Economic and Financial Review

Volume 49 | Number 4 Article 22

12-1-2011

Policy choices and challenges in expanding access to finance for growth in rural Nigeria.

A. E. Akinlo

Policy Choices and Challenges in Expanding Access to Finance for Growth in Rural Nigeria

Prof. Anthony E. Akinlo[*]

I. Introduction

Access to finance, in general, is fundamental to growth and development. A well-functioning financial market assists in channeling funds to their most productive uses, and allocates risks to those who can best bear it. An efficient financial sector that responds to the needs of the private sector increases investment, enhances economic growth, creates job opportunities and improves income distribution. Access to financial services in the rural area, in particular, allows poor people to manage their household cash flows, start new agricultural activities and set up small businesses. When poor households have access to higher earnings and well-secured facilities to save their money, they can pay for health care and education, and plan and invest in the future of their farms or businesses.

Based on the available evidence, the Nigerian financial system has witnessed significant developments in terms of growth and depth over the years. The development could be attributed in part to the vast network of financial institutions, including rural finance. In the area of rural finance, for instance, the Government and the Central Bank of Nigeria had to intervene, especially with the stipulation of credit guidelines to favour agriculture and agro-allied activities, which constitutes 70.0 per cent of the activities in the rural areas. Several programmes and schemes were also implemented to enhance increased credit to the rural areas. These include sectoral allocation of credit and concessionary interest to rural and micro entrepreneurs. As an illustration, in 1969, commercial banks in Nigeria were compelled to lend at least a minimum percentage of their loanable funds to the agricultural sector, which increased from 4.0 per cent in 1972 to 18.0 per cent in 1996. Also in 1977, the CBN introduced the rural banking policy that required commercial banks, not only to open stipulated numbers of rural branches, but also, to advance not less than 50 per cent of the total deposit mobilised in the rural areas to rural borrowers. The number of rural branches thus, increased from 13 at the inception of the rural banking scheme in 1977 to 722 in

[*] Anthony Akinlo is a Professor of Economics at the Obafemi Awolowo University, Ile-Ife. Author's e-mail: aakinlo@oauife.edu.ng

2005. Finally, programmes such as the Agricultural Development Programme (ADP), the National Directorate of Employment (NDE), the Directorate of Food, Road and Rural Infrastructure (DFFRI), Better Life for Rural Women, and National Microfinance Policy and Regulatory Framework (NMPRF), were all geared towards access to finance for growth in the rural areas.

Improvements in rural finance, notwithstanding, the supply of formal finance appears to be biased against the rural population. Rural communities remain centre of deprivations inspite of the various efforts aimed at increasing financial services to them by the Government and the CBN. This, therefore, raises the following questions: what are the constraints and challenges of providing financial services in the rural areas? What are the policy initiatives that can be introduced to improve rural financial services in Nigeria? Hence, the main objective of the paper is to examine the challenges and ways to improve rural financial services in Nigeria.

The rest of the paper proceeds as follows. Section 2 discusses some conceptual issues in rural financial policy. Section 3 examines various challenges facing expansion of financial services to the rural areas while Section 4 identifies policy programmes and challenges in expanding access to finance for growth in rural areas. The last Section provides the conclusions.

II. Conceptual Issues in the Provision of Rural Finance Services

II.1 The Concept of Rural Finance

Rural finance refers to the broad range of financial services, such as savings, credit, payment transfers, leasing, insurance, etc, rendered by formal and informal financial service providers operating in rural markets. According to the Consultative Group to Assist the Poor (CGAP), rural finance is the financial services offered and used in rural areas by people of all income levels. It addresses the financial needs of the rural population. It assists in facilitating economic opportunities and plays a critical role in household strategies to reduce vulnerability. Where economic opportunities already exist, access to credit can assist in enhancing greater adoption of improved technology, thereby, increasing the level of productivity and incomes (Wangwe and Lwakatare, 2004).

Basically, the objectives of rural financial systems include, amongst others, promotion of measures to facilitate the access of all categories of rural entrepreneurs (individuals farmers, rural industrialists, cooperatives, e.t.c.) to credit on reasonable terms, and the provision of secured facilities to save money and serve as insurance against risk. Others are promoting the establishment of, and support for the provision of banking and credit institutions, which are particularly responsive to the needs of rural producers.

II.2 Rural Financial System and Economic Development.

