

# Financing Rural Economic Activities: Some Related Issues

Successive governments in Sri Lanka, since independence, have endeavoured to develop the rural economy of the country recognising its economic, social as well as political importance. Seventy two percent of the population live in rural areas and they are engaged mainly in agricultural activities : growing paddy and other traditional subsidiary food crops. The traditional agricultural sector provides employment to about 38 percent of the employed labour force in the country. The government invested substantially in farmer resettlement and irrigation systems to increase agricultural production with the ultimate objective of achieving self-sufficiency in food. In addition, a large number of low-income people in rural areas is engaged in cottage industry and in other small scale enterprises to eke out a living. Financing of these diverse rural sector activities has a wide impact on the majority of the population in reducing poverty and improving living standards.

The non-availability of credit from the formal sector financial institutions was considered a major hindrance in efforts to develop of the rural economy. Therefore, the government intervened directly to provide credit for agriculture and other rural economic activities. The necessary funds were either provided by the government or received from donors. The government took steps to create the institutional network by establishing state owned commercial banks, specialised banks and other specialised financial institutions. The government also designed credit programmes under which loans were provided for the purposes determined by the government. However, this scenario has undergone some change with the recent deregulation of the financial sector. The purpose of this paper is to throw some light on the issues relating to the financing of rural economic activities.

## The Issues in Rural Financing during the early periods

The major issues relating to financing rural economic activities during the early periods were as follows:

- (a) Increasing the outreach of formal sector financial institutions to rural areas;
- (b) Designing of rural credit schemes to be

- implemented by these institutions; and
- (c) Minimising risks to financial institutions involved in rural financing.

### (a) Increasing the outreach to rural areas

At the time of independence in 1948, the rural sector remained neglected by the formal sector financial institutions. The banking system that prevailed at the time was concentrated to cater to the needs of the organised sector i.e., export import trade, the larger industries, plantation companies and the urban services sector. The government took some initiative, even in early 20<sup>th</sup> century, to tackle this problem by promoting the co-operative credit societies to provide credit facilities for farmers and arti-

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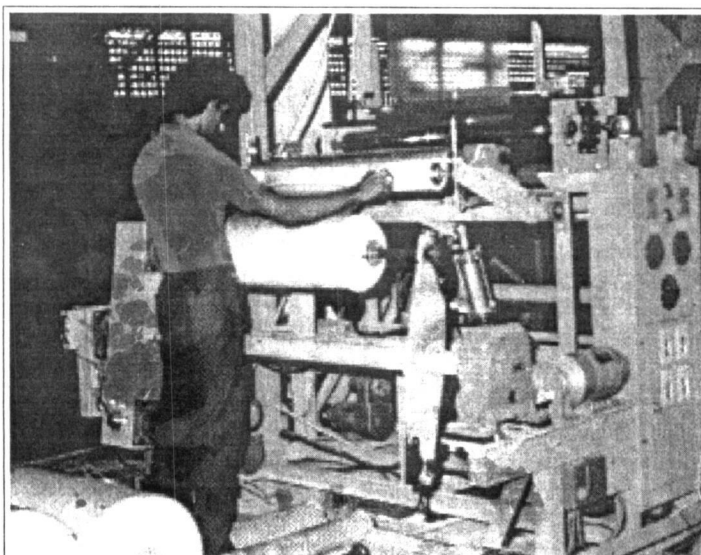
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sans. However, the co-operative sector was unable to supply credit at the village level adequately. The farmers could not get working capital requirements from these co-operative societies mainly due to the low resource base of these societies. Therefore, in the late 1940s and the 1950s, the government started financing through government departments the cultivation of rice and a few other crops. The government departments were not geared to providing credit and recovering loans and the

scheme failed. As an alternative the government established Co-operative Rural Banks (CRBs) and the People's Bank in early 1960s with a view to increasing the outreach into rural areas. The Bank of Ceylon was nationalised during the same period and the government expected it to play an active role in taking banking facilities to hitherto un-banked areas. In the 1980s, the government's drive to fund the outreach was further accelerated with the establishment of Regional Rural Development Banks (Regional Development Banks). These efforts were successful within a relatively short period in developing a large network of bank branches spread in rural areas providing financial services even in remote villages. These banks were also able to mobilize large volumes of savings. The banking habit expanded rapidly with increased banking density in rural areas. The issue, however, was the sustainability this outreach as many of the rural branches were unable to run as profit centres that would ensure the long-term sustainability of the institution.

### (b) Designing rural credit schemes to suit the rural population.

The banks have been reluctant to extend credit to rural people mainly for the following reasons.



