oriented durable goods purchase. Access to this type of savings account contributed to an increase in food expenditure for the family, investments in female-owned businesses, and investments in preventative health in Kenya and increased expenditures and crop outputs in Malawi (Dupas and Robinson 2013, Brune et al. 2013). Insurance can help the poor in mitigating risks and managing shocks. For example, weather-based index insurance enabled farmers in India to shift from subsistence to riskier but more remunerative cash crops (Cole et al. 2013). Similar results were reported also in Ghana, where farmers were able to obtain higher yields and income due to higher use of fertilizer and hired labour (Karlan et al. 2014).

2.3 Impact of Microcredit on Poverty: An IFAD Project Experience

Many studies have attempted to analyze the impact of microcredit on the well-being of the poor. For example, Gaiha (2001) has attempted to review the Maharashtra Rural Credit Project (MRCP) – a microcredit scheme supported by the International Fund for Agricultural Development (IFAD) and implemented in Maharashtra state of India—by focusing on the process of implementation and its implications for targeting, especially of women, and the trade-off between coverage of the poor and sustainability of the scheme. Some of the important findings of this study are as follows:

- The non-poor beneficiaries of individual loans under the scheme turned out to be more than the poor. However, self-help groups (SHGs) with a good track record consisted mostly of poor women.
- Exclusion of the poorest (e.g. indigenous people/tribal population) was partly a result of their own lack of awareness about the project and diffidence about their ability to repay loans. But more seriously, their exclusion also reflected their social exclusion, the resistance of upper castes, and the nexus among the bank staff, Sarpanch (village head) and the Village Development Committee.
- The loan processing time was much longer for the poor. Moreover, the affluent secured much larger loans.
- The financial discipline demonstrated by the SHGs was impressive. This was reflected in high rates of loan repayment.
- While no case of violence was reported, there were indications of male dominance in the selection and use of the assets.
- Combining financial services with some forms of insurance (e.g. against illness and accidents) would make the project more attractive to the rural poor, as their ability to deal with contingencies is limited.

CHAPTER 3
Financial Inclusion

Although there have been efforts in the past to collect indicators of financial access from providers of financial services as well as from the users, the Global Findex database is the first major effort to provide cross-country, time-series data on individual's use of financial services (Demirguc-Kunt and Klapper 2012). The Global Findex indicators measure the use of financial services and are based on survey data collected in 2011 covering more than 150,000 adults in 148 countries.

This study shows that about half of the adults in the world or approximately 2.5 billion adults do not have an individual or joint account at a formal financial institution—bank, credit union, cooperative, post office or microfinance institution (Microfinance Barometer 2014). In developing countries 59% of adults do not have formal accounts compared to only 11% in developed countries. There are wide variations in account penetration by region, gender, economic status as well as between rural and urban areas.

Among the regions of the world, East Asia and the Pacific has the lowest percentage of unbanked adults at 55% whereas in South Asia, two-thirds of adults do not have accounts, which is higher than in Sub-Saharan Africa and Middle East and North Africa regions but lower than in other regions (Table 1). Globally, 53% of women do not have a formal account, which is significantly higher than 45% for men indicating a wide gender gap. Although in all regions women have lower access to formal accounts, gender gap is the highest in South Asia (75% for unbanked women versus 59% for unbanked men). Globally, only 77% of adults living on less than $ 2 a day do not have a formal account. In developing countries, those in the richest quintile are on average more than twice as likely as those in the poorest quintile to have a formal account. In all regions, adults in rural areas are less likely to have a formal account than those living in cities. Technological and other innovations can help mitigate this constraint to a large extent as demonstrated by the use of mobile phones for banking purposes in many countries of the world.

Table 1. Global Unbanked People in 2011

Region	Unbanked people		Share of women (%)	Share of men (%)	Urban share (%)	Rural share (%)
	Million	%				
East Asia & Pacific	648	45	48	42	29	50
South Asia	764	67	75	59	61	69
Middle East & North Africa	207	82	87	77	82	89
Europe & Central Asia	171	55	60	50	49	58
Sub-Saharan Africa	359	76	79	73	60	79
Latin America & Caribbean	252	61	65	56	56	66
World total	2 401	49	53	45	41	54

Source: Global Findex Database

Barriers to Financial Inclusion. Globally, the most frequently cited reason for not having a formal account (cited by 30% of adults with a formal account) is lack of enough money to use one. This shows that those whose income is small or irregular do not view a formal account as necessary. Other common reasons for not having a formal account are that banks or accounts are too expensive (mentioned by 25% of adults with a formal account) and that another family member already has an account (cited by 25%). Other reasons mentioned by the respondents are that banks are too far away (cited by 20%), lack of necessary documentation (18%), lack of trust in banks (13%), and religious reasons (5%).

Distance to a bank is a more important barrier in rural areas than in cities. However, technological and other innovations have the potential to help overcome this constraint. For example, mobile money has shown the potential of technical innovation to promote financial inclusion. It has allowed underserved people to conduct financial transactions in a relatively cheap and reliable way. Likewise, the use of other forms of branchless banking has grown rapidly in many developing countries in recent years. One popular form has been the use of bank agents, who operate out of retail stores, gas stations or post offices. In Asian countries such as Bangladesh, Laos, Nepal and the Philippines, more than 10% of account holders already report using bank agents (Demirguc-Kunt and Klapper 2013).

Governments in many countries are increasingly using formal accounts to disburse transfer payments to the poor. For example, in India the government recently started to deposit government pension and scholarship payments directly into the bank accounts of 250,000 people in 20 districts. There is a plan to expand this programme, which has the potential of preventing corruption and expanding financial access (Harris 2013).

In developing countries, family and friends are the most commonly reported sources of new loans whereas most adults borrow from formal financial institutions in high-income countries. In both East Asia and the Pacific, and South Asia, only 9% of adults borrowed from formal sources (Demirguc-Kunt and Klapper 2013). Some Asian countries such as Bangladesh (23% of adults), Sri Lanka (15%) and Thailand (15%) reported higher level of borrowing from formal sources, which may be a reflection of a broad coverage of community-based models in these countries that provide small loans to the poor. The most common reason for borrowing was reported to be emergency or health purposes, particularly among the poorest followed by payment of school fees, home construction, funeral or wedding.

Only about 20% of adults in South Asia reported having saved in the past 12 months, half of them at a financial institution. In contrast, 40% of adults in East Asia and the Pacific saved, most of whom in formal financial institutions. Only 17% of adults in developing countries bought health insurance. There was a wide variation across region. In China 47% of adults bought some form of health insurance whereas only 9% in East Asia and the Pacific (except China) and 5% in South Asia report having paid for health insurance. Although people working in the agriculture sector (including fisheries and forestry) are prone to weather-related risks, only 6% in this sector report having bought crop, rainfall or livestock insurance in the past 12 months.

3.1 Coverage of Microfinance in Asia/Pacific

Microfinance has emerged in the world as a significant instrument of financial inclusion. Table 2 shows the number of borrowers in different regions of the world, their portfolio size, and the share of rural borrowers. This is based on the information provided by 1,252 microfinance institutions (MFIs), who report to Mix and who represent the majority of microfinance service providers in the world. In 2012, these MFIs provided loans worth USD 81.5 billion to 91.4 million low-income clients of whom about two-thirds were rural clients. There was a 5% increase in outreach in 2012 after a 4% decline in 2011, with all regions and 73 out of 95 countries reporting growth in outreach in 2012 (Microfinance Barometer 2014).

South Asia alone has 47.5 million borrowers, which is 52% of the world's total. Of the largest 100 MFIs, 43 are in this region accounting for roughly half of global borrowers. This region also leads in terms of proportion of female borrowers (92%) and share of rural borrowers (80%). East Asia and Pacific has 12.8 million borrowers (14% of global total) with 71% of rural and 64% of female borrowers. This region has the second highest portfolio size at USD 21.2 billion, second only to Latin America and Caribbean (USD 33.4 billion).

Table 2. Microfinance coverage, 2012

Region	Number of borrowers			Annual Growth (%)		Share of rural borrowers %	Portfolio size (USD billion)	No. of MFIs reporting to Mix
	Total million	Male (%)	Female (%)	2012	2013			
East Asia & Pacific	12.8	36	64	7.2	3.5	71	21.2	157
South Asia	47.5	8	92	2.9	9.6	80	8.9	166
Middle East & North Africa	1.8	41	59	1.9	1.0	45	1.6	39
Europe & Central Asia	2.7	53	47	9.2	3.7	64	11.4	206
Sub-Saharan Africa	7.3	37	63	10.9	0.9	54	4.9	313
Latin America & Caribbean	19.2	32	68	8.2	2.8	37	33.4	374
World total	91.2	21	79	5.0	6.5	66	81.5	1 252

Source: Mix Market

3.2 Institutional Credit to Rural and Agriculture Sector

Among the many causes of rural poverty, the lack of access to formal and adequate financial services remains a major impediment to the socio-economic choices of rural poor people and smallholder farmers (IFAD 2009). Many studies have demonstrated the crucial role of finance in raising agricultural productivity and incomes. Based on a study in India Binswanger et al. (1993) concluded that the availability of credit was more important than subsidized interest rates, and the expansion of banking had a larger impact on output through expanding fertilizer use than through increased investments. Bank expansion was facilitated by public investment on roads and reduced transaction costs for banks and farmers. World Bank (2007) argued that financial constraints are more pervasive in agriculture than in other sectors. In order to provide broader access to financial services-credit, savings, insurance, and transfer services for remittance to smallholders and to reduce their exposure to uninsured risks, financial instruments will be required that improve the productivity, profitability, and sustainability of smallholder agriculture. In addition to farming, agricultural households in developing economies diversify their income across different sources, and credit constraints can adversely affect their ability to take up non-farm activities (Ellis 2000).