Financial sector development is germane to economic growth and, thus, poverty reduction (DFID 2004a and 2004b). Several studies have established the fact that a well-functioning financial system is critical to long term growth. Studies by Demirguc-Kunt and Levine (2004), Levine (1997), King and Levine (1993), Abu-Bader and Abu-Qarn (2005) and Habibullah and End (2006) had confirmed strong and positive link between financial development and economic growth. World Bank (2004) showed that national savings, i.e. aggregate income less total expenditure, and economic growth are positively related. Likewise, Fry (1995) confirmed positive correlation between the level of financial savings and economic growth. Savings are very critical in the domestic economy as they allow households to maintain precautionary balances against shocks. As noted by Marr and Onumah (2004), rural financial system enabled households build up cash collateral and the track record of saving that would allow them had easier access to credit. Most rural communities lacked secure and accessible deposit facilities and, consequently, savings were held as cash or assets. Such savings were harder to mobilize and did not increase availability of loanable funds (DFID, 2004c). Arising from this, rural entrepreneurs find it extremely difficult to access fund, and thus, have to rely majorly on self-financing.

With over 60 per cent of Nigeria's population engaged in agricultural production and living in poverty, the need for credit to support development of agriculture-based livelihoods has been emphasized. However, the rural economy is financially fragile. Lack of credit constitutes a binding constraint, limiting investment in productivity-enhancing technology and inputs. Asides, finance is needed for commodity marketing, sometimes through inventory-backed financing, which offers rural producers, traders and processors the opportunity to improve household income through adopting better produce marketing and raw material procurement strategies (Coutler and Onumah, 2002). Access to payment systems offered by the financial institutions affords the rural producers and traders opportunity of participating in modern, efficient commodity trading systems that offer better prices.

III. Challenges of Access to Financial Services in Rural Areas.

Several studies have identified major constraints to rural financial market development. These include Besley (1994), Hoff and Stiglitz (1990), and Demirguc-Kunt and Levine (2004). Some of these constraints are discussed below:

Higher risks: Credit risk is higher in rural areas both for borrowers and rural financial institutions. High and often covariant, risks in the rural economy are related to the dominance of agriculture, which accounts for a high percentage of the Gross Domestic Product (GDP), and employment (HDR, 2000). The revenues of rural households, whose incomes mostly depend on seasonal agricultural and livestocks production, are volatile due to several factors that affect production such as fluctuating weather conditions and pests or diseases. Besides, crop marketing systems in the rural areas are inefficient and small-scale farmers are exposed to greater uncertainty regarding the marketing of their output as a result of the liberalization of agricultural markets since the 1990s. As a result of lack of storage facilities, rural farmers often sell the bulk of their output at harvest when prices are low, leading to low and variable income. Similarly, the traders that form the link between producers and the wholesalers markets tend to be under-capitalized. Faced with limited access to trade finance from formal financial institutions, they often have to offer trade credit to wholesalers and processors. This usually creates a liquidity problem and limits their ability to absorb (and store) the substantial surplus available during the harvest season. The attendant glut often leads low farm gate prices with no market instruments to manage price risk.

Lack of credit information: Problems precipitated by uncertainty are exacerbated by lack of reliable information on the past credit history of borrowers. Indeed, credit information on rural borrowers is difficult to obtain as majority of them rely on moneylenders and other informal lenders. Asides, many rural customers do not keep record of their transactions. The unavailability of credit information to a very large extent constrains the flow of credit to the rural dwellers because performance risk measures are unavailable; and the current risk-management practice of banks is to control loan amounts.

Lack of collateral: Rural financial institutions can reduce the risk of loss due to uncertainty by demanding collaterals from borrowers. Collateral ensures that the lender can recover part, if not all, of his loan in case of default. In addition, it helped not only to reduce information asymmetries, but assist in screening out high-risk borrowers. However, many rural households either entirely lack collateral or do not have a legal title to their house or land. Financial institutions, thus, have no means of securing their credits against defaults. Defaulting clients run high risks as well. This is because financial institutions will typically impose punitive interest rates for delayed payments and might even confiscate assets of defaulting clients.

