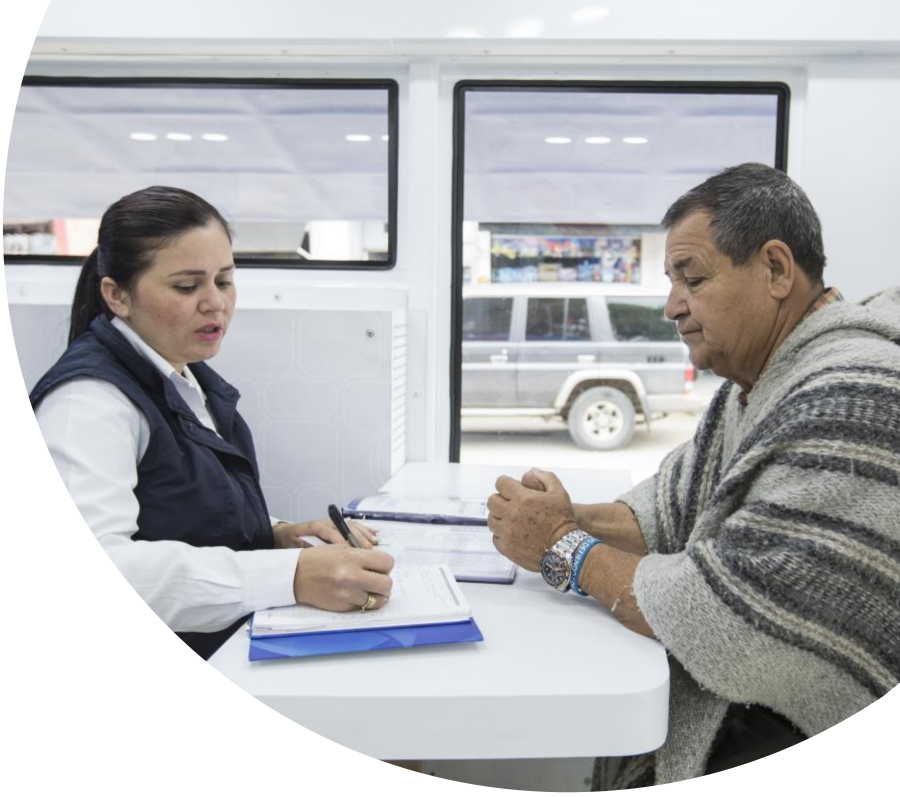


USAID RURAL FINANCE INITIATIVE TECHNICAL BRIEF No. 1

Helping Rural Financial Institutions Expand Rural Service Delivery

Access to financial services enables rural households to build financial security, start enterprises, and insure against risks. This access, in turn, generates secondary benefits, improving resilience, health, nutrition, and broad-based economic growth. Colombia's economy has grown steadily for 30 years, but the World Bank ranks Colombia as the world's ninth most economically unequal country. An urban-rural divide largely excludes smallholders from the banking system. Only 11 percent of rural producers access formal finance; they cite distance, loan application complexity, and high transaction costs as barriers to access. Given entrenched biases, women, indigenous groups, Afro-Colombians, war victims, and ex-combatants have even less access to financial services than other rural producers.

For a decade, the Colombian government, in partnership with USAID (see box), has prioritized improving access to financial services. This effort initially focused on national financial sector modernization and urban microfinance. Recently, the effort has expanded, and it now also focuses on access to investment capital and rural financial services — especially for poor, vulnerable groups. In 2015, USAID launched the Rural Finance Initiative (RFI), implemented by Chemonics International, to provide technical assistance to financial institutions so that they could seize profitable opportunities to expand client-responsive services into rural markets. Since then, USAID's RFI team has followed a set of five working principles to undertake five