Handloom and powerloom industry which provided income for livelihood for rural youth in the past hardly have an existence at present.

They were unable to provide the type of collateral insisted upon by the banks. The enterprises, for which credit was sought, were very small and of high risk. Therefore, it was considered that these people as well as the activities were "unbankable". It was also believed that they couldn't afford the market rates of interest because they were poor. In the early schemes, subsidised rates of interest and less stringent collateral requirements or loans without collateral became the main features. As the cost of funds to the banks did not permit the banks to charge interest less than the market rates, the government provided refinance facilities against the loans granted under these programmes while allowing the banks to retain an attractive margin over the refinance rate of interest. Credit facilities were provided on crop basis and the farmers were provided with pre-determined scales of credit under the Cultivation Loans Schemes. The banks had little opportunity to exercise their discretion in the selection of borrowers or determining the credit volumes. The Central Bank prepared guidelines giving the type of collateral, scale of finance for each activity and other terms and conditions. Banks were given targets for lending.

### (c) Minimising the risks of financial institutions in rural financing

A major factor that made banks reluctant to involve themselves in rural credit was high risk. Granting credit to the low-income persons was considered a high-risk operation due to their inability to provide good collateral as required by banks. Agriculture is subject to the vagaries of weather and markets for such commodities are highly volatile. As a solution to this problem, the government introduced credit guarantee against the losses to banks in the implementation of these credit schemes. In addition, the government created the Agricultural Insurance Board, which provided insurance cover for crop losses of the farmers who obtained loans under the cultivation loan schemes of the government. Practically, this provided additional protection for the banks in the event of crop failure.

The above approaches appeared to be working satisfactorily in the environment of strict regulation of the financial sector that prevailed until the late 1970s. With the gradual liberalisation of financial markets, sustainability of these programmes as well as of the state banks was brought to question. Refinancing facilities were terminated and credit guarantee by the government withdrawn. The new environment that emerged with financial deregulation gave new dimensions to old challenges and gave rise to new issues. These developments made it nec-

essary to have a fresh critical look at the experience of credit programmes implemented hitherto.

### Problems with supply driven subsidised credit.

The supply driven subsidised credit programmes introduced by the government suffered from intrinsic as well as operational weaknesses. When credit was made available below market rates, there was rent seeking by borrowers. Though the government policy was to provide credit to all potential beneficiaries, determined according to eligibility criteria, the high costs involved in making small loans made the banks to focus on a far relatively large scale borrowers at the expense of low income rural families. Further, when state-owned banks granted loans at the insistence of the government, such loans were considered an entitlement by the borrowers. These loans were considered as an attractive means to muster political support among the rural people. The result was large-scale wilful default of such loans.

The transaction costs of these loans were generally high because the lending institutions adopted time consuming and cumbersome procedures, the less influential borrower was made to make several trips to the lending institution to obtain his loan. Such loan procedures are open to corruption and inefficiencies adding to transaction costs. Another problem associated with directed subsidised credit programmes was that the size of loans was pre-determined, and sometimes did not meet the actual requirements of the borrower. If the loan amount was too small it was not sufficient to meet the cost of acquiring the income earning asset and the project did not generate the expected cash inflow. This situation led the borrowers to borrow from informal sources at much higher interest rates to supplement the bank credit or to buy an asset of lower quality. Or, because as fungible credit, he tended to use the funds for some other non-productive purpose because the amount of credit made available by the bank was not sufficient for the intended purpose.

Subsidised credit programmes also hindered the development of market based rural financial institutions because those institutions found it difficult to mobilise savings at a rate of interest high enough to extend as credit at a competitive rate. As a whole, subsidised credit programmes and the institutions implementing such programmes suffered from political interference (if the institution was state-owned), poor management, supplying of improper loan products, low recovery rates, high transaction costs and high loan losses.

### New developments in financing rural economic activities

With the liberalisation of financial markets some

innovative approaches were developed in many parts of the world for the provision of financial services in rural areas. With these innovations, new and revolutionary ideas were subjected to testing and the results threw new light on rural financing. First, under the earlier schemes, supply of credit was considered an essential input in rural development programmes. In the light of new knowledge, it became clear that the rural people, like other customers of a financial institution, needed a range of financial services rather than credit only. These services are termed as 'micro-finance'. Micro-finance is defined by Asian Development Bank as "the provision of a broad range of financial services such as deposit facilities, loans, payment services, money transfers, and insurance to the poor and low income households and their micro-enterprises." Secondly, it was proved that the poor also could save and these savings could be substantial if proper savings products with the required flexibility were made available to the poor and low-income families. Thirdly, the poor and low-income people were also good credit risks that they maintained very high levels of repayments while using credit effectively for economic empowerment. Fourthly, credit for the poor did not need subsidised because they could market rates of interest. Fifthly, micro-finance could be an effective tool in alleviating poverty of millions of people. Sixthly, micro-finance could be a commercially operated financial service, undertaken even by large financial institutions in penetrating into rural financial markets.