High transaction costs: The transaction costs of rural lending in Nigeria are high, mainly due to small loan sizes, high frequency of transactions, large geographical spread, the heterogeneity of borrowers, and poor infrastructure. Arising from the high level of poverty in the rural areas, the quantum of financial services needed tends to be small. The small sizes of rural loans, resulting in a high due-diligence cost per loan, exacerbated by the heterogeneity of borrowers, make it extremely difficult for formal financial institutions to cover costs. The clients also face other problems. For instance, as a result of poor infrastructure such as transportation, communication and information technology, clients have to travel long distances to deposit savings or repay a loan. As they usually travel on foot, this could cost them an entire working day. Rural financial institutions also face additional costs for ensuring security and managing liquidity. High unit costs are usually passed on to the rural clients thereby making them pay higher interest rates.

High rates of illiteracy: The rate of illiteracy is higher in the rural areas compared with the urban centres. Poorly educated people face an additional challenge in accessing financial services. It is difficult for them to analyse credit risks and the profitability of loan or savings scheme, to provide necessary documents for loan procurement and to understand conditions and contracts. Some institutions fail to communicate interest rates and commissions in a transparent manner, indeed some institutions have important information about the credit constraints, which can contain additional costs for borrowers in small prints, which are often ignored. In view of the various problems in the rural areas, financial institutions are faced with the difficulty of finding, hiring and keeping well-trained staff that will reside in them.

Weak legal framework and enforcement issues: Government has not been able to develop and enforce a legal and regulatory framework conducive to rural finance, so that contract design, contract renegotiation and contract enforcement remain weak, making it rather more difficult for financial institutions to provide clients with the right incentives for repayment. Land titling and registration systems are weak, and the use and transfer of land is difficult under the current framework.

Government policy: Before the mid-80s, several government policies, including interest rates, high fiscal deficits and sectoral lending controls contributed to the underdevelopment of financial markets and the supply of rural finance (Fry, 1995). Fiscal deficits led to government's appropriation of a large share of financial savings for itself, pre-empting credit to the private sector. Likewise, government's deficit financing policies provided bankers with opportunities to deploy bank resources in government securities, which are not only safe but also yielded high profits for banks in a falling interest rate environment. Furthermore, monetary policy interventions to contain inflationary pressure – usually through the sale of government debt instruments like treasury bills - tend to reduce the volume of credit available to the private sector as well as raise the cost of borrowing. Macroeconomic instability, often in the form of high inflation, is equally known to adversely affect financial development as it discourages saving in financial form (Khan, 2002).

IV. Meeting the Challenge of Increasing Access to Rural Finance.

Increasing access to finance for Nigerian's rural dwellers to meet their diverse financial needs presents a formidable challenge in a country as vast and varied as Nigeria. The first challenge relates to making the financial institutions introduce products and services that are flexible, reliable, convenient and available on a regular basis. Besides, there is the challenge of introducing measures that allow for low-cost ways of reaching the rural poor. Finally, there is the big challenge of introducing reforms in government policy to enhance the overall incentive framework, and of the regulatory as well as legal system within which rural banks operate, with a view to promoting greater efficiency and competition in rural finance.

Generally, rural finance can be promoted by supporting informal schemes such as community-based savings groups, as well as by fostering formal institutions through technical assistance (supply-side measures) and assisting poor households and small enterprises in accessing financial services (demand-side measures). Besides, donors can provide support to the development of favourable policy and regulatory frameworks. Some specific programmes to enhance increased access of rural dwellers to finance under the broad groups mentioned above are highlighted below:

Introduction of flexible and easily accessible products: There is the need for banks to introduce flexible and easily accessible products. Rural households and small entrepreneurs have specific needs which vary from those of urban clients as most of them depend on agricultural cycles. It has been shown that rural clients prefer to borrow frequently, and repay in small instalments. By implication, the savings and repayment mechanism that are being promoted by urban microfinance institutions are not likely to work effectively for the rural clients. This simply means that the formal financial institutions need to explore the possibility of offering new and more flexible loan products. In particular, financial institutions need to understand the cash flow of rural households and offer adapted loan repayment and savings collection schemes.

Besides, the banks' branches in the rural areas will need to explore opportunities of offering composite financial services as they do in the urban areas. It needs be pointed out that the rural clients, not only seek savings and lending activities but also, seek insurance such as health, life and crop. Moreover, in view of the increasing volume of international remittances flowing into the country in recent years, rural financial institutions need evolve remittance services to take care of their clients. Efforts at reducing the transaction costs and increasing the availability of remittance services through expanded bank branch coverage will not only assist in generating new businesses but also help in weaning away customers from using informal channels for remittances.