There are many challenges to providing financial services to poor rural households, including weak infrastructure and low population density in rural areas (IFAD 2009). The capacity of financial service providers and the level of client education are usually limited in rural areas. The financial market may be distorted from subsidized, targeted lending. Also, financial institutions may be hesitant in lending to the agriculture sector because of its seasonality and inherent risks of farming. Another important challenge has been the lack of access of women and the poorest of the poor to credit due to lack of property rights or secure land tenure. These challenges increase the transaction costs and risks of providing financial services to smallholders and other rural entrepreneurs.

Many studies have shown that the supply-led approach to agricultural credit that has historically been followed in many developing countries has created viable alternatives to moneylender, although for households with somewhat greater assets and sources of collateral. Better access to bank has also increased fertilizer use and investment in agriculture, but has been less successful in generating viable institutions, including failing to generate agricultural employment (Binswanger and Khandker 1995). The contemporary approach to rural/agricultural finance includes a broadened view of finance to include farming and rural non-farm activities, recognition of the importance of savings, and a realization that market discipline is reinforced through market interest rates for both savings and credit (Meyer 2013). In this new paradigm, the focus of lending shifted from meeting supply targets to responding to demand, and the measure of success of financial institutions changed from loan disbursements to financial viability and sustainability. The efforts of governments and development partners focused on the creation of a conducive policy environment, improving the legal and regulatory framework for rural financial market, building institutional capacity, and promoting innovations to lower transaction costs and improve risk management.

3.3 Microfinance in Agriculture

Microfinance programmes were started in many countries by non-governmental organizations to help the poor. Several innovative lending technologies and institutional designs played an important role in the success of many of these programmes (Gonzales-Vega 2003). First, group lending on a joint liability basis helps resolve the lack of collateral by the poor. Peer pressure contributes to timely loan repayment as the whole group cannot get a new loan if any member defaults. As the loans are small, it helps reduce risks for both lenders and borrowers. Frequent loan payments allow lenders to effectively monitor borrowers. A wide variety of delivery systems and institutional models exist for microfinance, including non-governmental organizations, cooperatives, self-help groups, rural banks, commercial and agricultural development banks.

The microfinance sector has grown very rapidly during the 2000s attracting almost $ 1 billion a year (CGAP 2006). It has also become increasingly commercialized with large investments from private and social investors. As of December 2008, a total of 61 donors and investors had committed $ 14.8 billion to microfinance (CGAP 2009).

Historically, microfinance involved small group loans in urban areas and rural areas with high population densities, as the high cost of making and recovering small loans required high volumes per loan officer. As these loans did not require collaterals, frequent loan repayments, usually weekly or monthly were considered essential to maintain financial discipline. This approach favoured borrowers with more regular sources of cash income (e.g. petty trade). As a result, microfinance has not been able to cater to farmers with seasonal cash flows. Bangladesh provides a good example of this trend. Some 25-30 million borrowers had access to microcredit in Bangladesh in 2008, with 6-7 million of these engaged in crop production but only 1-1.5 million borrowers took loans specifically designed for seasonal or investment lending in agriculture (Alamgir 2009). Within the agriculture sector, MFIs usually provide loans for small livestock or dairy production with relatively quick returns but not for crop production with seasonal returns.

There are several challenges in designing microfinance products suitable for farmers (Meyer 2011). First, most MFI borrowers are women whereas crop farming is usually dominated by men. Second, for MFIs standardized annual loans are earlier to manage, as most of them still use manual bookkeeping. Third, MFIs prefer loans with periodic payments rather than lump-sum ones, as it is easier to monitor clients who make periodic payments. Fourth, agriculture is perceived as a risky enterprise by MFIs. Finally, decentralized decision making and capacity building of staff is needed to develop flexible loans that suit farmers' cash flows.

In recent years, there have been many initiatives to design innovative loan products suitable for seasonal agriculture. For example, the International Fund for Agricultural Development (IFAD) and the Asian Development Bank (ADB) have sponsored projects to support apex funding institutions such as the Palli Karma Sahayak Foundation (PKSF) in Bangladesh to find innovative ways to provide agricultural loans. There are several examples showing that MFIs have found ways to reduce costs and risks of agricultural lending. The success of MFIs in agricultural lending in recent years has been facilitated by a number of innovative practices. These include treating the borrower as a firm household, determining loan size and repayment schedules based on the cyclical cash flow of the household, and delinking loan payments from loan use (Meyer 2011). In order to reduce risks, MFIs lend to borrowers with diversified cash flows, diversify portfolio risks by lending to farmers in different regions with different crop and livestock enterprises, link credit with area-based index insurance, and insulate themselves from political interference (CGAP/IFAD 2005). Box 1 below describes a successful example of microfinance in agriculture.

Box 1: Microfinance in Agriculture: The Experience from an IFAD-Supported Project in Bangladesh

The International Fund for Agricultural Development (IFAD) funded a project entitled Microfinance for Marginal and Small Farmers Project from 2005 to 2011 at a total project cost of US$ 29.74 million (of which IFAD loan was US$ 20.06 million) which was implemented by Palli Karma Sahayak Foundation (PKSF), a government apex funding agency for non-governmental organizations (NGOs).

The project was designed with the realization that earlier policies that channeled formal credit for agriculture through the nationalized commercial banks did not cater to many small and marginal farmers, and that any barriers to lending for agriculture by microfinance institutions (MFIs) should be removed. The project strategy was built on the channeling of microcredit funds to beneficiary groups organized by MFIs. These NGO-MFIs were selected partner organizations (POs) of PKSF, which had a well-established system to provide microfinance services to the landless poor. The project aimed to extend these services to a new target group—small and marginal farmers. The project design saw the need for loans and other financial services (savings and insurance) to be tailored to meet the needs of farmers. The design recognized that lending to farmers needed to account for the special risks involved in agriculture.

During the course of the project, a number of changes/innovations were introduced. The first of these was a move from loans with weekly repayments to loans where repayment was in a lump-sum after harvest or sale of animal. The second change introduced was the concentration of agricultural extension advice and training on five main topics, all of which can lead to substantial savings in production costs and an increase in yields. A third important development, introduced at the time of the mid-term review of the project was the recognition that the partner organizations needed more agricultural expertise. As a result, the project created additional posts of assistant agricultural officers.

The project made an important breakthrough in extending microfinance services to agriculture. Women members accounted for 85% of total borrowers. Over half of loans have been seasonal loans, an important innovation which fit better with the cash-flow from farming. PKSF has developed simple methods of supervising seasonal loans and has succeeded in getting them accepted as an appropriate financial product to meet the needs of farmers. Partner organizations have reported good loan repayment rates.

The project implemented through 35 POs of PKSF in 133 Upazilas spread over 14 districts of the country assisted more than 200,000 producers to become active microfinance clients. Currently, innovative financing and agricultural technologies tested by the project have been made available to more than 800,000 marginal and small farmers across the country. In 2014, the US Department of Treasury selected this project as a winner of Development Impact Honors Award 2014.

Sources: (i) operations.ifad.org/documents/654016/c97ff515-fd4d-4371-987a-e305cf873389, (ii) pksf-bd.org/?p=2227

CHAPTER 4
Challenges of Rural/Agricultural Finance

4.1 Challenges related to provision of services to rural households

There are many constraints to supplying agricultural and rural finance in developing countries. These constraints have been classified into four broad categories: (i) vulnerability constraints, including systemic, market, and credit risks; (ii) operational constraints due to low investment returns, low investment, low asset levels, and geographic dispersion; (iii) capacity constraints including infrastructural capacity, technical capacity and training, social exclusion and institutional capacity; and (iv) political and regulatory constraint, such as political and social interference and regulatory framework (Miller 2004).

Borrowers in rural areas are more dispersed than in urban areas due to low population densities. Transaction costs for delivering loans are high for financial institutions because rural clients demand relatively small loans and savings accounts. Poorly developed infrastructure in rural areas increases information costs for service providers as well as users. Agricultural incomes are subject to seasonality and several types of risks: yield risks due to weather, diseases, and insects; market risks due to local and global weather and market variations; timing uncertainties due to farm-specific weather variations; uncertainties in the timing of repairs and reinvestments; and illness, accidents, and other life-cycle risks (Meyer 2011). Rural borrowers usually do not have loan collateral due to lack of assets or poorly defined property rights. Inadequate regulation and supervision of financial intermediaries, limited lobbying power among the rural poor, weak governance, corruption, and other political factors also limit the provision of rural finance (Yaron et al. 1997).

A number of studies have analyzed the determinants of increased use of institutional credit in agriculture. A study in India found that a number of socio-demographic factors, such as education, farm size, family size, caste, gender and occupation of household, affected the quantum of institutional credit availed by farm households (Kumar et al. 2010). The study showed that bigger household size and larger farm size increased the probability of taking credit from institutional sources. It also reconfirmed the disadvantages faced by poorer segments of society (e.g. lower castes, tribal populations) and women in accessing institutional credit. The level of education was positively correlated with access to institutional credit indicating the need for capacity building of farmers. The study also highlighted the need for procedural simplification for loan disbursement to enable less educated and illiterate household to access institutional credit.

It is estimated that there are 500 million smallholder farms in the world with 2.5 billion people living in these households (IFAD 2014). Several studies argue that different kinds of smallholders have different kinds of financial needs and financial products needs to be tailored to suit their differentiated needs. A recent divides the world's smallholder farms into three broad categories: approximately 300 million (60% of total) subsistence oriented or noncommercial smallholder farmers, 165 million (33%) commercial smallholders in loose value chains, and 35 million (7%) commercial smallholders in tight value chains (Peck and Anderson 2013). Noncommercial smallholders usually grow staple food crops, have limited access to land, technology, markets, and technical information and use limited amounts of purchased inputs. They are highly vulnerable to income and other shocks and are not linked to any structured value chains. They meet their basic financial needs through informal financial mechanisms such as local savings and loan groups. Their demand for financial services poses three major challenges to service providers: their income is low, irregular and unpredictable; the average size of financial transaction is small; and the cost of developing a financial product is large relative to its potential income.

