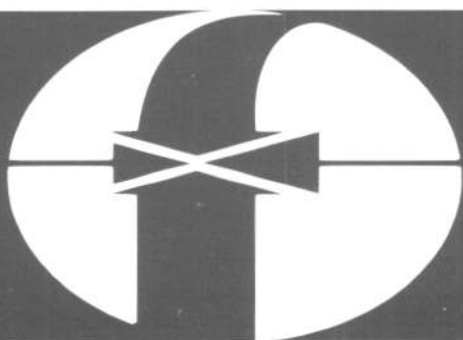


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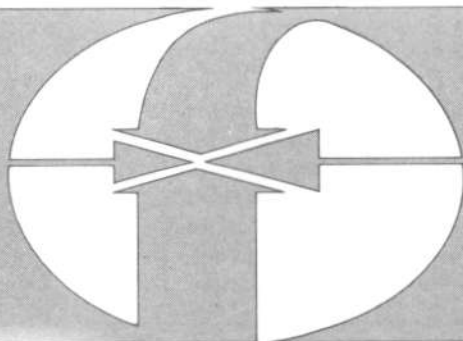
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RURAL CREDIT PROJECT DESIGN, IMPLEMENTATION AND LOAN COLLECTION PERFORMANCE

J.D. Von Pischke

International Bank for Reconstruction and Development

1. Introduction (*).

Poor loan collection performance by formal agricultural lenders in developing countries is often attributed to general conditions of low levels of economic development. Frequently cited farm level causes of loan arrears include small farmers' poverty, large farmer's political influence, low returns and lack of profitable innovations in tropical and sub-tropical agriculture, unfamiliarity with modern commercial practice among certain rural societies, cultural factors such as the weakness or absence of moral incentives or of small group sanctions for timely repayment, illiteracy, lack of farm planning, insufficient supervision by extension officials, and low level of formal education achieved by typical borrowers. Problems at the lenders level which may contribute to poor collection performance are frequently put down under the broad headings of teething problems of new financial institutions, such as cooperatives and specialized farm credit agencies, deficiencies in loan administration, and the lack of market information such as systems of credit rating based on repayment performance. In addition, difficulties in enforcing contracts through judicial or administrative law processes may be cited as a country-level problem constraining lender performance.

Alleged causes of poor repayment performance based on the general condition of a developing economy are obviously beyond the control of the lender. Realistic farm credit strategies must accept the state of the economy and its agriculture as largely given, and work within the external constraints which these impose. Viewed from this perspective, agricultural lenders frequently have no one but themselves (or their shareholders, in the case of public sector institutions) to blame for poor collection performance. This perspective is constructive because it emphasises internal problems within a lender's control which may be attacked in efforts to improve loan portfolio quality.

The main concern of this paper is the arrears problem over the long run. The continuation of a commercially non-viable level of portfolio performance may reflect quite different causes from those resulting in occasionally poor portfolio performance. For example, agricultural lenders will in the normal course of events occasionally suffer arrears on a short term basis as a result of poor har-

(*) The views and interpretations in this paper are those of the author and should not be attributed to the World Bank, to affiliated organizations or to any individual acting in their behalf.

vests and other conditions which affect farmer's incomes adversely. This situation is not necessarily serious if arrears are cleared during good years.

This paper is also not concerned with arrears which arise from pilot project undertaken on a modest scale for experimental purposes. Participation in a market is the best way of obtaining information about how that market operates, where its opportunities lie, and what is and what is not feasible. The accumulation of arrears is one of the costs sounding out the potential market for farm credit. As such, arrears are a price which it may well be worthwhile to pay, so long as any given trial is small and easily discontinued once its lack of viability is reasonably well established.

Finally, the discussion in this paper is primarily directed towards factors involving present borrowers, to those who in fact have credit. An equally fascinating subject, the effect of loan defaults on those who do not have credit and on society at large, deserves separate treatment.

The following sections of this paper list a number of credit project design and implementational problems which lead to poor loan collection performance. These problems may be stated as issues involving competing project design approaches and objectives, or incompatibility between project objectives and the capacity or effectiveness of credit as a tool for encouraging agricultural development or promoting target group equity.

