THE CHALLANGES OF RURAL LENDING - RISKS AND COSTS -

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Abstract: Urban and rural areas differ in many aspects. One of them is the relevance of agricultural in rural areas. Agricultural is distinct from other sectors because of the seasonality, geographic limitations, price volatility and dependence on natural conditions. Moreover, the rural populations are often poor and have great difficulties in managing risk, coping with shocks and accessing consistent cash-flows. These differences may affect the characteristics necessary for the success of the financial institutions operating on rural markets.

This paper outlines the various risks of rural finance, discusses the cost involved in agricultural lending and presents techniques for risk and cost reduction.

Key words: rural lending , credit, agriculture, financial institutions,risk, costs

The Risks of Rural Lending

Moral Hazard

As in any lender-borrower relationship, there is a general problem of moral hazard that is the result of specific personal characteristics and decisions of each individual borrower. In this regard, rural population do not differ from any other borrower group in terms of information, incentives, monitoring and enforcement problems associated with the lending process.

Production and Yield Risk

Agricultural yields are generally uncertain, as natural hazards such as the weather, pests and diseases and other production calamities impact on farm output. Even slight changes in weather conditions - less rain than usual - can seriously impact on farm production. Pests and diseases may spread quickly, leading to a loss of part or all of the crop’s produce. The soil quality of the plots as well as their location also significantly influence productivity and yield risk. Seasonality of agricultural production provides an additional risk.

For all these risk management techniques, the experience of the small farmer is the core requirement for good results. Accordingly, prudent lending decisions need to be based on an assessment of the management capacity of the farmer.

Price and Market Risk

Price uncertainty due to market fluctuations is particularly significant where market information is lacking or scanty, or where markets are imperfect – features which are prevalent in many developing countries. The relatively long period of time between planting a crop or starting livestock activities and the realization of farm output implies that market prices may change from

what has been projected. This problem is particularly relevant for longer term agricultural activities, such as perennial tree crops like apples or citric culture, as several years lie between planting and first harvest. Price fluctuations may be particularly severe in export markets. Over-production, however, may also considerably influence domestic market prices. In many countries, price uncertainty has increased with liberalization of agricultural marketing. Market risk also includes the potential losses involved in marketing agricultural products. Transportation, as has been pointed out earlier, is a major challenge in many rural areas. Substantial losses may also occur due to a lack of appropriate storage facilities.

Lack of Diversification

Price and market risk, as much as production and yield risk, is higher for farmers concentrating on a single crop or livestock activity. Accordingly, many farmers apply risk diversification techniques to reduce these risks. Complementing market-oriented production with subsistence farming is one particular safety-net arrangement, which provides survival measures once yield, production, price and market risks diminish the profits made. Besides this, many farm households incorporate in their overall diversification strategy also non-farm activities.

Lack of Collateral

Most small farmers possess little to no assets. Even fewer small farmers possess land titles or goods which are traditionally used as loan collateral by banks. The most accepted asset for use as

loan collateral is land, because it cannot be removed but can generally be transferred at a specific market price. Small farmers' land, however, may also have a very limited value if there is no land

market. Land titles may also be unavailable or costly to obtain. Finally, land registration is often imperfect in many countries.

Political Risk

Political interference in agricultural markets is a common feature to be found in many developing

countries. Price intervention in agricultural markets, for example, is popular, as low food prices are in the interest of urban consumers. On the other hand, fixed prices for agricultural produce are also a frequently used political tool to ensure a certain level of income for small farmers. Agricultural lending has a long-standing history of political intervention and distortion, which substantially contributed to the disinterest of commercial lenders in this business.

The Costs of Rural Lending

Lending to small farmers can be a costly endeavor. As a matter of fact, lending in rural areas is generally more expensive than lending in urban areas. Clients are widely dispersed, and long distances have to be traveled by loan officers and/or customers. Lending in small amounts is, in general, more costly than lending in bigger amounts, as the cost of assessing, monitoring, and following up on loans does not decrease with the size of the loan. Rather, substantial parts of administrative lending costs are of a fixed nature.

The key cost driver in lending is the necessity to obtain substantial information about the potential borrower and to be able to do a close monitoring. Information is vital in assessing and managing risk.

Dispersed Clients

Low population density coupled with dispersed location of rural clients make the provision of formal financial services costly. Both from the lender's and borrower's perspective, the long distances between communities and the inadequate rural transportation facilities in many developing countries increase the costs of loan appraisal, loan monitoring and enforcement of loan repayments.

