

Lines of credit

Inclusive rural financial services



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Introduction

Donors and other aid organizations often use lines of credit (LOCs) to assist small rural financial service providers (FSPs) in their development. However, LOCs can be more destructive than helpful and organizations should use them sparingly and with caution. This knowledge document discusses the problems with LOCs and how and when they might best be used. It highlights the philosophy and rationale for using LOCs, examining the strengths, weaknesses and opportunities of different types of credit arrangements. It also summarizes global experience with LOCs to clearly outline the limitations of their use and serves as an initial guide for IFAD project design. It presents practical aspects of specific approaches, methodologies and models that have been tested and can be recommended for implementation and scaling up, including best practices and case studies.

Background and context

The LOC is a loan to a participating financial institution (PFI) for on-lending to customers who are expected to repay their loans with interest. Repaid funds can be revolved until the LOC becomes due for repayment. Since the PFI assumes the credit risk, the LOC is a liability for the intermediary organization. LOC funds obtained by a government through an IFAD programme are usually managed by a financial institution that wholesales the funds to retail-level microfinance institutions (MFIs).

There is good reason to provide professionally-managed LOC programmes that can complement savings mobilization and intermediation measures. IFAD provides LOCs because commercial players are often reluctant to venture into rural and remote communities due to high transactions costs. Additional liquidity provides opportunities, which include: (i) supporting the development of PFIs; (ii) financing real subsector (agriculture) investment needs; (iii) promoting private sector-led small and medium-sized enterprise (SME) development; (iv) helping to broaden and increase efficiency in the allocation of the scarce resources and services to an unsaturated rural financial market; and (v) supporting the country's poverty reduction agenda. However, LOCs often remain untouched because the FSP might not have adequate capacity to serve low-income people (e.g. range of products, delivery methodology).

One opportunity for overcoming this problem is through replacing traditional brick and mortar banking business models with Internet and e-money platform services; these high volume/low price mechanisms will drive outreach growth. The challenge of the traditional banking sector is to consider facilities such as LOCs and to develop operations and processes that allow them to disburse the funds in a retail service that is cost-effective. Here, we will see large numbers of customers accessing small, repetitive loans from high-value LOC funds with attractive margins being made in the process.

Rationale

It has proven difficult to provide sustainable financial services aimed at rural areas and agriculture in developing countries. Billions of dollars have been spent subsidizing programmes and policies to develop financial institutions to serve this neglected market and yet in most countries, decision makers, ministers of food and agriculture, and farmers are dissatisfied with the results. Critics of the market-oriented financial reforms that were implemented following the collapse of the directed credit paradigm claim that these reforms have failed, given that agriculture continues to receive only a small share of total formal credit and that most farmers must rely on savings or informal credit supplies to finance their operating costs and long-term investments.

There are issues with donor-funded LOCs, some of which are described briefly below:

- **Risk of distorting the rural finance market.** The provision of external and often below-market rate funding risks discouraging FSPs from developing long-term local sources of funding since the FSP may become dependent on donors.
- **Privileging the donor project over good financial management practices.** The structure of LOCs is often focused on the needs of the donor project rather than the needs of the FSP and its clients.
- FSPs with social development goals are usually enticed to serve niche clients. As a result, they often do not invest in an analysis of demand and, thus, **fail to understand the needs of the targeted clients.**
- Similarly, FSPs do not invest in risk analysis and, thus, are **not able to develop appropriately customized or adapted approaches to manage risks.**
- Donors often finance pilot projects but **fail to fund a reasonable roll-out or scaling up.**

The enthusiasm that clients express for LOCs is often not out of need but rather out of hope to obtain loans on cheaper terms or conditions, or with lower qualifying requirements.

Consequently, the risk of underperforming LOCs is substantial. One option is for development agencies to allow participating FSPs to be flexible to make LOCs “as open as possible”. For example, participating FSPs could approach the private sector to finance products of the LOC, while donors focus on building capacity and the creditworthiness of the target clients to make them attractive as clients to the FSPs.

Summary of key issues linked to LOCs

Future IFAD-designed projects should draw on the following lessons learned (see *Lines of Credit: Lessons Learned* for more details):

- LOCs do not meet the longer-term needs of FSPs.
- LOCs can negatively impact the financial sector.
- Liquidity (i.e. access to loan capital) is not usually the main constraint for FSPs. More commonly, they do not have the capacity, products or systems in place to serve poor clients. Support should be targeted at developing their capacity.
- LOCs can distort credit markets by undercutting and eliminating sustainable, unsubsidized competitors and blocking the entry of new service providers, as well as alienating other donors and FSPs.
- With access to large amounts of low-cost capital, FSPs may become less attentive to their lending practices. Wholesalers, for example, may feel pressure to disburse funds to weak institutions or in tranches too large to effectively manage, leading to increased defaults or overexpansion.
- LOC-financed products are often unsustainable. When access to the LOC stops, FSPs may go back to serving mainstream borrowers and stop serving the target group.
- Some FSPs rely too heavily on donors and the LOC, and they fail to craft a clear strategy to mainstream market-based credit. When projects end, FSPs must be strong enough to fund their own loan portfolio.

Challenges, opportunities and benefits

Strength: When used in a targeted manner to develop capacity, LOCs can be used for institutions to deepen the depth and breadth of outreach in rural areas.

Weakness: When used without an understanding of the demand market and the risk potential, LOCs can do more harm than good by making the institution overly reliant on outside funds or by simply becoming a cheap source of access to capital.

If LOCs are to be useful, then they must be made available with coordinated technical assistance (TA) and resources for capacity-building. If a project is working with an FSP on product development, for example, then the product should be researched, designed and ready to pilot before it can access capital for its launch and testing (assuming the agreed on targets were met).

Rather than rely on LOCs, governments and donors should support MFIs in attracting savings. They can do this by:

- (i) providing TA to the MFIs to help them build their capacity to mobilize deposits

- (ii) encouraging MFIs that mobilize deposits to use borrowing only as a supplement to deposits to avoid excessive dependence on outside funding
- (iii) supporting the development of a well-designed deposit insurance fund once effective prudential supervision has been established
- (iv) encouraging the progressive integration of the MFIs into domestic and foreign capital markets.

Brief description of the LOC toolkit

⇒ **Teaser:** Sets out the scope (you are here).

How To Do Note: Conceptualizes key issues and provides guidance for design and implementation.

Lessons Learned: Analyses past experiences with recommendations for the future.





International Fund for Agricultural Development
 Via Paolo di Dono, 44 - 00142 Rome, Italy
 Tel: +39 06 54591 - Fax: +39 06 5043463
 E-mail: ifad@ifad.org


www.ifad.org


www.ruralpovertyportal.org

 ifad-un.blogspot.com

 www.facebook.com/ifad

 instagram.com/ifadnews

 www.twitter.com/ifadnews

 www.youtube.com/user/ifadTV

Originators

Michael Hamp

Lead Technical Specialist, Inclusive Rural Financial Services
 Policy and Technical Advisory Division
 E-mail: m.hamp@ifad.org

Francesco Rispoli

Senior Technical Specialist, Inclusive Rural Financial Services
 Policy and Technical Advisory Division
 E-mail: f.rispoli@ifad.org

Jonathan Agwe

Technical Specialist, Inclusive Rural Financial Services
 Senior Policy and Technical Advisory Division
 E-mail: j.agwe@ifad.org

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Contact

Maria-Elena Mangiafico

Knowledge Management and Grants Officer
 Policy and Technical Advisory Division
 E-mail: m.mangiafico@ifad.org

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