2. Credit project design problems

Debt vs equity. There is a great temptation for public sector lenders to use credit to try to compensate for the presumably low level and low potential level of capital accumulation in small scale agriculture.

In financial terms, credit used as a substitute for risk or equity capital subjects the lender to the risk of ownership in the borrower's undertaking. One of the risks of ownership is uncertainty of return. Unless loan repayment terms are extremely flexible, poor collection performance often results (if loan repayment terms are extremely flexible, loan administration may be very difficult). In financial terms, the provision of amounts of credit which are large in relation to the debt capacities of borrowers imposes debt servicing obligations upon borrowers which are large relative to their cash flows, increasing the probability that

borrowers will be unable to repay as scheduled. Debt capacity is defined here as a function of future cash flow, with the projections appropriately adjusted to reflect the probability of adverse events. In other words, debt capacity is based on to repayment capacity. Overloading the farmer with debt is one way to ensure poor loan collection performance.

Realism vs aspiration. Project designers — in aid agencies as well as in ministries of agriculture or planning — seek to demonstrate that a favorable rate of financial return is achievable for their particular project. When the first trial projection yields a return which the analyst feels is on the low side, the normal response is to make minor adjustments in key values, such as yields, prices and the rate of project expansion. The cumulative effort of successive minor adjustments can be startling. In most cases there is no conspiracy of deception. The fault rests rather with the manner in which public sector projects develop on paper prior to implementation. The projection of high financial returns by optimistic designers is manifested in unrealistic assumptions about what the typical borrower will be able to accomplish. Such assumptions may also be produced by the occasional inability of project designers to accord sufficient weight to the economic factors which make it impossible for farmers to reproduce experiment station results.

Expected Value vs Dispersion. Project design often excludes detailed consideration of the variety of results which occur in the field. The expected *mean* or average farm cash flow is used as a basis for project formulation and projection by the project designers. The implementing agency will find that many of its problems stem from the *range* or diversity of results actually achieved by ultimate borrowers. The dispersion of the distribution of borrowers' actual cash flows, from the very successful to the flattest failures, is not easily dealt with by the project planner, even if attempts at sensitivity analysis are included in his projections.

The meter vs the centimeter. Reflecting the nature of their respective subject matters, different professional disciplines involved in project design work to different tolerances. For example, the rural developer is probably doing a good job if he can project within $\pm 25\%$ the actual number of people who will adopt a certain project-induced innovation. The agriculturalist is probably doing a good job if he can predict within $\pm 10\%$ the yields per hectare which are achieved on an average farm. The financial analyst is confined to much smaller margins. If the

spread between the agricultural lender's cost of capital and lending rate is only 5%, the financial analyst who does a good job in projecting loan recovery rates or loan administration costs will have to be concerned about very small differences. Margins of error which may appear immaterial in the contexts of rural development or agriculture may be extremely large in terms of finance, where, for example, a 1% net return on total assets is above average for a commercial bank. The low margins and fine tolerances of finance can pose formidable challenges to rural credit projects.

Bookkeeping convenience vs borrower cash flow patterns. Lenders or project designers may tailor loan maturities for their own convenience rather than that of the borrower. Due dates at the close of accounting years or quarters are harmonious with bookkeeping rhythms, but may not coincide with peaks in borrowers' liquidity cycles. Periodic installments of equal size are easiest to handle by the lender, but the cash flow available from loan-supported enterprises and investments may not conform to this steady pattern.

Collection mechanism. Some project designers expect borrowers to walk in off the street to repay their loans. Not an unreasonable expectation, perhaps, if the borrower lives on the same street or just around the corner. But, when a visit to the lender's office involves a journey of 20 km. from the borrower's farm the situation is of a different order. In many instances instructions for repayment could be lodged with cooperatives, marketing board agents and employers (especially the civil service) for automatic deductions at source from borrowers' cash flows, which could improve collection performance greatly.