Moreover, financial institutions have to be innovative to reduce costs. Innovative distribution channels such as mobile branch offices or bank-counter located in rural post offices and shops can assist in reducing the fixed costs of operation. Aside from this, the use of information technology such as handheld computers or mobile phones is a major way of reducing transaction costs. Also, as part of innovation, there is need to simplify the procedures to open bank account and other banking procedures. These will not only help in reducing transaction costs, but also serve as incentive for rural households to bank with the formal financial institutions.

Provision of favourable enabling environment: An enabling and conducive environment is a prerequisite for an efficient financial system and effective rural development and poverty reduction. At the macro level, a number of factors are very important for preventing systemic risk. This entails implementation of measures (monetary, fiscal, financial etc) to achieve basic macroeconomic goals such as high growth rate, low inflation and low unemployment rate. Macroeconomic policy measures that promote growth and poverty reduction will ensure increased financial flow to the rural areas. Expansion of income that leads to increased domestic consumption and investment will expand the range of production activities for the rural dwellers, thereby providing the small entrepreneurs the opportunity to enter the market. Moreover, monetary policy interventions to contain inflationary pressures will lead to stability and growth, which will impact positively on the cost of fund, thereby lowering the cost of borrowing for rural clients.

Building on the existing infrastructure: One major component of high transaction cost is transportation expenses. This tends to be high due to the fact that many borrowers are located at long distances from the loan offices. When the opportunity cost of labour, in terms of the work time lost, is taken into consideration in the computation of the borrowers' transaction costs, the loans will be very expensive to the borrowers. This equally poses a big challenge to the financial institutions as they find themselves spending considerable time visiting areas that are sometimes remotely located. This explains why provision of roads is very critical to increased rural access to finance. Provision of roads will lead to reduction in transaction costs of inputs and outputs, thereby leading to an increase in agricultural output, crop area and yield. Moreover, agricultural output itself is limited by inadequate off-farm, "upstream" and "downstream" facilities. Better infrastructure can stimulate rural income by lowering the costs of trade with the country's urban areas and foreign markets. Infrastructural development will help to integrate the remote rural areas into the broader market, thereby contributing to the marketization and profitability of agriculture. It will assist in promoting information flows between communities in rural and urban areas, thus, linking farmers to market for goods, input supplies, and agricultural extension services.

Additionally, financial institutions should adopt the policy of risks minimization. It is true that financial institutions in the rural areas lack collateral or the possibility to legally enforce contracts. However, they can use social links (for example through group savings and lending) to reduce their risks. The so-called linkage model combines informal systems, such as self-help groups, with formal banks. Groups are linked to the bank through a group contract, so the bank does not have to deal with each client separately (Inforesources, 2008). Adopting this approach will help the financial institutions to reduce their risks and transfer transaction costs to the self-help group. Also, there is the suggestion that collateral can be created in the rural areas through warehouse receipt systems (Coutler and Onumah, 2002), with a view to taking care of the problem of lack of collateral in the rural areas. Warehouse receipts is defined as documents issued by warehouse operators as evidence that specified commodities (of stated quantity and quality) have been deposited at particular locations by named depositors (Coutler and Onumah, 2002). The depositor may be a producer, farmer group, trader, exporter, processor or indeed any individual or corporate body. The commodity remains the property of the depositor until sold at market, while the warehouse operator can extend credit in the form of cash to people who deposit commodities in his warehouse. Several benefits of the system have been noted in the literature. These include: provision of opportunity for lenders to mitigate credit risk by using the stored commodity as collateral; reduction in transaction costs, thereby encouraging commercial lending to the rural sector; and provision of opportunity for farmers to market their crops and get a better price as they could defer sale of produce until prices rise after the traditional harvest season (Coutler and Onumah, 2002). All the same, the system has its own disadvantages. One, it tends to exclude smallholders and small-scale traders. Two, lack of regulatory oversight of the collateral managers could lead to fraud, which might discourage inventory-backed financing by banks.

Finally, there is a need to scale up microfinance in the provision of rural finance. As various efforts are made towards improving formal financial sector's ability to serve the poor, microfinance can play an important role in filling the gap. Indeed, they offer the potential for sustainability and growth. Moreover, arising from their demonstrated success in providing benefits to the poor, international donors and governments are more disposed to supporting microfinance institutions. This explains why the activities and operations of these institutions need to be scaled up. Scaling up access to finance for Nigeria's rural poor through microfinance will require attention in the following areas: an enabling policy, legal and regulatory environment for microfinance, attention to group quality, and the importance of financial sustainability, appropriate products and services, and good staffing and geographical distribution of the microfinance institutions.