Commercial smallholders in loose value chains grow a mix of staple food and high-value crops but have limited access to purchased inputs, financial services and markets. Although these farmers have access to a wider range of financial products than subsistence farmers, some financial products or approaches (e.g. weather-index based insurance, contract farming) may not be suitable or available to them. Commercial smallholders in tight value chains grow high-value crops and usually have production contracts with buyers. They benefit from specialized agricultural finance approaches such as contract farming, equipment leasing, and long-term investment loans. They also demand more sophisticated risk management products including crop and livestock insurance. One important challenge they face is the need to maintain high standards of quality and phyto-sanitary requirements of outputs to be sold under contract framing.

CHAPTER 5
Emerging challenges in microfinance for agriculture

5.1 Product design for rural poor and smallholders

The microfinance revolution has shown that innovative financial products and processes can contribute to financial inclusion by expanding outreach among the poor. However, experience has shown that microfinance schemes are concentrated in urban areas or rural areas which are densely populated and have bypassed the remote rural areas where the poorest of the poor live. Furthermore, as discussed above, the cost of developing a financial product for the unserved population (e.g. noncommercial smallholder farmers) may be large relative to the potential income from such development (Peck and Anderson 2013). Governments and donors have an important role in supporting MFIs and other financial institutions to develop innovative financial products that are appropriate for poor rural producers including smallholder farmers. One example of such support is the programme funded by CGAP and the Ford Foundation to test nine graduation models that target the poorest of the poor (El-Zogbi et al. 2009). More such efforts are needed to develop and/or adapt new financial products for poor households in rural areas.

5.2 Appropriate use of subsidies

Many studies have documented that rural finance that subsidized interest rates led to distortion of financial markets without significant impact on the welfare of borrowers. However, there is now a growing interest in identifying areas for smart or market friendly subsidies that focus on economic environment, rules and regulations and support institutions that can contribute to the performance of the financial system (Meyer 2011). Subsidies can be used to provide innovation grants to help MFIs develop and test new financial products, develop management information systems, and provide capacity building training.

However, critics argue that subsidies for financial institutions can create subsidy dependence as the recipients of subsidies expect it to continue in the future in increasing amounts. Also, the high level of profits that private and institutional investors earned from microfinance operations has led to ethical questions about the use of and gains from public subsidies and from high interest rates charged for microcredit (Von Pischke 2008). High returns from microfinance have encouraged investors to invest private capital in the microfinance sector. However, concerns have been raised about the high profits earned by the private investors by charging extremely high rates of interest to poor borrowers.

Development partners have also reviewed their experiences in the use of grants and subsidies and have identified new strategies. IFAD developed its rural finance policy in 2009 based on six guiding principles for support at the micro, meso and macro level (IFAD 2009). These guiding principles are: (i) support access to a variety of financial services, including savings, credit, remittances and insurance, recognizing that rural poor people require a wide range of financial services; (ii) promote a wide range of financial institutions, models and delivery channels, tailoring each intervention to the given location and target group; (iii) support demand-driven and innovative approaches with the potential to expand the frontiers of rural finance; (iv) encourage, in collaboration with private sector partners, market-based approaches that strengthen rural financial markets, avoid distortions in the financial sector and leverage IFAD's resources; (v) develop and support long-term strategies focusing on sustainability and poverty outreach, given that rural finance institutions need to be competitive and cost-effective to reach scale and responsibly serve their clients; and (vi) participate in policy dialogues that promote an enabling environment for rural finance, recognizing the role of governments in promoting a conducive environment for pro-poor rural finance. IFAD recognizes that donor support is required mainly to strengthen the delivery capacity of financial service providers in rural areas and to upgrade non-formal institutions to higher level forms as necessary. It considers the provision of training and consultancy services, improvement of professional standards, and purchase of operating assets as different forms of subsidies.

World Bank (2006) has developed a strategy involving three pillars of support for rural finance sector development: (i) government policies and the legal, regulatory, and supervisory framework; (ii) financial sector and real sector infrastructure; and (iii) financial institutions. It has identified several areas for subsidies that can contribute to poverty reduction without distorting the development of sustainable rural finance. These areas include: providing technical assistance to financial intermediaries to improve systems that enhance efficiency, such as management information systems; developing and introducing demand-responsive products on a pilot basis; helping develop or improve service delivery mechanisms that enable greater outreach into rural areas; covering a portion of the cost of establishing new branches in areas that do not have financial intermediaries that serve the poor; creating capacity within regulatory and supervisory bodies; supporting the creation of industry associations; and developing training institutes and credit information agencies. World Bank recommends that subsidies should be time-bound, limited, and decreasing over time.

5.3 Rigorous evidence of impact

Increasingly, donors link funding to evidence of impact of rural/microfinance on the welfare of the poor and sustainability of financial system. Historically, most studies have confirmed the positive impact of rural/microfinance on businesses and the welfare of poor borrowers. Some studies based on more robust impact evaluation techniques challenged these results (Duflo et al. 2008). However, as discussed above, more recent studies using similar methodologies have shown positive impacts of rural/ microfinance on businesses and the welfare of the poor (e.g. income, food consumption, women's empowerment).

Notwithstanding these findings, there is a dearth of studies that examine the welfare impacts of innovative financial products introduced in recent years, such as youth financing. There is a need to develop monitoring tools to collect data and evaluation techniques that can rigorously assess the impact of such programmes. Similarly, evidence-based evaluations are needed to show the impact of the new index based insurance products in terms of reducing vulnerability, providing income protection, improving risk taking ability, farm level investments and enterprise diversification, and the ripple effects of such insurance products on the uninsured to help formulate policies (Nagarajan 2011). For this, there is a need to develop cost-effective methodologies to collect long-term data from weather stations, insurers and clients, and to conduct rigorous impact evaluations.

5.4 Over-indebtedness among poor borrowers

Historically, microcredit has had an impressive repayment record with very low levels of loan delinquency. However, in recent years, there have been many reports of rising rates of delinquency in several countries such as India, Pakistan, Bosnia-Herzegovina, Ghana, Morocco, etc. This has not only threatened the viability of microfinance institutions but has also increased vulnerability and welfare loss of poor borrowers. Reduced consumption levels and a loss of creditworthiness are some of the adverse effects of over-indebtedness on borrowers. It can also cause a loss of social prestige of borrowers and more serious psychological effects on their mental health including suicides in extreme cases. Over-indebtedness can also lead to damaging over-reaction by policy makers (e.g. interest rate caps) or cutback in funding level from donors and private investors for microfinance schemes. Studies show that there are three broad categories of factors responsible for over-indebtedness—lender behavior (e.g. slackening of lending standards, pressure on borrowers to take out new loans, coercive loan collection practices), borrower behavior (e.g. focus on current consumption by borrowers with little attention to future consequences), and external shocks (e.g. idiosyncratic risks faced by the poor such as illness in the family, natural disasters, conflicts).

Schicks and Rosenberg (2011) have reviewed the findings of six recent studies covering six countries (Bolivia, Bosnia-Herzegovina, Cambodia, Ghana, India, and Peru), which have looked at the issue of over-indebtedness of microcredit borrowers. These studies have used different approaches to define and/or measure over-indebtedness—negative impact of loans on borrowers, incidence of default and arrears, debt ratios, incidence of multiple borrowing, and borrower struggle and sacrifice. There are two major issues with respect to these approaches. First, all of these methods of assessing over-indebtedness have limitations. For example, several studies find the incidence of multiple borrowing to be associated with a higher risk of default. However, borrowing from multiple sources is a common strategy of poor households for cash-flow management. Assessing over-indebtedness based on whether loans are making borrowers worse-off seems theoretically attractive but it is difficult and cumbersome to reliably determine whether loans are hurting borrowers. Second, the countries selected for these studies do not represent the vast majority of countries where microcredit is an important component of rural finance service delivery. By design, these countries are those which were facing problems related to repayment of microcredit loans and therefore represent a biased sample. Third, the evidence from these studies is insufficient to draw definitive conclusions about the degree of microcredit indebtedness. In view of these limitations, there is a need for further carefully designed studies covering representative sample of countries using a standard methodology to draw general conclusions about microcredit over-indebtedness and to find appropriate solutions to address the problem.

5.5 Replication and scaling up

Several innovative approaches to deliver financial services to the poor in rural areas have been successfully demonstrated in many countries. These include weather index based insurance, youth financing programmes, digital finance, etc. However, these approaches have not been scaled up to expand outreach. It is important to understand the constraints related to policies, infrastructure, technologies, etc. which impede the successful replication and scaling up of such new approaches. It will then be possible to take necessary measures to tackle these problems.

5.6 Institutional Development

Diverse types of financial institutions provide financial services to rural households. These include agricultural development banks, commercial banks, microfinance institutions, self-help groups, cooperatives, saving and credit associations, etc. These institutions offer different advantages and suffer from different limitations. For example, the agricultural development banks were established in the 1960s and 1970s to provide financial services to farmers and other rural entrepreneurs. They focused on the subsidized directed-credit programmes. However, they failed in most countries as their operations proved to be costly and unsustainable in the long-term and they failed to reach the majority of rural producers. Membership-based institutions have the potential to provide financial services to rural households in remote areas in a cost-effective manner, as they are based in such areas and have access to local information. However, such institutions usually face problems related to governance. Commercial banks have the advantage of providing multiple financial services, have wider network of branches, and are regulated better than other types of institutions. However, experience shows that they shy away from remote rural areas, as they find it cost prohibitive to manage small loans.