Institutional scope or range of services offered. It is also not realistic to expect all borrowers to walk in off the street at the specified time to repay loans if they have no other reason for walking in. By providing credit only, many specialised farm credit institutions are at a handicap in establishing a good financial relationship with their customers. Farmers, even small farmers, use money transfer services an often would use of deposit facilities (at least during the flush season immediately following a harvest) if these were provided on attractive terms. By not offering a range of financial services, a farm credit agency denies itself many opportunities for expansion and also deprives itself of information about the nature of the rural financial market. The intermediary who can observe flows through depositors' accounts as well as the progress of his loan portfolio has better market information than the intermediary who is only a lender in the rural

financial market. The rural credit literature generally neglects loans against the borrower's savings account, and they constitute only one example of the flexibility offered by providing a range of financial services. Financial institutions which offer rural people only medium and long term loans are in the worst possible position to establish a relationship with their clientele. Lenders in the short term market at least have the reassurance that their borrowers will tend to return the next season to obtain another loan, and that the probability of periodic contact provides an opportunity to impress upon the loan applicant the importance and the rewards of establishing a reputation as a good payer.

Interest rates. Unrealistically low interest rates such as those charged by most farm credit agencies in developing countries encourage poor repayment. Little sense of urgency to repay is attached to money provided at a discount. Nominal interest rates exceeded by the rate of inflation actually reward borrowers who delay repayment. Inflation tends to make it easier to repay later, few alternative lenders to which the borrower has access in the formal sector provide funds at such an incredibly low or negative cost, and many borrowers delay repayment because they can obtain a profit by employing these cheap funds at higher rates of return on their farm and in alternative uses. Even if for « practical » reasons it is « impossible » to raise the rate of interest on farm loans to something approaching the rural discount rate used by farmers in their private calculations, what is the case against raising interest charges on *arrears* to a realistic rate, if not a true penalty rate? After all, borrowers in arrears engage in anti-social behaviour by tying up the resources of the community in contravention of their loan contracts stipulating timely repayment.

3. Credit project implementation problems

Low service levels may actually encourage farmers, once they have received credit, to delay repayment. Low service levels are reflected in high transaction costs imposed on loan applicants. These costs may take the form of an impersonalized or even intimidating loan application process, having to wait in the credit agency office for several hours in order to initiate or conduct a transaction or consult with a responsible staff member, non-official payments from borrowers to credit agency staff or others in control of credit access, the necessity of following up applications closely in order to obtain action, delays in loan approval

and inconvenient loan disbursement procedures (e.g., issuing a check to farmers who do not maintain deposit accounts. In situations such as these the borrower can save himself the trouble of repeated participation in the loan application ritual simply by failing to repay an outstanding loan and reinvesting the amount due in his operations, rather than repaying his loan and reapplying for credit in the future.

Coordination. Timeliness is often essential for successful agricultural innovation — e.g., if improved varieties are to achieve their potential yields. When credit is being used to support innovations, its timely provision is important. Loans made available too late in a season may not be of any benefit to farmers. Even if loans are available on time, are the inputs available? Certain projects have been hampered by the inability of public sector marketing authorities to get inputs to farmers at the proper time. Once the credit-supported enterprise is in production, are marketing arrangements adequate to ensure farmers a reasonable price and timely payment for their crop deliveries? Implementation problems of these types tend to depress borrowers cash flows and reduce their repayment capacity.

Access. The loan allocation process may also lead to poor collection. Poor credit decisions may be made because of information problems and lack of decision makers experience in lending to specific target groups. Political pressures may skew the distribution of funds away from the pattern envisaged in project design. If political interference diverts credit away from target groups towards those with relatively smaller repayment capacities, it may jeopardise loan recovery. Political pressure on the loan allocation process will also impinge on collection activities, restricting the lender in the exercise of his best judgement.

Financial housekeeping. Poor collection performance may result from loans not properly documented, which makes it impossible to enforce repayment. Accounting problems may make it difficult for farm credit institutions to know exactly the repayment position of specific borrowers. A lender without accurate accounting information cannot administer loans or follow up defaulters very effectively.