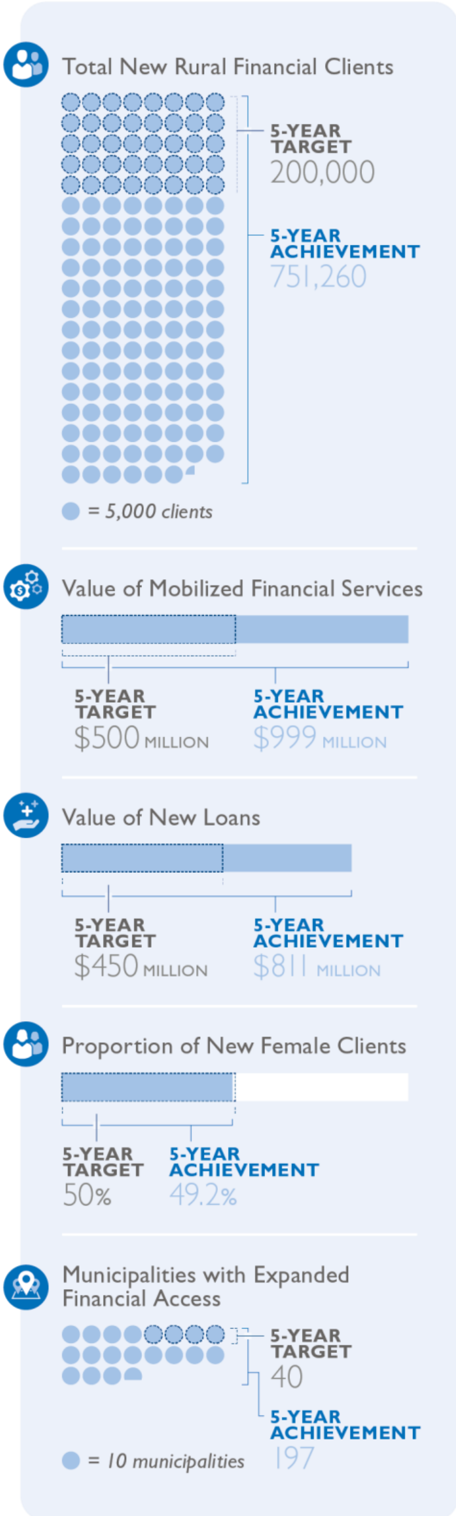
Elements of USAID Support for Financial Issues in Colombia: 2000 to 2015

- Improved policy, including for microfinance, electronic services, low-volume savings accounts, and movable assets
- Strengthened institutions (e.g., merging the Banking and Securities Superintendencies to form the Finance Superintendence)
- A new model for banking correspondents
- Microfinance methodology introduced to financial institutions (urban clients)
- Expansion of Local Credit and Savings Groups
- Creation of first private investment fund

distinct financial innovations, Together, these principles and innovations have produced the improvements detailed below.

USAID'S RFI: TARGETS AND ACHIEVEMENT

USAID set aggressive targets for the five-year RFI activity, requiring that the teamwork with 12 financial institutions to link 200,000 new rural clients with $500 million in formal financial services in select economic corridors of Colombia and deliver improved access to loans, savings, and insurance. With four and a half of five years completed, USAID's RFI has surpassed targets and is on track to achieve outcomes. Working with 14 financial institutions — including two of the country's three largest banks — the RFI team has developed and enacted rural market expansion plans that have achieved rapid impacts in the sector (see Exhibit 1, at right).



ELEMENTS OF THE USAID RFI APPROACH

How did USAID, through RFI, reach more than 750,000 rural clients and mobilize $999 million in financial services in less than five years? With USAID's prior investments in Colombia's financial sector setting the stage, the RFI team drove rapid change through a combination of a unique consulting culture and approach; strict adherence to working principles that informed all activities; and a focus on a set of critical innovations in risk management, loan origination, product design, and digital finance.

USAID's RFI team members served as the central change agents by providing highly customized advisory services, mixing expertise from the Colombian financial sector and the development community. RFI's staff have complementary skills in financial and risk analysis, micro-finance and rural savings, and digital finance. Each of the six RFI technical and financial team members oversees tailored advisory services for two or three financial institutions, supported by specialized short-term local experts. These technical team members are not only intimately familiar with the needs of their assigned financial institutions but also broadly aware of RFI's overall strategy, thanks to periodic full-team planning and knowledge-sharing sessions to build common vision, culture, and method. RFI's five working principles (see box on next page) reflect a unique approach to rural financial inclusion rooted in a recognition that an array of financial institutions can develop viable new business lines in rural areas if those institutions are open to diverse clients, cost models, risk profiles, and products.