This shows that there is no single best type of delivery channel for every rural area, the most appropriate model (private, cooperative, community, local or national government) will depend on the given sociocultural factors and legal framework. It is important to design institutional development programmes with incentives to build internal capacity and reduce dependency, and encourage the inclusion of training and technical assistance in the institution's programme (IFAD 2009). Governments and donors should support financial institutions on a competitive basis and based on their performance. Interest rates should not be subsidized at client level or support the establishment of interest rate caps or other mechanisms that distort markets.

5.7 Ensuring sustainability

In microfinance, sustainability can be considered at several levels – institutional, group and individual – and can relate to organizational, managerial and financial aspects. However, the issue of financial sustainability of microfinance institutions has attracted more attention in mainstream analysis at the expense of the sustainability of the client/borrower (Thapa 2006). Generally speaking, two types of self-sufficiency have been defined for MFIs. Operational self-sufficiency requires MFIs to meet all administrative costs and loan losses from operating income. It is computed by dividing operating income by operating expenses. It is suggested, based on international experience, that successful MFIs should be able to achieve operational self-sufficiency within three to seven years. MFIs achieve financial self-sufficiency when are able to cover all administrative costs, loan losses and financing costs from operating income, after adjusting for inflation and subsidies and treating all funding as if it had a commercial cost. Successful MFIs are expected to achieve financial self-sufficiency within five to ten years.

A true test of the sustainability of any microfinance institution lies in its ability to perform during financial crises. A survey of Indonesia, the Philippines, Malaysia and Thailand showed that MFIs in general fared better than the commercial banking systems during the Asian financial crisis of 1997-1998 (McGuire and Conroy 1998). The crisis seemed to have more adverse impact on institutions catering to small business clients than on specialist MFIs serving the poor, and that the adverse impact on microfinance was most severe in those countries where it was linked most closely to the formal financial system. Those microfinance programmes, including Grameen Bank replications, which targeted the poorest were least affected by the crisis. In contrast, those MFIs which relied on government and donor agencies for resources fared better. However, it does not mean that microfinance should not be more integrated into the formal financial system. In order to expand outreach and serve the poor, MFIs have to establish such linkages. What it indicates is that such linkages make MFIs more prone to cyclical fluctuations.

In discussing sustainability of MFIs, some distinguish between the intended beneficiary school and the intermediary school, where the former is more concerned with the impact of microfinance on the client households and the latter with outreach and institutional sustainability of MFIs (Hulme and Mosley 1996). Microfinance institutions come under pressure to increase the number of beneficiaries so that economies of scale can be achieved and the cost of servicing numerous small transactions starts to fall. These MFIs face major organizational and management problems as they scale up their operations.

This duality reflects the apparent tension between financial sustainability and poverty reduction, that is, whether financial sustainability of MFIs can be reconciled with the objective of reaching the poorest households. Exclusion of the poorest from microfinance schemes is well-known, although the reasons for their exclusion remain unexplored. There is often a perception that moderately poor are less likely to default than poorest of the poor. In such a case, targeting moderately poor is likely to be more sustainable financially. Therefore, exclusion of the poor may well be connected with a concern for financial sustainability. For example, a study points out that "… shifting of the target group to the marginal farmer category (the not-so-poor or the vulnerable non-poor) may be the only way for the

MFIs to achieve their twin goals of poverty reduction and financial sustainability". Indeed, this is symptomatic of a "…. shift in emphasis of targeted credit programmes from exclusive anti-poverty towards primarily financial sustainability with a bit of poverty reduction on the side" (Sinha 1998). Besley (1997), on the other hand, contends that inclusion of the non-poor may be necessary to a limited degree to prevent them from capturing benefits meant for the poor. But whether, in fact, participation of the non-poor is self-limiting and beneficial to the poor remains to be demonstrated.

5.8 Governance

The term 'governance' assumed prominence in the discussion of economic and social development issues since the early 1990s. In microfinance literature, the term was first used by CGAP in 1997 when governance was defined as, 'a system of checks and balances whereby a board is established to manage the managers. Governance is sometimes conceived as a virtuous circle that links the shareholder to the board, to the management, to the staff, to the customer, and to the community at large'.

As microfinance reaches a large number of clients, manages increasing volume of financial resources, borrows substantial amounts from financial markets, and starts to earn profit, governance becomes an important requirement (Thapa 2006). Four unique attributes of microfinance makes governance of MFIs different and more challenging than that of other types of institutions: the dual mission of microfinance—achieving profitability and maintaining a social objective; ownership of MFIs; the fiduciary responsibility of the board; and risk assessment in MFIs (Rock et al. 1998).

Most MFIs are promoted by NGOs with donor support and start with a social objective of reaching the poor. As they evolve and expand outreach, they start to focus on achieving financial self-sufficiency, as donor money and subsidies decline. As a result, most MFIs attract private capital including deposits to expand their operations. Although the dual objectives of MFIs appear contradictory, several MFIs have shown that the social objective and profit are not mutually exclusive.

Different stakeholders may have different objectives for a MFI. For example, donors, non-profit organizations and technical assistance providers may emphasize the MFI's social mission, while private investors and employees may be more interested in financial sustainability. However, there are cases where diverse interests have been preserved by making sure each stakeholder has representation on the board of directors. Acknowledging the multiplicity of stakeholders can help in maintaining an institution's initial strategic orientations.

The mission of an institution and the choices it makes for institutional type and ownership structure are closely related and influence each other. Different types of MFIs show structural weaknesses related to ownership that can have an adverse effect on the effectiveness of microfinance. NGOs do not have real owners, as the capital for non-profit NGOs is provided by donors, foundations and individuals. MFIs' ownership has not expanded significantly beyond NGOs and public sector organizations. The focus of commercial banks on profit maximization and the lack of representation of microfinance in their board is a structural weakness. In the case of credit unions, the divergent priorities of borrowers and savers can create conflicts in the board.

Generally speaking, the fiduciary responsibility of the board of any financial intermediary like MFIs is greater than for other non-financial entities. Since in many developing countries, there is a lack of deposit insurance, the board's fiduciary responsibility increases further. Although MFI board has a fiduciary responsibility when a non-profit MFI secures funds from donors, the responsibility is greater when the MFI intermediates funds by borrowing from a bank, by mobilizing deposits or by floating an instrument in the securities exchange.

Guarding against risks is the responsibility of the management of an MFI. Establishing mechanisms to manage risks is directly related to how governance works. MFIs should be aware that microfinance is subject to a variety of risks. These include operational risks (e.g. loan default), information related risks (e.g. unreliable management information system), organizational risks (e.g. risks related to internal control procedures), strategic risks (e.g. competitive environment), and environmental risks (e.g. climate or political risks).

One important risk that MFIs face is that of mission drift, which appears when a MFI transforms from a project with strong social objectives to a formal institution with a strong pressure to mobilize financial resources and achieving sustainability quickly. In order to achieve financial sustainability, MFIs have to reduce costs and increase revenues. This usually involves higher loan amounts, lending to sectors with strong economic potential, diversifying products and increasing staff productivity. These measures may lead to redirecting services towards a different type of clientele or changes to the client-MFI relationship, for example, less proximity with clients or less in-depth knowledge of clients (IFAD et al. 2006). Some NGOs have been able to manage the transformation to a regulated MFI and avoid the mission drift. In discussing governance in microfinance, it is important to broaden the scope of study to include all stakeholders involved (employees, managers, elected officials, clients, donors, bank partners, shareholders, the government, etc.) as well as any organizational form with a governing role that may have been set up at the establishment of the institution (IFAD et al. 2006).

5.9 Regulation of financial sector to ensure client protection

As discussed above, lenders' pressure on borrowers to take out new loans, and coercive loan collection practices were some of the reasons for rising loan delinquency in microcredit schemes in several countries in recent years. In many cases, this caused severe hardships for poor borrowers. It is now generally agreed that financial institutions should provide to borrowers necessary information so that they can make informed decisions about financial products. Also, the borrowers should have access to dispute settlement mechanisms. However, there is no consensus on the most effective ways to bring about discipline among financial sector actors. Possible approaches include government regulations, self-regulation by financial institutions, and peer monitoring. For example, following the microfinance crisis in India during 2010-2011, the Reserve Bank of India (Central Bank) introduced a number of measures to regulate the functioning of MFIs. These included a limit on the maximum income of borrowers (Rs. 60,000 for rural and Rs. 120,000 for urban areas), maximum limit on indebtedness (not to exceed Rs. 50,000), interest rate cap (maximum of 26%) and net interest margin (12%)[2] [Mahajan and Navin 2012)]. These measures have given greater clarity on the regulatory role of the central bank. In addition, there have been other reforms such as the strengthening of consumer protection norms, increased self-regulation by MFIs, etc. It is now important to assess the effectiveness of these different measures under different contexts. At the same time, it is also crucial to develop new approaches to measure the effectiveness of different measures.

[2] The interest rate cap was revised by the Reserve Bank of India as follows: cost of funds plus net interest margin (10% for large MFIs with loan portfolio exceeding Rs. 1,000 million and 12% for small MFIs).

CHAPTER 6
Opportunities in Rural/Agricultural/ Microfinance

After the failure of the subsidized directed credit approach of the 1960s and 1970s, a contemporary approach to rural finance emerged since the late 1980s, which focuses on building the sustainability of financial service providers, thinking beyond the short life cycle of donor-driven projects (IFAD 2009). Strong rural institutions and models present promising partnerships and business opportunities for development banks and commercial banks to participate in rural finance by scaling down their services with financial products suited to the needs of the poor and marginalized households in partnership with membership based organizations. In addition to institutional innovations, technological innovations have also provided new opportunities for different types of financial institutions to expand their services to poor rural households in remote areas. Some important developments and resultant opportunities are discussed below.

