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Inside:

Making Rural Finance Work

—Mark Wenner

Rural finance is getting a fresh look, thanks to recent innovations and successful examples of sustainable rural financial services. In some notable cases, institutions have managed to overcome or neutralize some of the difficult challenges characterizing rural markets.

> Recent developments hold promise for sustainable rural finance and poverty alleviation…

The history of rural finance is littered with failed state banks and agriculture credit programs. Government attempts to channel subsidized resources to the sector have overwhelmingly failed to alleviate poverty, reduce inequalities, or promote sustained agricultural growth. To the contrary, much of the disbursed credit has been diverted to non-agricultural ends and higher income clients have tended to benefit more than poorer clients. Moreover, the financial institutions administering the programs have suffered from high delinquency rates and low profitability. In short, the financial viability of many participating financial intermediaries has been compromised.

Today there is a renewed interest in rural finance. In spite of the discouraging experiences of the past, some recent developments hold promise for sustainable rural finance. In some cases, microfinance institutions have successfully modified

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Attracting Social Investment Capital to Latin America

—Marc de Sousa-Shields

The number of investors seeking socially responsible investments (SRI) is steadily increasing. By recent estimates, the latent demand for such investments is about $200 billion, 10 percent of which would be directed to emerging markets. However, so far investors have been challenged to find the appropriate vehicles to meet their needs. Few socially responsible investment funds (SRI funds) have been able to overcome the challenge of pooling many small deposits from a large number of social investors while

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technologies used in urban areas. In other cases, marketing companies and non-profit institutions have stepped in as intermediaries between banks and farmers to form inter-linking financing schemes. In still other cases, financial institutions have developed new and innovative products as a way to enter rural markets.

What Makes Rural Finance Difficult

Rural finance faces the same general set of challenges as urban finance: how to cope with imperfect client information; how to manage and mitigate risk; and how to minimize transaction costs (see box 1). However, for a number of reasons, these problems are significantly more severe in rural areas.

- Imperfect client information. Various conditions, including lower levels of education, the general absence of written records, the absence of formal credit histories, and the greater heterogeneity in production and marketing conditions, combine to make the gathering and analysis of information about client-creditworthiness costly and generally unreliable.

- Risk management. A marked seasonality in income flows, less defined property rights, and higher levels of price and production risk compared to urban investment projects increase the risk of rural investments. In addition, the virtual absence of insurance and hedging instruments makes it very difficult to mitigate these higher risks.

- Transaction costs. Poor physical infrastructure and the limited capacity of public institutions make these costs higher for both clients and intermediaries. In particular, road conditions are typically poor, telecommunications are unreliable and expensive, and government deed registries are inaccurate and inefficient.

In addition, many agricultural projects have long gestation periods, unlike undertakings in the service and commerce sectors. The slower turnover of capital in agricultural enterprises means that there is a higher demand for medium-term and long-term financing than in other sectors. The problem is that medium to long-term financing is hard to obtain even in urban markets. In rural areas, providing long-term financing is clearly an enormous challenge.

Overcoming the Challenges of Rural Markets

It is encouraging that a number of institutions have managed to overcome or neutralize the difficult challenges of rural markets.

Modified Lending Technologies

Two of the most successful cases of institutions that have modified urban technologies are Financiera Calpía in El Salvador and Prodem in Bolivia. Both these institutions began as non-profit organizations in urban areas, perfected a microcredit technology, and became regulated financial entities with deposit-taking privileges. They have extended into rural areas partly to deal with increased competition in traditional markets and partly as a strategic commitment. The secret to the success of Financiera Calpía and Prodem lies in their clear strategic missions, able management and staff, good management information systems, and a refined lending technology well-suited to their respective operating environments.

Certain modifications in lending technology have been especially successful. The institutions allow for less frequent loan repayment schedules, finance households with varied sources of income, and use personnel with a solid background in agronomy. Significantly, they limit exposure to agriculture in the total portfolio. Whereas state agricultural development banks have traditionally lent almost exclusively to agriculture, Financiera Calpía and Prodem keep agricultural lending to less than half of the total rural portfolio. Moreover, they focus their analysis on household repayment capacity, rather than the client's project production choices. They explicitly recognize the fungibility of money by focusing on the rural household as the unit of analysis, not only the individual applicant or individual investment project.