Five Working Principles

1. *Adapt operations to a low-margin business*. Rural clients represent an important growth opportunity for financial institutions, but rural banking is a high-volume and low-margin business. To make money in this market, financial institutions must reach new clients and then adjust their operations to meet unique client and market needs.
2. *Focus relentlessly on cost.* To add new clients, financial institutions must lower the cost of delivering financial services. Eighty-eight percent of rural clients hold assets, and 55 percent save, but 90 percent save outside the formal financial system, largely because of the system's transaction costs. The RFI team has relentlessly focused on reducing financial institutions' costs while establishing models to estimate per-client costs for new client acquisition and service delivery.
3. *Diversify by offering more than micro-finance*. Historically, outreach to the rural poor has focused on micro-lending, but financial institutions need to deliver diversified services that go beyond lending to include savings, insurance, and other services. Recognizing that rural banking expansion would not be sustained without the delivery of new and additional services, the team has worked with banks to develop those products.
4. *Work with both the largest and smallest financial institutions*. For rural banking to succeed at scale in Colombia, small and large financial institutions needed to be involved. The RFI team has worked with financial institutions of all sizes. Large banks would demonstrate the potential to leverage significant capital in rural areas, while smaller and regional financial institutions — because of their already-established client connections — would demonstrate the ability to bring in large numbers of customers.
5. *Work with the whole pyramid, not just the bottom*. If the rural economy is to move, enterprises and enterprising behavior must be financed for firms of all sizes, from microenterprises to small and large enterprises. To be viable, financial institutions need both the large client base from small enterprises and the capital and business of large enterprises. RFI, therefore, has worked with the bottom of the pyramid, but it has also worked with the rest of the pyramid.

Informed by these working principles, the RFI team has focused on delivering these *five innovations*, which together have proven the key to expanding rural financial access:

(1) Expanding the client base through new engagement channels. Globally, no intervention has proven more effective in improving rural financial inclusion than improving access to financial services.[1] Construction of new branch offices provides the most recognizable means of expanding access, but in sparsely populated areas, the financial benefit of new branches is generally lower than in urban areas given the lower incomes, smaller populations, and greater distances that clients must travel to reach branches, which result in higher client transaction costs. Although the RFI team advised clients on estimated returns from new branches and allocated incentive grants to encourage new branch construction, RFI's channel expansion work has primarily focused on strategies involving banking correspondents, rural financial advisors, and mobile banking. Each of these strategies allows rural clients greater access to financial services. To increase the number of banking correspondents (non-financial commercial establishments operating brick-and-mortar businesses in a community and offering financial services), the RFI team advised on placing correspondents in specific locations, the services correspondents would offer, and the internal guidelines governing correspondents' management. The RFI team helped expand the number of mobile rural financial advisors (members of rural communities engaged by financial institutions as employees or consultants) by supporting advisor training and refining guidelines for their roles. To support rural inclusion in the form of

[1] Cámara, N., and Tuesta, D. (2014). "Measuring Financial Inclusion: A Multidimensional Index." BBVA Research Working Paper, No. 14/26. Madrid, Spain: BBVA Research.

specially equipped buses and trucks, RFI has assisted partner financial institutions in equipping and sending mobile banks on circuits to remote villages.

(2) Improving risk management. The best risk management comes through innovative design of financial products and processes that most directly meet the needs of rural clients and of issuing financial institutions. The risk profile of a farmer who depends entirely on a crop production cycle is fundamentally different from the risk profile of an urban retail sales operation, given differences in timing of cash flow, climate risk, and other factors. Before designing new products, the RFI team needed to respond to the financial institutions' most pressing, immediate needs. The team did so by reviewing each institution's risk policy and guidelines; prioritizing short-term risk issues (those of greatest concern to the financial institutions); and addressing profitability, repayment, and shared costs. Working with Financial Institution Risk Departments, the team helped them understand and manage risk through models of credit scoring and improved evaluation of credit profiles.

These policy-level risk issues, once resolved, allowed the RFI team to shift its focus to developing innovative products and profiles that would work with lower-income rural clients, for whom formal collateral requirements in land or commercial assets were prohibitive because of issues like landlessness; lack of title; and biases against women, ethnic groups, and war victims holding a title. The RFI team developed and adapted lending guarantees using less onerous requirements, such as having guarantors or promissory notes, savings group guarantees in loan origination, or establishment of credit history through a series of small loans. Yet even when using these innovations, the team recognized that most micro-loans would still be made with minimal collateral.

To address this remaining risk, the RFI team has worked with financial institutions to "build information collateral," a method for capturing client information in the context of their communities and using that information to understand and reduce risk. With extended channels to connect to clients and improved engagement and understanding of client needs, this collateral information — including a family's history, social connections, and farmland quality — can be as important and useful to a financial institution's profitability as traditional collateral methods, at least for micro-loans. A given potential rural client may have no formal collateral, but if a financial institution learns she has a history in the community and an established reputation for probity and resourcefulness, the risk of a loan to her is likely to be less than a loan to a just-arrived migrant to the community. (For larger loans, the financial institutions may continue using traditional guarantees.)