Limited Existing Information Base on Potential Customers

There is a general absence of credit histories as few financial institutions offer the possibility to generate a track-record with them. Beginning a relationship between the agricultural lender and a client is particularly costly and involves substantial "start-up" information costs. The lender must capture key first-hand information from the borrower, which requires time and experienced staff. After establishing a track record with the agricultural lender, the information costs diminish.

Limited Written Documentation to Base Credit Assessment On

Small farmers usually show a low level of formal education and are not used to manage written documents or keep records. Consequently, the loan appraisal must often be based on capturing first-hand information by interviewing the potential borrower.

Complexity of Economic Activities of Rural Households

This diversity in farm and non-farm income-generating activities of rural households requires better knowledge of the farm household financial situation. This can extend the bank staff time (and expenses) needed for loan appraisal. It may also require the setting of individual loan repayment terms. It is likely to increase the costs of training agricultural loan officers.

Demand for Variations in Lenders' Institutional Capacity

As agricultural production, the agricultural lending business is largely seasonal. Given the fact that seasonal agricultural activities are very time-sensitive, credit appraisals must be carried out within a short period of time and timely loan disbursements must be ensured. Consequently, the institutional capacity of agricultural lenders must adjust to these variations of credit demand during the year. There might be a need for additional, temporary staff in financial institutions during peak periods while in other months a reduced workload in agricultural lending must be off-set by other lending activities. Cost-effective planning for adequate staff and institutional capacity (liquidity requirements) is therefore a challenging endeavor.

Risk and Cost Management in Rural Lending

Given the complex risk structures and high administrative costs, efficiency is essential in agricultural lending. Thus, implementing streamlined policies, procedures and tools is a must. However, standardization in agricultural lending has to deal with the challenge of a high degree of heterogeneity of the farmer clientele and the complexity of economic activities within each farm household.

Risk Management

In order to reduce **production, market and price risks**, the following measures can be taken:

- An assessment of the specific risks that are associated with different agricultural production activities in different areas is essential in determining the potential risk exposure of lenders.
- Loan appraisal should include a thorough assessment of the borrower loan repayment capacity and his creditworthiness; also external risk factors of farm production should be taken into account.
- Individualized loan products and loan repayment schedules that are set in accordance with the loan repayment capacity of the borrower reduce the risk of loan default
- Collaboration with organizations which know farmers well reduces client information costs and risks of lenders.
- Rural lending should start in production zones that present low risks; operations can then gradually be expanded to more risky areas.
- The loan term and repayment installments are tailored to the estimated net cash flow of the prospective borrower. Farmers who rely only on farm production activities normally pay back their loans in one installment after selling their farm produce. Others are capable of repaying their loans in periodic installments. These farmers have a more diversified income base with relatively stable monthly income flows from non-farm activities and salaries or remittances from other family members.
- Loan portfolio diversification serves to protect rural lenders against covariant risks. Rural lenders should diversify their loan portfolio by financing a mix of loans with different lending purposes, loan terms and loan repayment schedules. Still, rural lenders need to set ceilings on the share and volume of total farmer loans by zone.
- Managing of external risks through insurance (single-peril crop insurance, multi-peril crop insurance, crop-revenue insurance, livestock insurance, equipment insurance, house insurance, health insurance etc).
- Staff incentives systems motivate staff and effectively increase their lending productivity. The loan portfolio growth and loan portfolio quality should be an important reference point in performance-based incentives for loan officers.

In order to reduce **moral hazard related risks**, the following measures can be taken:

- Clear information should be given to borrowers on the financial conditions of loans and loan repayment obligations (interest rates and fees, collateral requirements, loan repayment terms and contractual loan obligations). The objective of client education is to promote a positive credit culture and to foster mutual respect between the lender and the borrower.
- Co-signing of loan contracts and moral persuasion are effective means to enhance good credit discipline. Sometimes, both husband and wife sign the loan contract. This extends the lender-borrower relationship to the whole household and it deepens the sense of obligation by the borrower.
- Close contacts between the lender (loan officers) and the borrower are conducive for an atmosphere of mutual trust that improves credit discipline.
- Partnerships with agricultural products processors in well integrated marketing chains can significantly reduce the risks (and costs) of rural lending. The intervention can be applied in the selection process: processors' field agents know the producers and can make a pre-selection based on their personal knowledge of the producers' morality and ability; this contributes to greatly reducing the intermediation expenses for the lender; in order to ensure that the pre-selection process done by the agro-processors is done seriously, it is preferable that they carry a portion of the risk.