6.1 Advances in institutions

Following the adoption of the new approach to rural finance in the late 1980s, a number of institutional developments have taken place, both at the retail level and at the wholesale and apex levels which have opened up new opportunities for financial inclusion. At the retail level, microfinance institutions (MFIs) have designed and implemented innovative approaches to expand the delivery of financial services to poor rural clients. As discussed above, more than 1,250 MFIs reach more than 91 million clients worldwide, two-thirds of whom are in rural areas. Although most MFIs focused on urban areas with high population density, they have gradually expanded the coverage of rural areas. Also, although the majority of them provide only microcredit, there are innovative MFIs which also provide deposit and crop and livestock insurance. Some MFIs have also started to provide microcredit to the agriculture sector by introducing modifications in the mainstream microcredit methodologies to suit the needs of smallholder farmers. There is a lot of potential for MFIs to expand services in rural areas beyond microcredit.

Member-based institutions have also proliferated in many countries to provide financial services in rural areas. They not only own, manage and operate these institutions but also are their main clients. Most of these institutions are informal in nature but some are linked to banks as in the case of self-help groups (SHGs) in India. Although these institutions have limitations in becoming main financial intermediaries and face governance challenges, they are widely prevalent in rural areas and provide financial services to poor rural households.

Agricultural development banks were established in many developing countries during the 1960s and 1970s to provide credit and other financial services to the agriculture and rural development sector. Most of these banks did not perform well and had to be either privatized or closed. There have been some exceptions including the Bank of Agriculture and Agricultural Cooperatives (BAAC) in Thailand. Some argue in favour of reforming such development banks based on two reasons. First, there have been some examples of successful reform of such banks. Second, the closure of such institutions leads to the loss of banking outlets in rural areas. International partners such as the International Fund for Agricultural Development (IFAD) and Deustsche Gesellschaft fur Internationale Zusammenarbeit (GIZ) have supported reform of agricultural development banks based on their potential to serve the rural poor if they implement an appropriate framework of reform. In Asia and the Pacific region, the successful reform of BAAC in Thailand and the Bank Rakyat Indonesia (BRI) in Indonesia has demonstrated the potential for similar efforts in other countries (Seibel 2000). Some argue that these institutions should be transformed into sustainable financial intermediaries based on mobilization of domestic resources and provision of positive real returns to depositors; repayment of loans and coverage of costs from operational income; production of sufficient retained earnings to offset the erosion of resources from inflation and to finance expansion; and continually increased outreach to savers and borrowers and improved quality of services provided to all segments of the rural population, including the poor (Seibel et al. 2005).

Meyer (2011) identifies three important lessons from the reform efforts of agricultural development banks. First, successful reform is possible only if governments make fundamental changes in ownership, governance, products, and services. Second, selected microfinance procedures and lending methods should be adopted and applied to agriculture. Third, more sophisticated risk management techniques will be needed if these financial institutions provide large loans to farmers and nonfarm businesses linked to agriculture.

6.2 Apex institutions

Apex institutions are those which channel funds to retail financial institutions for on-lending to targeted categories of borrowers (Nagarajan and Meyer 2005). Governments and donors use these institutions to finance MFIs. Although the performance of such institutions in developing microfinance has been mixed, there are some success stories. One such example is the Palli Karma Sahayak Foundation (PKSF) in Bangladesh which was established by the Bangladesh Government in 1990 to provide funds to various organizations for their microcredit programmes to help the poor with no land or other collaterals. It provides funds to non-governmental organizations, voluntary agencies and societies, local government bodies, etc. to give microcredit to the poor. As of 2014, it has lent about USD 1.5 billion to its 268 partner organizations covering more than 8.23 million borrowers of which 91% are women (PKSF 2015).

Through a project funded by IFAD, PKSF made innovative contributions to enhancing access to finance by marginal and small farmers, who had little access to credit either from banks or MFIs. The project introduced a lump-sum repayment modality that could better match the farmers' cashflows, in place of weekly repayments that had normally been practiced by MFIs (IFAD 2014). The project introduced seasonal loans and agriculture sector microcredit products as part of their core programmes. Combined with technical support, the project contributed to improved agricultural production. This case of PKSF shows that with strong commitment from the government and the support of external development partner, apex institutions can play an important role in promoting financial inclusion.

6.3 International partnerships

The changing landscape of rural finance, which includes new types of financial service providers and innovative technologies has led to new partnerships between donors and a range of public, social and commercial investors. For example, recognizing the increasing importance of remittances in rural areas, a multi-donor funding facility was established at IFAD in 2005 to promote innovative approaches to remittances in rural areas (IFAD 2009). This facility, with funding support from the European Commission, Inter-American Development Bank, CGAP, Luxembourg, Spain, UNCDF and IFAD provides seed money to test innovative delivery mechanisms and money transfer products in rural areas. So far, it has funded 50 projects in 40 countries, some of which have been scaled up within IFAD-funded investment projects.

Since 2008, a joint IFAD-World Food Programme (WFP) initiative is supporting the sustainable development of weather risk management instruments in developing countries. Funded by the Bill and Melinda Gates Foundation and hosted by IFAD, the Weather Risk Management Facility (WRMF) has documented and analyzed innovative ways of responding to the needs of smallholder producers for risk management. It has funded pilot projects to develop weather index-based insurance, an insurance product correlated to weather patterns for crops, such as rainfall levels. Based on the findings of these pilots, it has published a book with 36 cases, six on disaster relief insurance programmes in 21 countries and 30 on index-based insurance programmes in 19 countries. These pilots show that there is lot of potential for scale and sustainability bin weather index-based insurance for agriculture and rural livelihoods.

In 2013, a new international partnership was started with the establishment of the Platform for Agricultural Risk Management (PARM), which is hosted by IFAD and supported by Agence Francaise de Developpment (AFD), European Commission (EC), Italy, New Partnership for Africa's Development (NEPAD) and IFAD. It is an outcome of the G8 and G20 discussions on food security and agricultural growth and is a partnership between developing countries and development partners designed to make risk management an integral part of policy planning and implementation in the agriculture sector. It is a four-year initiative initially focusing on the Sub-Saharan Africa. As a knowledge broker, PARM will facilitate the identification, assessment, quantification and management of agricultural risks in programme countries. Its initial focus will be on nine African countries and will subsequently cover countries from other regions of the world.

6.4 Innovative financial products

In recent years, several new financial products have been developed and piloted by various types of financial service providers with the objective of targeting smallholders and other rural households. They show the potential for expanded outreach as well as to provide non-credit financial services to these households.

Savings. Savings are important for poor households as a risk management strategy and for smoothing consumption. Deposit services are provided by commercial banks to poor clients but rarely to the poorest households. In recent years, some advances have been made to expand deposit services to the rural poor by introducing new products and processes. For example, in the Philippines access to commitment savings account led to an increase in the decision-making power of women, resulting in a shift toward female-oriented durable goods purchased in the household (Ashraf et al. 2010). BASIX, an MFI in India offers a flexible daily deposit scheme in which savings are collected daily from rural depositors by mobile deposit collectors (Nagarajan and Meyer 2005). Post-office banks are becoming important providers of deposit services to the poor in rural areas. Such post-office banks are operational in several Asian countries like China, India, Indonesia, South Korea and the Philippines. Although these banks are contributing to rural savings mobilization, they face governance problems and have limited capacity to intermediate the funds mobilized in rural areas. If these issues are resolved, they can play a crucial role in providing sustainable financial services to the rural poor.

Insurance. Providing sustainable insurance to smallholders for crops and livestock has always been a challenge. In recent years, the introduction of weather index-based insurance has opened up new opportunities to protect smallholder farmers against production risks. Under this type of insurance scheme, payments are made when an independently observed trigger, e.g. level of rainfall shows that an insurable event has happened. Index-based insurance has the potential of addressing the moral hazard and adverse selection problems, which have plagued the traditional crop or livestock insurance schemes. Additionally, administrative costs are reduced in such schemes as there is no need for verification of individual loss claims. Under an IFAD-WFP programme, a total of 30 index-based insurance pilots have been tried out in 19 developing countries with encouraging results (Hazell et al. 2010). This programme identifies a number of drivers which are important for the sustainability and scalability of weather index-based insurance: (i) create a proposition of real value to the ensured, and offer insurance as part of a wider packages of service; (ii) build the capacity and ownership of implementation stakeholders; (iii) increase client awareness of index insurance products; (iv) imbed onto existing, efficient delivery channels, engaging the private sector from the outset; (v) get access to international risk-transfer markets; (vi) improve the infrastructure and quality of weather data; (vii) promote enabling legal and regulatory frameworks; and (viii) monitor and evaluate products to promote continuous improvement.

Remittances. Increasingly, remittances are becoming an important source of income for poor households in developing countries and they help the poor meet consumption needs as well as make an investment. Asia and the Pacific region is the source of nearly 60 million migrant workers who sent almost US$ 260 billion to their families in 2012 (IFAD 2014c). Nearly 70 million Asian households benefit from this source of income, mostly in rural areas. There is thus an enormous potential to utilize this important source of income not only for consumption but also for investment in agriculture and rural development. Providing remittance-receiving households with more options for using their money will leverage the development impact of remittance on the communities where they live. However, MFIs and post offices, which have a wide network in rural areas are not active players in the remittance market. Regulatory framework and institutional capacity are the two main reasons that MFIs and postal networks have not yet captured a significant share of the remittance market. Regulations in most countries do not allow MFIs to perform foreign exchange transfer, unless they participate as subagents of commercial banks or authorized entities. In addition, most MFIs and postal networks lack staff trained to meet regulatory compliance rules, have insufficient infrastructure to handle remittances, are deficient in data management systems, and face financial liquidity issues (IFAD 2014c). If these challenges are addressed, these institutions can play an important role in channeling remittances for productive investment in rural areas.