In spite of the general success of Financiera Calpia and Prodem, they have not been able to provide significant amounts of medium- to long-term financing to their clients. This inability stems primarily from concerns about the matching of maturities for assets and liabilities, as well as interest rate risk over time.

Inter-Linked Financing Schemes

Inter-linking schemes take advantage of the particular strengths of the different partners to compensate for their weaknesses. Agricultural producers have the means of production, but desire assured marketing outlets, technical assistance, and access to external finance. Banks have capital, but lack the means to screen, monitor, and enforce loan contracts in a cost-effective manner with medium-and small-scale agricultural producers who often lack collateral. NGOs or private marketing companies have cost-advantages in acquiring knowledge about client creditworthiness and about crop supply and demand conditions in a particular locale, but have limited ability to provide financing to producers.

By forming an alliance or entering into triangular contracting, all parties gain. The NGO or private marketing company performs screening, monitoring, and contract enforcement functions on behalf of banks. In exchange for a share of their profits, it also enters into output marketing contracts with agricultural producers and provides extension services for them. As a result, agricultural producers obtain credit and assured outlets for sales, banks lower their risk and therefore the cost of rural loans, and the NGO or private marketing company develops new sources of income.

Critecnia S.A, a private for-profit company, is an example of an intermediary that has successfully stepped between banks and agricultural producers to form an inter-linking financing scheme. As its main activity, Critecnia provides management, extension, and marketing services to

Box 1. A Comparison of Urban and Rural Microcredit Technologies

Item	Distinction
Types of contracts offered	No distinction. Individual and group lending used in both areas.
Range of interest rates	Minor distinction. Interest rates range from 2 to 4 percent per month (cost- covering).
Typical terms	Minor distinction. Short-term lending (less than 12 months) is the norm in both areas. Some institutions are providing longer terms, but use traditional asset-based technologies or leasing modalities.
Payment schedules	In urban areas, payments occur weekly or monthly. In rural areas, payments are more flexible and infrequent, to match household cash flow patterns.
Graduating loans	Minor distinction. Institutions use series of graduating loans in both urban and rural areas. A "termination incentive" is commonly used. If client fails to repay, access to future loans is denied. A "farm budget approach" may be used in inter-linked schemes.
Processing times	No distinction. Processing times are equally short in urban and rural areas. (Average loan approval is 3 to 28 days for a new client, compared to 2 to 4 months with commercial and state banks.)
Management Information Systems	No distinction. Management Information Systems are used primarily to monitor risk and improve performance, not for donor reporting.
Credit evaluation	While the household is used as the unit of analysis in both urban and rural areas, households with multiple and varied sources of income are explicitly favored in rural areas.
Loan approval authority	No distinction. In both urban and rural operations, loan approval authority is decentralized.
Staff remuneration incentives	No distinction. Staff incentives in both urban and rural areas are based on productivity and portfolio quality.
Client monitoring	No distinction. Monitoring visits are frequent in both urban and rural areas.
Characteristics of loan officers	In urban microfinance institutions, loan officers typically have a high school diploma and are pursuing a bachelor college degree in economics, finance, business or other social science. Some have completed an undergraduate degree in one of these fields. In rural microfinance institutions, most loan officers have completed or are in the process of completing a bachelors degree in agronomy. Once hired, they typically receive intensive training in financial analysis and accounting. Institutions usually prefer recruits without prior lending experience but knowledge about the assigned region.
Nature of relationship with clients	No distinction. In both urban and rural areas, lending is relationship-based, not transaction-based. Loan officers seek to cultivate a trusting and long-standing relationship with clients, carefully understanding the clients' sectors and particular activities.
Collateral and guarantees	In urban microfinance, alternative forms of collateral are accepted, including post-dated checks, liens on equipment and home appliances, and co-signers. In rural areas, institutions rely more on a larger number of co-signers, and spouses are typically asked to co-sign the loan. If possible, the institution will seek the house plot as security. (This is not permitted in Bolivia.)
Special risk management techniques	In both urban and rural microfinance, institutions impose limits on their loan exposure to a single client. They also provision heavily for delinquent loans. In urban microfinance, institutions diversify their portfolio across sectors; usually the majority of portfolio is in commerce. In rural microfinance, institutions seek to limit their exposure to agricultural lending, and usually the majority of portfolio is non-farm lending.