Sanctions. Public sector farm lenders tend to have problems getting organized for the effective exercise of sanctions against bad payers. One sanction is to deny bad payers further access to credit, but this may conflict with the impression that poor payers include those who « need » credit the most. The ultimate sanction is of course foreclosure — seizing defaulters' chattels or land. Govern-

ment institutions established to assist farmers often do not like to be seen taking away the farmer's primary asset, his land, or carrying away his cattle or implements. Not to exercise sanctions, at least against those who abuse credit by being able but not willing to repay, inevitably leads to an accumulation of arrears. Accumulations which result from the reluctance to impose sanctions indicate that farmers have a more realistic view of the system than do project designers and administrators of farm loan portfolios. Arrears of this type show that defaulters are stronger than the government in the sense that they can obtain control over credit schemes established and administered by the government or its client agencies.

4. Effects of Poor Collection Performance

Having examined causes of poor collection performance which are within the control of the lender, it remains to ask what impact lenders' poor loan recovery records may have. Two main areas of concern are institutional development and welfare and equity.

4.1 Financial strength and institutional development

Impact on resources. Arrears are expensive for a lender. Recovery of overdue loans requires staff time and paperwork, and may involve transport costs for visits to defaulters' farms and legal expenses. It may be difficult under conventional loan contracts for the lender to pass along to defaulters the out-of-pocket costs connected with arrears. Thus, the administration costs of overdue loans usually increase the overall costs of lending without increasing by the same amount the revenue from lending. By decreasing lenders' net returns, arrears diminish the ability of the lender to generate resources internally for institutional growth.

Arrears may also limit the lender's access to external sources of funds. Efficient financial markets are sensitive to risk, and holders of highly risky loan portfolios, in these markets can raise funds only at a premium if they can raise funds at all. Farm credit institutions which are not financially viable will not gain access to

funds in the local marketplace on their own strength. While reliance on external donors and the national treasury may be convenient means of establishing a specialised farm credit institution of the traditional type, long term dependence on these sources of funds or on government guarantees limits the scope of the development of farm credit institutions. This is demonstrated by American and European experience where privileged farm credit institutions have not developed as dynamically as other intermediaries in the financial industry.

Staff morale. The accumulation over the longer term of large amounts of arrears which impair institutional performance indicates to professionals in accounting and finance that the situation is out of control. This realisation tends to weaken staff morale, and the individuals who have a professional approach to these functions may become discouraged and seek employment elsewhere or else divert their energies when they realize the futility of bringing a professional approach to their work. If a professional approach to accounting and finance is not pursued in a farm institution, it is unlikely that the institution will be able to perform very efficiently and that it will be able to serve rural people in a dynamic manner.

Establishment of a clientele. Loans not collected are loans which cannot be recycled by the lender to new borrowers. Farmers who might otherwise have had access to credit may be denied credit because those with loans outstanding are not prompt payers.

In addition, the accumulation of large amounts of arrears indicates that the lender has not established a viable basis for entering into mutually profitable relationships with borrowers. Poor collection records over the long term indicate that the lender is out of touch with his constituency or market. Until a mutually acceptable basis of doing business is established, the community, including those without access to credit, will not be well served by the farm credit institution, and other financial institutions may be discouraged from entering the farm credit market.

Today vs tomorrow. Accumulations of arrears deserve the serious attention of a credit institution's senior management. While preoccupied with arrears, senior management is not able to devote the same energy which it would otherwise focus on long term planning. Areas which may be neglected include: a) experimentation with or at least contemplation of new services which could be offered

to the rural community, b) exploring how productivity might be increased and terms of employment made more attractive for the institution's staff, and c) consideration of how decision making can be decentralised to provide greater institutional responsiveness and more meaningful tasks for promising junior staff, for example. Arrears can easily divert management from a comprehensive approach to its most creative task ensuring a better tomorrow.

4.2 Welfare and equity

While it may superficially appear that permitting arrears to accumulate, and eventually ceasing to try to collect amounts which have been overdue for long periods, is one means of helping poor farmers who have suffered reverses, reality is seldom this simple. The really poor among the rural community are generally not those who have access to credit. Loans tend to go to farmers who are better or bigger than average. Even among borrowers in arrears it is very difficult to ensure that only the poorest benefit from not being forced to repay their loans. Credit does not appear to be an efficient mechanism for income transfer — creditworthiness and « need » are usually opposite extremes.