6.5 Technological advances

Providing financial services to the poor in remote rural areas with low population density is costly for any financial institution. This leads service providers to shy away from such rural areas. However, in recent years there have been several technological advances which have helped reduce transaction costs for rural finance.

Mobile banking. Recent experiences in Asia, Africa and other regions of the world have shown that mobile banking and mobile money transfer have the potential to overcome the traditional barriers to financial inclusion by providing financial services in a convenient, transparent and secure manner to the rural poor, who are disadvantaged by the inaccessibility of appropriate financial services. Mobile banking includes mechanisms that enable clients to perform banking activities using alternative delivery channels such as point of sales machines, ATMs, internet banking and mobile phone banking. Increasing use of mobile phones and the widespread use of mobile-based financial services in developing countries have generated rising expectations in the development sector.

Use of mobile technologies can help more widespread access to rural and agricultural financial services by reducing the administrative costs to financial institutions and providing more accessible repayment and savings options for customers. Mobile money transfer enables agribusinesses to provide farmers more financial services such as payments into savings accounts or electronic vouchers for inputs and services (USAID 2013). In agricultural value chains, the use of mobile phones can reduce the cost to agribusinesses working with large numbers of small farmers and support increased investment in rural areas.

One crucial challenge in expanding the use of mobile banking and mobile money transfer is that the traditional difficulties, such as enrolling customers and developing agent networks, are amplified when dealing with smallholders who not only have generally lower levels of financial capability but who also generally live in rural areas with lower levels of infrastructure and network coverage (Grossman and Tarazi 2014). Training and capacity building can play an important role in such areas given the risk averse nature of smallholders and their lack of experience with technology.

6.6 Strategic alliances to offer new financial products

There are several instances in which rural financial institutions (RFIs) in developing countries have used strategic alliances and development partnerships to overcome barriers to financial inclusion by introducing new financial products. Such alliances and partnerships can help RFIs access financial resources, reduce transaction costs, acquire technical and management skills, access banking technology and infrastructure, and provide diverse financial products and services in rural areas (Gallardo et al. 2006). For example, the BASIX Group, a prominent MFI in India leveraged business alliances with insurance companies to provide livestock insurance, crop production insurance, and a specially designed life insurance policy for poor households. BASIX could not provide these services on its own. It also tried to develop a mechanism to protect its loan portfolio against risk of loan default by customers due to livestock death, adverse weather, etc. Its strategic partner ICICI Lombard General Insurance Company issued the bulk insurance policy to BASIX, which in turn retailed insurance coverage to smallholders and medium-sized farmers in Andhra Pradesh state of India. Likewise, as a corporate agent of Dabur CGU Life Insurance Company, BASIX provided specially designed life insurance policy to borrowers and non-borrowing customers.

CHAPTER 7 Threats to rural/agricultural/ microfinance

7.1 Future Financial crises

Following the 2008-2009 global financial crisis, there was contraction of credit, and the concomitant reduction in rural credit, with serious implications for the rural poor (Imai, Gaiha, Thapa and Annim 2010). Even though interest rates fell to stimulate demand for credit, there was a strong reluctance to lend in an environment lacking trust. So, effectively, contraction of credit implied higher interest rates and shorter maturities. The demand for credit reduced especially in the target groups of MFIs, and poverty increased through financial constraints on raising agricultural productivity. Vulnerability of low income households also got aggravated because of their failure to smooth consumption. On the other hand, the loan portfolio of MFIs shifted in favour of wealthier clients. In such a situation, the financial viability erodes because of moral hazard and adverse selection. A major priority therefore is to inject more capital into the financial system-especially MFIs. That these concerns emerged as major priorities was reflected in a survey conducted by the Microcredit Summit Campaign, reported in *Microcredit Summit e-news*, vol. 6, issue 2: October, 2008). A summary of the responses to the questions asked is given below.

The concerns stemmed from a tightening money market, higher cost of funds, and drying up of foreign funds. Higher rates of interest resulted in repayment difficulties and reduction in borrowing. Consumption of food is reduced in the event incomes cannot be supplemented. MFIs were being forced to be more cost-effective or else were likely to be wiped out. What was indeed most worrying was the pessimism of investors in microfinance. Few, if any, concrete strategies were identified to deal with the financial turmoil.

Another survey (CSFI, 2009), based on 430 respondents from 82 countries, including observers, regulators, investors and practitioners, threw new light on many of these issues. Going by the aggregate of responses, the concerns about credit risk and too little funding moved centre-stage. The fact that much funding was in non-local currency had added to foreign currency risk owing to volatility in the foreign exchange markets. All these risks taken together were reflected in more serious concerns about erosion of profitability. “Many respondents saw a vicious circle here: the recession creating a worse business environment, leading to mounting delinquencies and shrinking markets, leading to declining profitability, loss of investor confidence, and cutbacks in funding , and so on” (CSFI, 2009, p. 7).

Associated with the vulnerability of MFIs is the larger risk of mission drift and abandonment of their social objectives. There was a mixed response to how well prepared were the MFIs to handle these risks. Barely 5% of the respondents acknowledged that they were well prepared and 13% confessed that they were ill-prepared. The rest gave a mixed response. Among the Asian respondents, however, the concerns about these risks were more muted: liquidity and credit risks figured in their top ten, but not in the concentrated form of other regional respondents. There were also concerns about mission drift and political interference.

Similar impact of future financial crisis on microfinance and rural finance cannot be ruled out given their greater integration with domestic and international financial markets. It is also not easy to separate effects of financial and food price crises. CGAP Survey of 2008 showed that rising food prices following the financial crisis of 2007-2008 led to savings withdrawal, reduced spending on non-food items, and difficulty in loan repayments together with liquidity and credit risks for MFIs (CGAP 2008). Another study also showed that the effects on credit contraction were severe, though emerging Asian countries recovered quickly after the crisis (IFAD 2009b). The potential impact of global financial crisis on microfinance is multi-faceted: global liquidity crunch can affect the cost and availability of funding to MFIs, especially the non-deposit taking ones; anticipating funding shortage, MFIs will slow growth and reduce new lending; loan portfolio of MFIs may shift in favour of wealthier clients; rural credit flow may diminish with major implications for the rural poor; borrowers will likely default on loans fearing no new loans; and MFIs' borrowing in foreign exchange can face both interest rate increases and currency depreciation.

7.2 Climate change

Studies show that climate change will affect all countries, sectors and people. However, the poor countries and the poorest people in these countries, including the smallholders will be the most affected as they have the least resources to cope with the impact of climate change. There have been only a few studies to assess the linkage between climate change and microfinance. One important study has been the one conducted by the OECD in 2010, which analyzed existing portfolio of 22 leading MFIs each in Bangladesh and Nepal (Agrawal and Carraro 2010). This study revealed that many existing microfinance projects are already directed at sectors and activities that would be vulnerable to climate change. This overlap was found to be particularly strong for Bangladesh where agriculture, disaster relief and preparedness, and water and sanitation, which are particularly affected by climate change, constitute almost 70% of the existing microfinance portfolio. The degree of overlap between the priority categories of microfinance programmes and the key climate change vulnerabilities is 47% for Nepal. The main climate change vulnerability in Nepal is in water resources and hydropower sectors but the vulnerability is lower for water and sanitation sector. Agriculture, health and forestry are other sectors with high degree of climate change vulnerability.

Interestingly, there are two important characteristics of microfinance, which make it a good vehicle to implement programmes for adaptation to climate change. First, MFIs have good network of access to the rural poor including women, who are especially vulnerable to the impacts of climate change. Second, microfinance lending helps the poor build their assets, which helps them reduce overall vulnerability and also enhance their capacity to cope with the impacts of climate change.

In fact, several MFIs including those in Asia and the Pacific have started to provide funds to implement forestry and clean energy projects. MFIs can provide loans to rural households to enable them to buy energy saving devices. They can also finance entrepreneurs who supply energy saving devices to households. For example, BASIX, a prominent MFI in India provides a wide variety of services through a group of linked firms, including financial institutions serving the poor (Rippey 2009). It offers off-grid decentralized community-level power projects that bring energy to off-grid villages and promote creation of micro-enterprises in rural areas. In Bangladesh, Grameen Shakti, a non-profit company which is a member of the Grameen family distributes clean-energy products in remote villages. As of December 2014, it has distributed 1.55 million solar home systems, installed 30,291 biogas plants, and distributed 890,905 improved cooking stoves (Grameen Shakti 2015).

7.3 Political/policy backlash

In many developing countries, MFIs witnessed rapid growth particularly from 2006 onwards. To cope with this growth, they recruited a large number of staff but could not provide adequate training to them. Competition among the MFIs led to a focus on financial results at the cost of development priorities. In many cases, regulatory bodies could not provide adequate supervision of MFIs and client protection could not be ensured. MFIs could raise more funds as long as they maintained capital adequacy and a good repayment rate. In such a situation, multiple lending led to over-indebtedness among the borrowers and many MFIs resorted to coercive practices to ensure repayment of loans. There were also reports of exorbitant profits made by some social investors through IPOs in an environment of lack of transparency among financial service providers and a weak credit information sharing framework.