Source: Presented by Lisa Valenzuela (USAID) at the IDB Rural Finance Seminar, May 22, 2000 and modified by the author.

about 500 small cotton producers in two irrigated valleys in southern Peru, Cañete and Chincha. The producers typically have clear land titles, good credit histories, and a solid management reputations. To obtain better prices, they seek to market their output jointly. Critecnia uses its contracts with these producers to secure loans for them from private commercial banks. Critecnia administers the loan by purchasing inputs for the producers, providing extension services, and marketing their output. The producers repay the bank for the loan from the proceeds of their sales and Critecnia takes half the profit as payment for its services. In 1998, Critecnia posted an impressive 27.3 percent return on assets.

While inter-linking schemes appear promising, they have limitations. Most notably, the "broker" agent is rarely able to operate effectively beyond a few specialty crops or outside its geographic sphere of influence.

New and Innovative Products

A third way to overcome some of the difficulties of rural markets is by introducing new and innovative products specifically tailored to the circumstances of agricultural producers. Two financial intermediaries have successfully introduced new financial products in rural settings: Financiera Trisan in Costa Rica; and Asociación Ecuménica de Desarrollo (ANED) in Bolivia.

Financiera Trisan has recently developed a credit card specifically for retailers of agricultural inputs and individual agricultural producers with predictable cash flows. The program has evolved from being an enhanced form of supplier credit from the parent company—Trisan S.A., an agrochemical importer and wholesale distributor—to a credit card that can be used with a growing number of different types of rural merchants, ranging from agricultural input stores to gasoline stations to auto repair shops. The advantage of the credit card is that it drastically reduces transactions costs for clients, as well as for the merchants accepting the card. The card is currently used by approximately 2,500 agricultural producers. Plans are underway to introduce a smart card aimed at non-farm enterprises that have rotating inventories, such as dry good stores, bars, and restaurants.

ANED leases farm equipment and machinery to handicraft producers and small farmers, many of whom work properties of less than two hectares. In 1999, the majority of ANED's 329 leasing contracts were for irrigation water pumps, tractors, and plows. Under the leasing scheme, the leased equipment remains in the name of the lessor. The arrangement allows persons with no formal credit history, limited work experience, and/or limited collateral to acquire equipment worth $500 to $40,000. Furthermore, it permits financing to be extended up to five years, since it permits easier recovery and thus diminishes the risk of default. The main constraints on growth of the program include a lack of access to long-term funds, limited availability of insurance, uncertainty in the supervisory framework for entities engaged in leasing, and problems with equipment suppliers in stocking spare parts, in obtaining volume discounts, and in training perspective clients in the proper use of leased equipment.

Getting the Framework Right

To systematically attack the problems of risk, imperfect information, and high transaction costs, concerted and sustained actions will be needed on a variety of fronts: policy, institutional, and product development. There is a definite role for governments and international development organizations in addressing these challenges, notably in laying a sound foundation of policy and institutional reforms.

While much progress has been made in overall macroeconomic and financial market policies in the last decade, much work is needed in improving the legal, regulatory, and information environments and in building stronger rural finance retail institutions. The laissez-faire notion of "getting prices right" is not enough; it must be complemented by the idea of "getting institutions and technologies right," particularly once basic financial and economic liberalization has occurred.

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Attracting Social Investment Capital to Latin America

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simultaneously investing efficiently and profitably in a relatively large number of small investments (see box 2). This is particularly true of so-called high-impact funds that invest in microfinance institutions (MFIs) or small and micro enterprises. While offering potentially impressive financial returns, these enterprises require significant screening and selection efforts on the part of the funds because of the limited information available.

Given the right fund types, the capital market for these so-called high-impact investments in emerging markets could amount to $2 billion—some 10 percent of the total high-impact market of $20 billion. A significant share of this market would be focused on Latin America and could be developed with as little as $5 to $10 million in investors subsidies (see box 3). More importantly, once established, these socially responsible investment funds for high-impact investments in emerging markets will not only be sustainable, but could catalyze new domestic and international capital markets for small and micro businesses in Latin America.