Administratively, it is very difficult to discriminate among different groups of borrowers according to social-welfare criteria, enforcing one standard of repayment performance for one group tolerating a greatly inferior level for another. Even if it were possible to administer double or multiple standards efficiently between groups of borrowers, how would it be possible, within any single group, to distinguish those who are really unable to repay unless subjected to extreme hardship such as loss of land or imprisonment, from those who abuse credit by being able to repay but not willing to repay? Efforts to discriminate between inability and unwillingness are in practice quite costly, requiring lots of the lender's staff time or lots of time by extension officials, community development agents, and others who presumably are already overburdened with the task of implementing rural development.

The distinction between inability to repay and unwillingness to repay is difficult to define once a lender has a reputation of not enforcing loan contracts. A larger and larger proportion of borrowers will take liberties with their repayment obligations, and those who are apprehended will do their utmost to appear as po-

verty stricken as possible or to offer excuses to « prove » that their case is special and deserving of lenient consideration. The administrative difficulties posed by accumulation of arrears have a spread effect which progresses as rapidly as borrowers' realization that their loan contracts are no more than a piece of paper.

5. Conclusion

A variety of problems arising from inadequate farm credit project design tend to result in poor loan collection performance by agricultural lenders. But regardless of design, a number of credit project implementation problems can make it difficult for a lender to collect in a timely manner amounts which are due. Combinations of design problems and implementation problems can preclude farm credit institutions from functioning effectively in financial terms or from expanding services in a equitable way to larger numbers of rural people. These difficulties reflect the costs of poor collection performance, which tend to be institutionally debilitating.

Every lender and credit project faces external constraints on collection performance. In a low income country many of these constraints reflect the general conditions of the economy. Successful project design requires identification of these constraints and the development of strategies for dealing with them. Financial institutions and projects which are not appropriate for their environment obviously will not perform well. However, such external problems should not be confused with those which are internal to a project in the sense of being entirely within the control of the project designer and of the implementing credit agency which provides funds to farmers. The internal problems are so critical to project performance that they can easily make project success unlikely. Likewise, efforts to overcome the problem have a tremendous potential for contributing to institutional strength, precisely because they can be effected internally, primarily at a managerial or technical level rather than at a political or macro economic level. Separation of the internal from the external causes of poor loan collection performance constitutes a starting point for realistic use of farm credit as a development tool in agricultural and financial policy.

L'ELABORATION ET LA REALISATION DES PROJETS DE CREDIT AGRICOLE ET LE REMBOURSEMENT DES PRETS.

RESUME

Tout institut de crédit et tout projet de crédit font face à des contraintes externes qui influencent le remboursement des prêts. Dans les pays où le revenu est très bas ces contraintes réfléchissent les conditions générales de l'économie. Pour qu'un projet de crédit ait une bonne réussite il faut qu'au cours de son élaboration on essaie d'identifier ces contraintes et qu'on mette en place de stratégies efficaces. Les institutions financières et les projets qui ne seraient pas adaptés au milieu ne vont pas avoir de succès. Il ne faut pas toutefois confondre ces problèmes externes avec les problèmes internes au projet, c'est-à-dire les problèmes dont la solution est à la portée de ceux qui sont chargés d'élaborer ou de réaliser le projet même, des organismes de planification et des instituts qui octroient matériellement les fonds aux agriculteurs. Les problèmes internes sont d'importance fondamentale et peuvent facilement décider du succès ou de la faillite du projet. De même, les efforts qui seront faits pour résoudre ces problèmes vont contribuer de manière significative à la force institutionnelle du projet, puisqu'ils seront faits à l'intérieur, à un niveau directif et technique plutôt que politique ou macro-économique.

L'identification séparée des causes internes et externes des problèmes concernant le remboursement des prêts représente un point de départ pour une utilisation réaliste du crédit agricole en tant qu'instrument de développement de la politique financière et agricole. On analyse dans cet article, les faiblesses typiques qui affectent l'élaboration et la réalisation des projets de crédit et leur effet sur la force des instituts financiers et le bien-être social.