This situation led to a major backlash against the financial service providers in several countries since 2008. The government tightened the regulation of financial sector, especially of the microfinance sector that is generally loosely regulated. For example, after the microfinance crisis in India, especially in Andhra Pradesh state, the Reserve Bank of India implemented several regulatory measures including an interest rate cap on individual loans (26%), a net margin cap (12%), maximum income of the clients (Rs. 60,000 for rural and Rs. 120,000 for urban borrowers), size of indebtedness (not to exceed Rs. 50,000), and the extent of loan that can be used for consumption (maximum of 25%) [Mahajan and Navin 2012]. While most of these measures are important to strengthen consumer protection and for closer monitoring of the sector, the issue of interest rate cap remains a tricky one. Historically, microfinance has thrived despite high operating costs and risks because this sector has been able to avoid interest rate caps. Some argue that the microfinance sector is threatened in several countries that have imposed interest rate ceilings (Meyer 2011). Low interest rates may be less critical to borrowers than policy makers expect, as rates of return in most cases are higher than assumed.

CHAPTER 8
Future Directions

As discussed above, there have been many new developments in recent years in countries of Asia and the Pacific region in terms of new set of service providers and new financial products. These developments have created new opportunities to expand outreach to unserved areas and unserved populations in rural areas and to provide new financial services like micro-insurance, remittances, etc. Most of technological and institutional innovations have been initiated by financial service providers but the governments have also played an important role in creating conducive policy and regulatory environment. However, many challenges persist in expanding services to the poorest segments of society including women and smallholders. There is also a threat of government interventions and imposition of interest rate ceilings.

Fortunately, two new types of initiatives have been taken in recent years by a coalition of stakeholders to promote financial inclusion and responsible finance. The effective implementation of these initiatives is expected to address the challenges faced by the rural finance and microfinance sector. A brief description of these initiatives is presented below.

8.1 Promoting financial inclusion

As discussed earlier, recent studies using rigorous methodologies confirm that financial inclusion has the potential to improve the welfare of the rural poor, enhance business activities, and improve delivery of other social benefits cost effectively. However, as the Global Findex data show, a lot needs to be done to expand financial inclusion because millions of rural poor in developing countries, particularly women, poorest of the poor including smallholders do not have access to financial services. So, it will be an important challenge for policy makers and development partners to tackle the challenges constraining the expansion of financial inclusion.

In recent years, a number of important initiatives have been taken, both by policy makers and international development partners as well as financial service industry actors to promote financial inclusion. Global and national policy makers have identified financial inclusion as an important development priority. This topic was included as one of G20's pillars at the 2009 Pittsburgh Summit (G20 2009). More than 50 national level policy making and regulatory bodies have publicly committed to financial inclusion strategies for their countries (World Bank 2013a). The G20 Principles for Innovative Financial Inclusion were developed in 2010 and endorsed at the Toronto Summit in May 2010 and underpin the Financial Inclusion Action Plan endorsed at the Korea Summit in November 2010 (G20 2010). Innovative financial inclusion means improving access to financial services for poor people through the safe and sound spread of new approaches. The principles aim to help create an enabling policy and regulatory environment for innovative financial inclusion. These principles derive from the experiences and lessons learned from policy makers throughout the world, particularly leaders from developing countries. An important principle is a broad-based government commitment to financial inclusion to help reduce poverty. These principles call for the implementation of policy approaches that promote competition and provide market-based incentives for delivery of sustainable financial access and usage of a broad range of affordable services and a diversity of service providers. They promote technological and institutional innovations as a means to expand financial system access and usage, including by addressing infrastructure weaknesses. Also, they encourage a comprehensive approach to consumer protection that recognizes the roles of governments, service providers and consumers. G20 leaders have committed to take strong practical measures to prioritize financial inclusion while also approving an updated Financial Inclusion Action Plan at the G20 Leaders' Summit held on 15-16 November 2014 in Brisbane, Australia.

At the non-governmental level also, there have been many initiatives in recent years to promote financial inclusion. Initiated in September 2011 by the Alliance for Financial Inclusion (AFI), the Maya Declaration represent a measurable set of commitments by governments of developing and emerging countries to unlock the economic and social potential of the unbanked people through greater financial inclusion (Knaute 2014). More than 90 countries have supported this initiative. When a country signs the declaration, it makes measurable commitments in four broad areas related to financial inclusion: the creation of an enabling environment to harness new technology that increases access to and lowers the cost of financial services; the implementation of a stable and adapted framework that advances synergies in financial inclusion, integrity, and stability; the integration of consumer protection and empowerment as a key pillar of financial inclusion; and the use of data for informed policy making and tracking results.

While these measures taken both at governmental and non-governmental levels have great potentials to promote financial inclusion in developing countries, the impact of such measures has not yet been assessed independently. The key to success will lie in the conducive policy and regulatory actions taken by national governments in individual countries. Only then external development partners can meaningfully provide needed support to promote financial inclusion.

8.2 Promoting responsible finance

Following the recent microfinance crisis, this sector has acknowledged the need for a proactive responsible finance agenda. A consensus is emerging that providers of financial services to the poor should adopt standards that minimize risks for their clients, who have low and variable incomes, and limited formal education and exposure to formal finance. Responsible finance focuses on responsible delivery of financial services to the poor through client protection and social performance. Client protection is a core element of responsible finance. Three important strategies to promote client protection include: (i) client protection-focused codes of conduct and standards development, (ii) consumer protection regulation and supervision, and (iii) efforts to improve consumer awareness and financial capabilities (McKee et al. 2011). A second core element of responsible finance, especially for service providers with a social mission is social performance—a commitment to benefit clients.

Since the 2007-2008 global financial crisis, several initiatives have been taken to promote responsible finance. These include the Smart Campaign, the Universal Standards for Social Performance Management (USSPM), the Equator Principles and Global Alliance for Banking on Values, Financial Education initiative supported by Master Card and Citibank, and the World Bank Global Program on Consumer Protection and Financial Literacy (Goodall 2013). The Smart Campaign, which is committed to embedding client protection practices in the microfinance industry has developed tools to support practitioners. USSPM, launched in 2012 by the Social Performance Task Force (SPTF) is a set of management standards and practices that apply to all MFIs pursuing a double bottom line. The World Bank Global Program was launched in November 2010 to strengthen consumer rights and consumer education for clients who use three types of financial services—credit, savings and payment systems.

Although the above-mentioned initiatives have raised awareness among the financial sector actors about the role of responsible finance and progress has been achieved in promoting consumer protection and social performance, there are several unresolved issues to be addressed to move forward. First, the MFIs and other service providers will find it challenging to have time and resources to keep abreast of evolving principles and standards. Second, it is not clear what constitutes the most effective way to bring about discipline among the financial sector actors. It has not been established if government imposed regulations are more effective or self-regulation by service providers or through peer monitoring. Countries will have to find the most appropriate combination of different approaches that are suitable for their purpose. Third, simple and cost-effective methods need to be developed and tested to monitor the compliance by financial service providers.

References

Agrawal, S. and M. Carraro. 2010. Microfinance in Fostering Adaptation to Climate Change. OECD Environmental Working Paper No. 15, 2010, OECD Publications.

Alamgir, D. 2009. Microfinance in SAARC Region: Review of Microfinance Sector in Bangladesh. Bangladesh. Unpublished Paper.

Angelucci, M., D. Karlan and J. Zinman. 2013. Win Some Lose Some? Evidence from a Randomized Microcredit Program Placement Experiment by Compartamos Banco. NBER Working Papers 19119. Cambridge, Mass.: National Bureau of Economic Research, May.

Ashraf, N., D. Karlan and W. Yin. 2010. Female Empowerment: Impact of a Commitment Savings Product in the Philippines. World Development, 38(3): 333-44.

Attanasio, O., B. Ausburg, R. de Haas, E. Fitzsimons, and H. Harmgart. 2011. Group Lending or Individual Lending? Evidence from a Randomized Field Experiment in Mongolia. Working Paper W11/20. London: Institute for Fiscal Studies.

Banerjee, A., E. Duflo, R. Glennerster, and C. Kinnan. 2013. The Miracle of Microfinance? Evidence from a Randomized Evaluation. NBER Working Paper No. 18950. Cambridge, Mass.: National Bureau of Economic Research, May.

Besley, T. 1997. Political Economy of Alleviating Poverty: Theory and Institutions, *World Bank Research Observer*, Vol. 12

Binswanger, H. and S. Khandker. 1995. The Impact of Formal Finance on the Rural Economy of India. Journal of Development Studies, 32(2): 234-62.

Brune, L., X. Gine, J. Goldberg and D. Yang. 2013. Commitments to Save: A Field Experiment in Rural Malawi. http://econweb.umd.edu/~goldberg/docs/bggy_mwisavings.pdf.

CGAP/IFAD (Consultative Group to Assist the Poor/International Fund for Agricultural Development). 2005. Managing Risks and Designing Products for Agricultural Microfinance: Features of an Emerging Model. Occasional Paper No. 11, CGAP, Washington, D.C.

Cole, S., X. Gine, J. Tobacman, P. Topalova, R. Towsend and J. Vickery. 2013. Barriers to Household Risk Management: Evidence from India. American Economic Journal-Applied Economics, 5(1): 104-35.

Demetriades, P.O., S.H. Law. 2006. Finance, Institutions and Economic Development. International Journal of Finance and Economics, 11(3): 245-60.

Demirguc-Kunt, A. and L. Klapper. 2012. Measuring Financial Inclusion: Explaining Variation in Use of Financial Services across and within Countries. www.brookings.edu/~/media/Projects/BPEA/Spring%202013/2013a_klapper.pdf

Demirguc-Kunt, A. and L. Klapper. 2012. Measuring Financial Inclusion: The Global Findex Database. World Bank Policy Research Working Paper 6025. Washington, D.C.: World Bank.