Several high-impact funds now invest in Latin America, and offer a glimpse of the possibilities. However, they have yet to ignite widespread social investor interest. The challenges of simultaneously meeting social investor needs while making and servicing microenterprise deals have so far proven difficult to overcome. Mobilizing interest in socially responsible investment high-impact funds for emerging markets will likely require the creation of a new type of fund: one that combines the marketing and capital-pooling strengths of mutual funds with the investing capacity and management remuneration of venture capital funds. It will also require moving beyond subsidized demonstration funds that have characterized microenterprise investment activity to date.

SRI Funds and Micro/Small Enterprise Development in Latin America

Although SRI investors have traditionally focused on the United States and Europe, they have long demonstrated an interest in emerging markets. For example, in a national survey of social investors in the mid-1990s, the Social Investment Organization of Canada found that more than one in ten social investors would consider placing up to 10 percent of their portfolios in high-impact, developing country investments. More recently, the Calvert Foundation reported that some 20 percent of their investors expressed interest in SRI in emerging markets.[1]

Nevertheless, interest in emerging markets has yet to translate into SRI assets. While a few large-cap mutual funds for socially responsible investment now operate—including the Ethical Asia-Pacific Rim Fund (with $36 million in asssets) and the Calvert New Africa Fund (with $4 million)—no broadly available commercial SRI funds focus on Latin America. In fact, SRI assets in all of Latin America amount to just over $100 million.

The bulk of SRI capital in Latin America is managed by eleven so-called high-impact funds. Six are currently available to the public (see table 1). Most funds not publicly available are financed by multilateral and bilateral funding agencies, although some have limited private placement participation. Publicly available funds, by contrast, are open to both institutional

[1]Interview with Shari Berenbach, Executive Director, Calvert Foundation, August 15, 2000.

Box 2. What is a Socially Responsible Investment Fund?

The SRI industry has grown and matured over the last two decades and today is a $2 trillion investment sector. Social investors, now numbering in the millions, have helped to stimulate a rich and, more importantly, competitive SRI product offering.

SRI is best known for socially screened mutual funds. These funds are like conventional mutual funds in every respect, with the exception that they *screen* investments for social and environmental issues (see table below). The majority of funds apply negative screens that “filter” out the worst offenders on a given issue. For example, if mining companies X and Y have better environmental records than their competitors, they may be included in an SRI fund even if they have less than perfect environmental practices. This “best of the sector” approach stands in contrast to positively screened funds, which seek to invest in companies with high social and/or environmental standards, typically focusing on a single issue such as alternative energy or low-income housing.

Common SRI Screens

Negative Screens	**Example Measures**
Labor	Labor code violations, work place accidents
Environment	Environmental law violations, emissions
Community	Limited philanthropic giving or employee community volunteer programs
Gender	Absence of women in management, elder and child care leave programs
Minority	Lack of minorities in management and on Boards of Directors
Positive Screens	**Investment Targets**
Alternative Energy	Solar, geothermal, wind power business
Women	Women-owned or run business
Environment	Organic agriculture, alternative energy, recycling business
Community	Low-income housing, MFIs, community infrastructure

SRI funds can also be divided into two broad investment management categories: private fund management and publicly available funds. Private management funds represent the majority of SRI assets and refer to funds managed for institutions and, to a lesser extent, high net-worth individuals. Publicly available funds are those that are open to the general public via prospectus or limited offerings to sophisticated investors. High-impact SRI funds can be both broadly or narrowly offered and tend to invest either in microfinance institutions or micro/small enterprises, with some funds investing in both.

and individual investors. However, they do not specialize in Latin America or have commercially competitive rates of return.

Six of the eleven funds, including LACIF and PROFUND, fund microfinance instituions (MFIs) exclusively. These institutions, in turn, loan funds to poor microentreprenuers, providing them with working capital at relatively high rates of interest and short maturities. Other funds, such as those managed by Environmental Enterprise Assistance Fund, Terra Capital, and *Fondo Eco Empresa,* invest *directly* in small firms and microenterprises. Some of these firms are quite sophisticated businesses operated by middle or lower-middle class owners. These enterprise funds offer a variety of longer-term investment options, including long-term debt, subordinated debt, convertible debt, and equity. Capital is used primarily for investments to enhance productivity.