The above experience gave rise to new issues relating to financing the rural economy. Some of these issues as given below and discussed in the ensuing sections.

- (a) Whether the outreach has been sufficient and if not, what can be done to increase the outreach?
- (b) Sustainability of rural finance institutions and credit programmes;
- (c) Is the mobilisation of rural savings an essential item in micro-finance programmes? and,
- (d) How to cater to the financial needs of rural economy in a market based system.

#### (a) Issues relating to outreach

The availability of micro-finance in rural areas depends on the extent of outreach. According to the Consumer Finance and Socio Economic Survey of the Central Bank, 1996/1997, the percentage of rural loans provided by the formal sector institutions such as the commercial banks, rural banks and the co-operatives was about 41 per cent, indicating that almost 60 per cent of the rural borrowers depended on the informal sector

for credit. However, the percentage of the amount of loans obtained by these borrowers from the informal sector accounted to only 31 per cent, indicating that it was mostly the relatively small borrowers that had less access to credit from the formal institutions. In other words, the depth of outreach by the formal institutions, i.e. the reach to poorer groups, is still an important issue. However, it should be noted that poverty alone has to be made the criteria in the outreach. In the development of the rural economy, it is the economically active poor who should be provided with credit for their economic empowerment. The economically non-active poor need to be reached through other welfare programmes.

Why are formal sector institutions are not effective in outreach? One of the important factors that affect the outreach is the high cost associated with the process. Therefore, financial institutions need to evolve innovative approaches and mechanisms to improve outreach in a cost effective manner. Working through other village level organisations such as non-governmental organisations or approaching the rural clientele in groups rather than individual savers and borrowers are some of the approaches adopted by formal sector institutions in improving the outreach.

#### **(b) Sustainability of the institutions and the credit programmes**

Sustainability of rural financing schemes became an issue once the cheap sources of funds dried out with financial deregulation. Sustainability of rural financing programmes depend on the ability of institutions to recover the costs of providing micro-finance services in rural areas and make a profit out of this business. Under government-sponsored programmes, the banks enjoyed healthy interest margins and they had the protection against possible losses in these operations by way of credit guarantee. When cheap funds and the guarantee are not available, sustainability of the schemes depended on the ability to maintain high repayment rates and charging interest rates sufficient to cover the cost of funds and administrative costs. The experiences of many innovative micro-finance programmes such as the Grameen Bank, ASA in Bangladesh where the clients are poorest of the poor that the Unit Desa System of the Bank Rakyat Indonesia show that these persons can afford market rates of interest that can cover the costs.

Therefore, innovative approaches have to be developed to suit the specific country conditions if the formal sector institutions are to provide micro-finance in the rural sector on a sustainable manner. In other words, the solution to the prob-

lem of sustainability lies with the ability to provide micro-finance on a commercial basis.

The other issue relating to the institutional sustainability is the role of the state owned banks in financing the rural economy in a deregulated financial system. Some argue that state owned commercial banks should concentrate on commercial banking and new institutions should be created to provide the financial services needs of the rural sector, because the public sector banks are not geared to supply these services effectively. Others point out that there are certain success stories such as the Unit Desa System of Bank Rakyat, Indonesia (BRI) where even the public sector banks have initiated innovative approaches and supplied micro-finance products to cater to the needs at the grassroots level in a cost effective manner. The lessons learned from the experience of these developments should throw light in developing suitable approaches for public banks engaged in micro-finance in a sustainable manner. Sustainability of these institutions, one may argue, is basically related to the governance and management of the institution rather than mere ownership.

#### **(c) Why the mobilisation of rural savings is vital in rural financing?**

Mobilisation of savings did not figure prominently in the early rural finance initiatives. Micro-finance interventions in the early periods focussed on the supply of credit. During that time, the belief was that the poor spend almost their entire income on consumption and therefore are unable to set aside a part of his income as savings. The experience of micro-finance programmes implemented in many countries since late 1970s have proved that the poor also save and that they can also increase such savings. Further, these savings may not always be in cash form but they can be transformed to cash savings if the necessary facilities are made available. The poor expects their savings to be safe, that he can save in small quantities and can be conveniently withdrawn without much paper work.

In rural financing, savings provide a security against irregular cash inflows to the household and build confidence of the poor in undertaking risky but high return investments. In the absence of other forms of insurance, savings provide a safety net against unforeseen economic difficulties. For the lender, the savings provide a better security against credit risks.