Duflo, E., R. Glennerster and M. Kremer. 2008. Using Randomization in Development Economics Research: A Toolkit. In Handbook of Development Economics, Vol. 4, ed. T. Schultz and J. Strauss, 895-962. Amsterdam: North-Holland.

Dupas, P and J. Robinson. 2013. Savings Constraints and Microenterprise Development: Evidence from a Field Experiment in Kenya. American Economic Journal-Applied Economics, 5(1): 163-92.

Ellis, F. 2000. The Determinants of Rural Livelihood Diversification in Developing Countries. Journal of Agricultural Economics 51(2): 289-302.

G20. 2010. Innovative Financial Inclusion: Principles and Report on Innovative Financial Inclusion from the Access through Innovation Sub-Group of the G20 Financial Inclusion Expert Group. G20 FIEG-ATISG Report, 25 May 2010.

G20 Information Centre. 2009. G20 Leaders Statement: The Pittsburgh Summit. http://www.g20.utoronto.ca/2009/2009communique0925.html.

Gallardo, J., M. Goldberg and B. Randhawa. 2006. Strategic Alliances to Scale up Financial Services in Rural Areas. World Bank Working Paper No. 76. Washington, D.C.

Goodall, E. 2013. Overview of Initiatives for Responsible Practices in Microfinance. Microfinance Barometer 2013/Convergences.

Gonzalez-Vega, C. 2003. Lessons for Rural Finance from the Microfinance Revolution. In Promising Practices in Rural Finance: Experiences from Latin America and the Caribbean, ed. M. Wenner, J. Alvaredo and F. Galarza, 53-65. Washington, D.C.: Inter-American Development Bank.

Grameen Shakti. 2015. www.gshakti.org/index.php? option=com_content&view= category&layout= blog&id=54Itemid=78.

Greenwood, J., and B. Jovanovic. 1990. Financial Development, Growth, and the Distribution of Income. Journal of Political Economy, 98: 1076-1107.

Grossman, J. and M. Tarazi. 2014. Serving Smallholder Farmers: Recent Developments in Digital Finance. CGAP Focus Note No. 94, June 2014.

Harris, G. 2013. India Aims to Keep Money for Poor Out of Others' Pockets. New York Times, January 5, 2013.

Hulme, D. and Mosley, P., eds. (1996). Finance Against Poverty. London: Routledge.

Imai, K., T. Arun and S. Annim. 2010. Microfinance and Household Poverty Reduction: New Evidence from India. World Development, 38(12).

Imai, K., R. Gaiha, G. Thapa and S. Annim. 2010. Financial Crisis in Asia: Its Genesis, Severity and Impact on Poverty and Hunger. Kobe University, Research Institute for Economics and Business Administration. Discussion Paper DP 2010-33. Kobe, Japan.

International Fund for Agricultural Development (IFAD). 2014a. New Directions for Smallholder Agriculture, P. Hazell and A. Rahman, eds. London: Oxford University Press.

IFAD. 2014b. People's Republic of Bangladesh: Microfinance for Marginal and Small Farmers Project, Project Performance Assessment. IFAD Independent Office of Evaluation, Report No. 3307-BD, February 2014, Rome, Italy.

IFAD. 2014c. Sending Money Home to Asia: Trends and Opportunities in the World's Largest Remittance Marketplace. December 2014, IFAD, Rome, Italy.

IFAD. 2009. Rural Finance Policy. Rome, Italy: IFAD.

IFAD, GTZ, CERISE and IRAM. 2006. Handbook for the Analysis of the Governance of Microfinance Institutions.

Karlan, D.I. Osei-Akoto, R. Osei and C. Udry. 2014. Agricultural Decisions after Relaxing Credit and Risk Constraints. Quarterly Journal of Economics.

Karlan, D. and J. Zinman. 2010. Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts. Review of Financial Studies, 23: 433-64.

Katsushi Imai, Raghav Gaiha, Ganesh Thapa and Samuel Annim. 2012. Microfinance and Poverty: A Macro Perspective. World Development, 40(8): 1675-1689.

Khandker, S. 2005. Microfinance and Poverty: Evidence using Panel Data from Bangladesh. The World Bank Economic Review, 19(2): 263-286.

Knaute, M. 2014. The Maya Declaration: Putting Financial Inclusion on the World Map. Microfinance Barometer 2014/Convergences.

Kumar, A., K. Singh and S. Sinha. 2010. Institutional Credit to Agriculture Sector in India: Status, Performance and Determinants. Agricultural Economics Research Review, Vol. 23, July-December 2010: 253-264.

Levine, R. 2005. Finance and Growth: Theory and Evidence. In P. Aghion and S. Durlauf, eds, Handbook of Economic Growth, edition 1, volume 1. Amsterdam: Elsevier.

Liv, D. 2013. Study on the Drivers of Over-indebtedness of Microfinance Borrowers in Cambodia: An In-depth Investigation of Saturated Areas. Final Report. Cambodian Institute of Development Study, March 2013.

McGuire, P.B. and Conroy, J.D. 1998. Effects on Microfinance of the 1997-1998 Asian Financial Crisis. Brisbane: The Foundation for Development Cooperation.

Meyer, R. 2013. Microcredit and Agriculture: Challenges, Successes and Prospects. In Microfinance in Developing Countries: Issues, Policies and Performance Evaluation, Gueyie, J., R. Manos and J. Yaron, eds., New York: Palgrave Macmillan: 199-222.

Meyer, R. 2011. Subsidies as an Instrument in Agriculture Finance: A Review. Joint World Bank/BMZ/FAO/GIZ/IFAD/UNCDF Discussion Paper, June 2011. Washington, D.C.: World Bank.

Microfinance Information Exchange. 2010. Regional Benchmarking Latin America and the Caribbean 2009 Benchmarks. Washington, D.C.: MIX Market.

Miller, C. 2004. Twelve Key Challenges in Rural Finance. Unpublished Paper Presented at the SEEP Annual Meetings held in Washington, D.C., October 28, 2004.

Nagarajan, G. 2011. Rural Finance in Asia-Emerging Opportunities and Challenges. Paper Presented at the APRACA FinPower Regional Forum on Rural Finance Innovations and Emerging Issues, Bangkok, 13-14 December 2011.

Nagarajan, G. and R. Meyer. 2005. Rural Finance: Recent Advances and Emerging Lessons, Debates, and Opportunities. Reformatted version of Working Paper AEDE-WP-0041-05, Department of Agricultural, Environmental, and Development Economics, Ohio State University, Columbus, Ohio, USA.

Mosley, P. 2001. Microfinance and Poverty in Bolivia. Journal of Development Studies, 37(4): 101-132.

Pasali, S.S. 2013. Where is the Cheese? Synthesizing a Giant Literature on Causes and Consequences of Financial Sector Development. World Bank Policy Research Working Paper 6655. Washington, D.C.: World Bank, October.

Peck, R. and J. Anderson. 2013. Segmentation of Smallholder Households: Meeting the Range of Financial Needs in Agricultural Families. CGAP Focus Note No. 85, April 2013.

Palli Karma Sahayak Foundation (PKSF). 2015. PKSF-bd.or/?page_id=85.

Rippey, P. 2009. Microfinance and Climate Change: Threats and Opportunities. CGAP Focus Note No. 53, March 2009.

Rock, R., Otero, M. and Saltzman, S. 1998. Principles and Practices of Microfinance Governance. ACCION International. August 1998.

Schicks, J. 2011. Over-indebtedness of Micro-borrowers in Ghana: An Empirical Study from a Customer Protection Perspective. Center for Financial Inclusion Publication No. 15. The Smart Campaign/KfW/Centre for European Research in Microfinance, November 2011.

Seibel, H., T. Giehler and S. Karduck. 2004. Reforming Agricultural Banks. Eschborn, Germany: GTZ, January 21, 2004.

Seibel, H. 2000. Agricultural Development Banks: Close Them or Reform Them? Finance and Development, Vol. 37, No. 2, June 2000.

Sinha, S. 1998. Micro-Credit Programme Evaluation: A Critical Review. IDS Bulletin, Vol. 29.

Thapa, Ganesh. 2006. Sustainability and Governance of Microfinance Institutions: Recent Experiences and Some Lessons for South East Asia. Asian Journal of Agriculture and Development, Vol. 3. Nos. 1 and 3: 17-38.

United States Aid for International Development (USAID). 2013. Key Lessons for Mobile Finance in African Agriculture: Three Case Studies. Briefing Paper. January 2013.

Von Pischke, J. 2008. Gandhi vs Gauss: Ethical Issues in Micro and Small Business Finance. Savings and Development 32(3): 127-52.

World Bank. 2011. World Development Indicators 2011. Washington, D.C.: Oxford University Press.

World Bank. 2007. World Development Report 2008. Washington, D.C.: World Bank.

World Bank. 2006. Meeting Development Challenges: Renewed Approaches to Rural Finance. Agriculture and Rural Development. Washington, D.C.: World Bank.

Yaron, J., M. Benjamin and G. Piprek. 1997. Rural Finance: Issues, Design and Best Practices. Development Studies and Monographs Series 14, Washington, D.C.: World Bank.

Photo Credit and Layout Design:
Dr. Marlowe U. Aquino
IFAD-APRACA FinServAccess
Project Manager

Printed by

ASIA-PACIFIC RURAL AND AGRICULTURAL CREDIT ASSOCIATION (APRACA)
Room A303, Bank for Agriculture and Agricultural Cooperatives (BAAC)
469 Nakhonsawan Road, Dusit, Bangkok 10300, Thailand

Tel: (+662) 280-0195, 282-1365
Fax: (+662) 280-1524
E-mail: apraca@apraca.org
Website: www.apraca.org

ISBN 978-616-394-264-7