The Challenges of Running SRI Funds

SRI funds are complex. On the investor side, there are at least three main challenges, similar to those facing conventional mutual funds. First, a fund needs the capacity to market to a large number of social investors. This requires selling a simple investment concept—something a high-impact fund *is not*—to relatively unsophisticated investors. Second, a fund must be able to pool relatively small investments efficiently. According to some estimates, the average investment would be in the order of $2,000.[2] This makes it difficult to attain economies of scale. Finally, in order to attract new investors, the fund should hold the promise of a commercial risk-adjusted rate of return of 8 to 10 percent, based on current market environment. This target return is certainly possible, but has proven hard to obtain for most high-impact funds.

On the investment side, the challenges resemble those facing venture capital funds. First, the fund must be capable of efficiently placing and managing a relatively large number of investments with high due diligence and servicing costs. Second, within the terms of the fund's investment mandate, there must be reasonable diversification. Finally, funds need to remunerate managers based on performance, in order to provide them with the right incentives in their investment and fund-raising activities.

By design, existing high-impact funds tend to meet some of these challenges, but rarely all of them. The Calvert Fund, and to a lesser extent the Oikocredit Fund and the Sarona Fund, come very close to what may be called a *venture-mutual fund* model, as they serve a public market and make high-impact investments. However, these funds generally fail to provide commercial or near-commercial risk-adjusted

[2]Estimated average individual high-impact investment in Canada and the United States.

Table 1: Microfinance and Small/Micro Business Funds in Latin America

	Assets ($US millions)	Assets in Latin America	Target annual return	Publicly available?	Investment type
Widely available					
Oikocredit (EDCS)	125.0	36%	1.0%	Yes	Debt, some equity to cooperatives globally
Calvert High Impact	18.0	1%	0/3/5%[1]	Yes	Long-term debt to MFIs globally
VanCity IciD[2]	--	--	0/3%[1]	Yes	New fund, long-term debt via Calvert notes
Sarona	3.0	2.9%	0/3/5%[1]	Yes	Debt, limited equity globally
NicaFund	2.3	2.3%	3.5%[3]	Yes	Debt to Nicaragua Community Development Fund
ACCION Bridge Fund	6.5	6.5%	3.6%[3]	No[4]	Debt to ACCION partner NGOs
Venture funds					
EEAF[5]	10	100%	20%[2]	No	Equity and debt to environmental enterprise
Fondo Eco Empresa	10	100%	20%[2]	No	Equity and debt to environmental enterprise
LACIF	11	100%	8%[2]	No	Guarantee for MFI access to commercial debt markets
PROFUND	42	100%	--	No	Equity and debt to MFIs
Terra Capital	15	100%	20%[2]	No	Equity and debt environmental enterprise

Source: Enterprising Solutions Global Consulting (ESGC). ESGC tracks 33 international high impact development finance funds that invest in small, micro, and MFI enterprises around the world.

[1]Investors can choose the desired interest rate.
[2]International Community Investment Deposits.
[3]NicaFund and Latin American Bridge Fund returns for 1999.
[4]Targeted return.
[5]EEAF co-manages capital for the Corporación Financiera Ambiental.

rates of returns. Thus they have problems attracting clients from a broader spectrum of SRI investors.

Providing Incentives for Investor Participation in SRI Funds

High-impact SRI funds typically count on some form of subsidy to underwrite start-up costs or ongoing management expenses. For the most part, subsidies come in the form of cash or in-kind contributions to the funds, such as office space from the parent NGO. In some cases, however, investors provide the subsidy by accepting returns that are lower than those fully adjusted for risk.

Subsidies affect how funds are managed and, importantly, whether a fund needs to seek investors other than donor agencies. Several non-profit organizations have recently abandoned the practice of marketing existing or planned funds to the public because it is still easier to raise subsidized capital than tap SRI markets. Compounding this problem are subsidies to fund managers in the form of fixed-fee income. Under this arrangement, managers have less incentive to build market share than if their remuneration were based on return on assets or performance of assets under management. Consequently, while subsidies support the survival of specific funds, they also stunt the creation of a sustainable capital market for high-impact social investment in Latin America.