RURAL FINANCE INITIATIVE

(3) Agricultural value chain financing. The fastest way to add rural clients to partner financial institutions has been through investment in physical access points (e.g., branches, banking correspondents, roving rural advisors). The most enduring way to add clients will be through digital banking, but few innovations have the potential to accelerate investment across a single value chain like the agricultural value chain financing models that RFI is now developing. In agricultural value chain

financing, the financial institution works through a single point of entry in the value chain — the "anchor organization" — to lower the cost of delivering capital and other banking services (e.g., insurance and savings) to members. Anchor organizations can be producer associations, cooperatives, or even mid-sized rural enterprises with established suppliers. The RFI team has been working with financial institutions to assess the entrepreneurial capacity of anchor organizations using a 13-factor scoring method and then assisting financial institution with developing profitability models, including cash-flow and risk analysis, for the full value chain opportunity. Using the anchor organization as an entry point, financial institutions allocate loans directly to individual anchor organization members but do so based on the viability of the full value chain investment. RFI developed a Value Chain Financing Guide and piloted agricultural value chain finance activities with partner financial institutions, which are now beginning to scale up the method, with the potential for injecting capital to revitalize agriculture in conflict-affected regions.

(4) Accessing Development Credit Authority (DCA) Loan Portfolio Guarantees Although the RFI approach does not require the availability of DCA loan portfolio guarantees, they have proven a helpful accelerator to the activity. In RFI's first year, all 12 partner financial institutions started the rapid expansion of client numbers and mobilized finance, but only three of those took advantage of DCA resources. By the RFI's third year, most participating financial institutions were using DCA loan guarantees, but only 55 percent of the 197 RFI municipalities were drawing on those DCA resources. The lesson is that DCA Loan Portfolio Guarantees can add to the attractiveness of rural lending by financial institutions but that without a complementary suite of rural products and services, DCA's overall contribution will be limited. To help financial institutions maintain a healthy portfolio, RFI helps financial institutions use DCA guarantees for those deserving loans that require extra risk mitigation, balancing them with loans that do not need the guarantee.

(5) Building the entrepreneurial capacity of clients. Financial institutions working with sophisticated urban enterprises expect potential borrowers to provide the essential information needed to assess risk and profitability, but the smaller rural enterprises RFI targeted rarely have that same level of documentation. In response, the RFI team has helped build the entrepreneurial capacity of borrowers by working with financial institutions to develop models for assessing that capacity, ensuring that financial institutions allocate sufficient resources for ongoing training, designing profitability and cash flow models based on the needs of rural clients, and assisting in the development of online or tablet-based training programs. In addition to introducing these tools, the RFI team has worked with financial institutions to embed the costs of this capacity development into the cost of loans to ensure sustainability.

TOWARD SCALE AND SUSTAINED SYSTEMIC CHANGE

More than four years into RFI, the 14 participating Colombian financial institutions continue to add new channels for reaching new clients while diversifying service offerings. As financial institutions develop more ambitious investments to attract rural clients, their image among rural communities evolves from self-interested capitalists to trusted partners in local development. The potential for continued expansion of rural financial services to scale and the potential for sustained contribution to the rural economy will be determined by success in a number of critical areas. Digital banking must continue its growth while shifting its current focus on client services to integrated payment platforms. Financial institutions' lending portfolios will also need to evolve. Currently, working capital loans predominate in lending portfolios, often used to address cash flow constraints by financing input purchase or labor costs prior to harvest. These portfolios will need to evolve to include more investment capital loans, which can spur leaps in productivity through the purchase of productivity-enhancing technologies including farming and processing machinery or information technologies.

Although RFI has focused on a handful of financial institutions, largely national and regional enterprises, the next phase of service improvements must be taken up by the 4,000 or so community-based financial institutions that benefit from well-established relations with their clients but whose gaps in human capital and technology prevent them from improving their service delivery. Additionally, the early promise that agricultural value chain financing has shown must be accelerated.

In drawing on its five working principles to deliver five innovations, the RFI team has shown the innovations' viability, proving in the process that Colombia's rural population should be seen not as a development burden but as a vast, attractive market for private financial institutions of all types — a market that simultaneously serves private sector investors, the Colombian government, and its international partners, including the U.S. government.