Risks from changes in domestic and international policies can be alleviated through the following measures:

- Rural lending institutions should be free of political interference in their daily management.
- Rural lenders regularly need to monitor policy and market changes that affect their rural (especially agricultural) clientele.

Collateral substitutes replace more conventional types of loan guarantees and can provide important loan repayment incentives. These types of collateral have a more psychological than actual market value. Among the various types of collateral substitutes we can mention:

- Group guarantee in case of group lending. Even if all financial transactions are conducted directly between the bank and the individual group members, peer group pressure, however, is activated at the time when loan repayments are due, as new loans will be only provided when all members of the group have fully repaid their loans.
- Pledge assets. In the case of small loans to low income borrowers, the assets involved have a limited market value, but they are highly valued by their owners who would have difficulty in replacing them. Typically, these goods include household appliances and furniture as well as farm equipment.
- "Symbolic" forms of loan collateral. These can include the physical possession of land title documents by the bank during the course of the loan. Pledges of future crop harvests and household savings are also accepted, although they are not legally enforceable.
- Co-signers or guarantors. Two types of guarantors can be used: i) "moral guarantors", who have a close relationship with the borrower household, are required for small loans. They are used mainly as prevention against moral hazard. ii) "personal guarantors", on the other hand, are appraised in the same way as the borrower and, in the case of loan default, they are responsible to meet all the loan obligations.
- Guarantee funds available in different countries.
- Lending risk insurance. Banks can contract global non-payment insurance with an insurance company for all its rural loans. The costs of this insurance are worked in the interest rate charged to each individual customer; the insurance replaces other collateral requirements.
- Partnership schemes agricultural products processors in well integrated marketing chains. The intervention can be applied in the recovery process, by deducting installments directly from the processors' payments to the producers that would be assigned to the bank; this arrangement requires signing a three party agreement.
- Partnerships with agricultural equipment suppliers in order to facilitate liquidation of collateral in case of need.

Cost Reduction

Rural lending is a costly business because it serves a **dispersed rural clientele**. Many of the cost reduction strategies, as outlined below, involve heavy initial overhead costs. This implies that they do not produce a return in a short period of time and an assessment should be made of their long-term cost effectiveness. Main strategies to reduce the financial transaction costs include the following:

- Adopting a cluster approach: choosing larger villages with good agricultural potential and with a village headman who is willing to participate actively in lending activities such as spreading information and organizing meetings.
- Using innovative information and communication technology (various forms of branchless banking-model)
- Decentralization of lending decisions to branch staff and loan officers.
- Delegation of parts of the appraisal, disbursement and monitoring procedures to other groups that are in close contact with the borrowers, e.g. community groups/associations, business development centers etc.
- Applying appropriate route-planning to avoid excessive traveling and reducing transport costs.
- Investing in qualified, well trained and highly motivated field staff in order to have has a positive impact on the lending productivity.
- Using a standard loan appraisal form with standard loan assessment indicators, which are computerized.
- Using simplified loan appraisal procedures to reduce the time required for loan processing, loan approval and loan disbursements.
- Defining borrower pre-selection criteria to sort out borrowers with an insufficient repayment capacity or unwillingness to repay at the earliest stage possible of the loan appraisal.

Limited existing information on potential clients as well as **limited written documentation** can be reduced by the following measures:

- Close contacts with local organizations and networks provide relevant client information.
- Loan officers with agricultural knowledge, good communication skills and well accustomed with the local region can significantly reduce the time and costs of collecting information and to prepare the credit files.
- Effective management information systems provide crucial information (appropriate client information system and a comprehensive database which tracks customer performance and economic activity profiles).

Seasonality and complexity of activities in rural households require specialized and well trained loan officers. The productivity of rural (agricultural) loan officers, in contrast with urban lending activities, is subject to seasonal fluctuations. Diversification of the rural loan portfolio in terms of location and lending purposes helps to balance the uneven staff work load due to the seasonality in agricultural lending. At the same time, the skills, knowledge (background in agronomy, farm management, rural economy) and personal qualities of the loan officer are prerequisites for efficient loan appraisal.

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