For the most part, the model for attracting investor interest in high-impact funds has been to promote demonstration funds to prove concepts and leave capital markets to coalesce around them. However, this approach has not proven effective in developing the capital market for SRI high-impact funds. Altering investor behavior and building new capital markets requires more than demonstrating viability; it also requires creating fund types appropriate to the task.

Enter the "Venture Mutual Fund"

The introduction of a hybrid *venture-mutual fund* model could provide the necessary impetus for the SRI industry. This approach has proven successful in Canada where the government in the early 1990s provided individuals with a 50 percent tax credit and a minimum guaranteed return for investments up to $5,000 in so-called Labor Sponsored Investment Funds. These funds pool modest deposits from thousands of individual Canadian investors (like a mutual fund) and invest in high-risk small or even micro-sized businesses (like a venture capital fund). This scheme, with its investor incentive, has helped the Canadian SRI industry grow from virtually zero to $4 billion in less than ten years. As investors have become more familiar with venture capital risk-and-return calculations, the government has been able to slowly reduce the size of the tax break and hence the subsidy.

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Box 3. Leveraging Incentives for SRI Capital Market Development

A simple change in standard practice could potentially generate significant deposits in SRI investment funds: providing relatively small incentives to investors, rather than to fund managers. The table below shows the costs of guaranteeing an 8 percent return to investors for funds of various sizes achieving different rates of return.

A $50 million dollar fund with a 5 percent actual return would cost $2 million in subsidies. A fund of $500 million would cost only $5 million in subsidies if the actual return were 7 percent. For these two examples, the leverage effect, or investment attracted by the guarantee, would be 25 and 100 times.

Subsidies need not be cash up front. Indeed, donor investors such as foundations and multilaterals could provide first-loss equity that could be used to pay investors if a fund did not achieve targeted returns. If this were the case, investor subsidies could be temporary: needed only as long as it took to attract enough capital for funds to attain financial self-sufficiency. Should funds beat minimum guarantee levels, managers could be compensated with generous bonuses, providing market- based performance incentives.

Example of Incentive Structure for SRI Fund Development

Fund Assets ($US millions)	Return		Subsidy required for fund sustainability ($US millions)	Leverage effect of subsidy (Assets/Subsidies)
	Actual return to fund	Return guaranteed to investor		
50	5.0%	8.0%	-2.0	25
200	5.0%	8.0%	-6.0	33
200	6.0%	8.0%	-4.0	50
200	7.0%	8.0%	-2.0	100
500	7.0%	8.0%	-5.0	100

Source: Author's calculations

Leveraging significant Latin American high-impact capital may not require the kinds of subsidies it took to catalyze Canada's venture capital industry. An informal poll of SRI investment managers suggested that a competitive return would be between 8 and 12 percent a year. This return is not inconsistent with the return targets of 15 to 20 percent set by high-impact venture funds such as PROFUND, and the 10 to 30 percent return on equity reported by many microfinance institutions. If these kinds of returns can be realized, it may eliminate much of the need for investor subsidies. However, given that the investment risk is significant, a minimum guaranteed return may be justified to attract a significant client base—at least initially.

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Publication Announcement

The publication "The Latin American Microfinance Industry: How Does it Measure Up?", authored by Miguel Taborga and Tor Jansson, is now available in English. Using information from 17 Latin American microfinance institutions, the publication explores financial indicators in six major categories (profitability, capital, asset quality, liquidity, productivity, growth) and proposes benchmark values for these indicators.

To order the publication (free of charge), contact the Microenterprise Unit at sds/mic iadb/org.

In Future Issues...

Leasing as a way to provide long-term financing to microenterprises

Is there a model for sustainable business development services to microenterprises?

Why some microfinance institutions fail

Reforming the regulatory and supervisory framework for microfinance

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The Microenterprise Unit manages the IDB's microenterprise projects with the private sector and provides training, disseminates best practices, and develops policies and strategies to guide Bank country operations and promote the growth of the microenterprise sector in Latin America and the Caribbean.

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