An important issue relating to micro-savings is whether such savings are mobilised as compulsory savings. If savings are generated by withholding a part of a loan amount or as regular compulsory savings the institutions may not be sustainable when such schemes are terminated or when

the poor is economically empowered and does not want to abide by such regularities. The deduction of a part of the loan amount may either lead to the borrower applying for a bigger loan that he could set aside a part of it as savings and he may be left with the amount required by him. Otherwise, he may be getting an amount less than his requirement. Therefore, though compulsory savings may be useful for mobilising savings at the initial stages of a programme, in the long-run, the sustainability of a scheme or a micro-finance institution depends on the amount of voluntary savings that can be mobilised. It is also the practice of some institutions that these mandatory savings are not earn any interest and the institution considers them as free money. This situation discourages the saver and institution's real liability exposure is not revealed. Another issue relating to mobilisation of micro-savings is that when an institution depends on savings by the beneficiaries alone, the resource base of the institution becomes weak and the growth of the institution is adversely affected. Therefore it is important that these institutions mobilise savings from the non-poor, as well, who demand the availability of savings products suitable to their requirements.

#### **(d) How to cater to the financial needs of rural economy in a market based system?**

With the introduction of the financial deregulation, doubts arose whether the banks would be able to continue with rural financing under a market based system. In other words, can micro-finance be commercially viable? The foundations of this doubt were that rural finance was a welfare-oriented activity that could only be carried out with government or donor assistance. The experience of the BRI in the Unit Desa Scheme and micro-finance systems implemented in many other countries showed that micro-finance could be done in a commercially viable manner with a significant profit. Profitability requires the covering of costs and risks without government subsidy and providing cover against credit risks while making provisions against the loan losses.

A brief examination of the experience of the BRI's micro-banking activities, the largest micro-finance institution in the world, may prove beyond doubt that micro-finance is a commercially profitable industry.

In the 1970s, the Indonesian Government established special units attached to the BRI for channelling credit under subsidised rural lending programmes. The deposit rates were fixed at 15 per cent and the loans were granted under the subsidised programmes at 12 per cent per an-

num. The system resulted in heavy loan losses due to arrears of loans. By early 1980's, the micro-finance units of the BRI were either to be closed down due to heavy losses or to be converted to commercially viable units. In 1983, the bank was permitted to determine the interest rates on its own discretion. Loan interest rates were raised to 1.5 per cent per month (effective rate is 32 per cent per annum) and savings were mobilised from all potential savers irrespective of whether they were the members of the unit by introducing attractive savings products. A strong political decision was taken that the government will not interfere with the operations of the micro-finance units and the staff was provided with incentives for their achievements within one year. The micro-finance units became commercially profitable and since then have continued to increase the profit levels. What is learnt from this experience is that in increasing the profitability of micro-finance, the introduction of savings, loans and insurance products that suit the demand of the low income groups is vital. Similarly, the dedication of the staff and setting incentive right are also important. Further, use of information

technology to improve the services also plays an important role in increasing efficiency in providing micro-finance services.

#### Conclusion

Developing the rural economy has favourable social and economic impacts and financing rural economic activities can play a major role in the process. Financing should not be construed as providing only credit, it should rather cover all micro-finance services including mobilising savings, credit and social safety nets that improves the capacity of the household to face unforeseen disasters. Micro-finance, therefore, is an effective tool for developing the rural economy and empowering the poor and low income households, economically. In the early periods, the issues concerned were basically the outreach, designing credit schemes to suit directed lending and the assisting the institutions in minimising credit risks. However, at present, the issue of outreach has taken a new dimension, the government does not insist on institutions to expand the outreach to rural areas. Geographical outreach as well as the depth of the outreach, i.e. the outreach to poorer groups are equally important. The outreach,

in the absence of government insistence, has to be considered on a commercial basis. Among the other issues that have to be considered is the sustainability of rural financing institutions and rural credit programmes. Sustainability of the schemes on the one hand depends on the approaches used in expanding savings, loans and other financial services to rural areas and the marketability or the demand driven nature of the micro-finance products, on the other hand. The rate of interest charged the micro-finance institutions is a major factor in ensuring the long-term sustainability of those institutions. The financial institutions have to implement innovative schemes to take such facilities to rural areas in a cost effective manner to make micro-finance profitable. There are success stories that micro-financing can help alleviate poverty while being economically profitable from the institutional point of view. The authorities can ensure the sustainability of micro-finance programmes by refraining from undue interference in the operations of the systems but providing necessary regulation and supervision to ensure proper governance in these institutions.