Scaling up microfinance will also require partnership between civil society, government and its institutions as well as donors to provide seed resources for expansion of these services. It also entails commitment of grant resources to help offset the overhead cost associated with operating these facilities. This is because experiences have shown that even in the case of Grameen Bank, the pioneer in this endeavour, the bank remains constrained by high expenses per unit transacted, and relies on donors and socially- conscious investors (Murdock, 1999).

Studies have also emphasize the need for governments, in collaboration with NGOs and private sector that are involved in agro-allied businesses, with the support of international donor agencies, to facilitate the establishment of Farmer Support Services (FSS) in the rural areas to assist farmers in accessing credit. Such service could be made available through microfinance facility, technical assistance, trainings and marketing information.

V. Conclusion

Rural finance is now recognised as an important tool in the fight to reduce poverty, increase growth and enhance donors' development effectiveness agenda. It encompasses all savings, lending, financing and risk-minimising opportunities (formal and informal) and related norms and institutions in rural areas. In addition to fostering rural development, rural finance is increasingly used as an incentive to promote sustainable use of natural resources, use of alternative energies, and environmentally-sound behaviour. However, despite the importance of rural finance for growth and the significant demand for financial services, financial service providers, such as banks, credit unions, microfinance institutions or insurance companies, are typically reluctant to serve rural areas. Consequently, majority of the country's rural population does not have access to the formal financial system.

The reluctance of financial institutions to serve rural areas is not unconnected with the various challenges involved in such endeavour. These challenges include the weak infrastructure and low population density that characterized the rural sub-sector. The capacity of financial service providers and the level of client education in rural communities are quite limited. Moreover, financial institutions are tardy in granting loans to the agricultural sector given its seasonality and the inherent risks of farming. These challenges explain the high transaction costs and the risks inherent in serving the rural areas by the financial institutions.

It, therefore, becomes imperative to address these challenges so as to enhance rural dwellers' access to finance. A new approach to rural finance must focus on building the sustainability of the financial service providers, thinking beyond the short life cycle of donor-driven projects. The financial institutions must develop appropriate market-based innovative products and strategies that will enhance the level and quality of financial services rendered to the rural sector of the country. This would require that the government addresses the issue of environment, especially, the provision of necessary infrastructure, developing appropriate policies and programmes that benefit the majority and allowing privately-managed institutions to evolve.

References

Abu-Bader, S. and A. M. Abu-Qarn, (2005). Financial development and economic growth: time series evidence from Egypt. *Discussion Paper* No. 05-14a, Monaster *Centre for Economic Research,* Ben-Gurion University of Negev, Israel.

Besley, T. (1994). How do market failures justify interventions in rural financial markets? *World Bank Research Observer* 9: 27-47.

Coutler, J. and G. E. Onumah, (2002). The role of warehouse receipt systems in enhanced commodity marketing and rural livelihoods in Africa. *Food Policy* 27: 319-337.

Demirguc-Kunt, A. and R. Levine, (2004). *Financial structure and economic growth: a cross-country comparison of banks, markets and development*. MIT Press: Cambridge MA, USA.

DFID. (2004a). Financial sector development: a prerequisite for growth and poverty reduction? *Policy Division Briefing Note*. Department for International Development: London, UK.

DFID. (2004b). The importance of the financial sector development for growth and poverty reduction. *Policy Division Working Paper.* Department for International Developemnt: London, UK.

DFID. (2004c). making rural finance count for the poor. *Policy Division Working Paper.* Department for International Development: London, UK.

Fry, M. J. (1995). *Money, interest and banking in economic development*. John Hopkins Press: Baltimore, USA and London, UK.

Habibullah, M. S. and Y. End, (2006). Does financial development cause economic growth? A panel data analysis for the Asian developing countries. *Journal of the Asian Pacific Economy* 11, 377-393.

Hoff, K. and J. Stiglitz, (1990). Imperfect information and rural credit markets: puzzles and policy perspectives. World Bank Economic Review 4(3):235-250. IFAD, 2009. Rural Finance. Policy. Rome

IFAD (2004). Decision tools for rural finance. Available at http://www.ifad.org/ruralfinance/dt/full/1.htm#4.

Inforesources (2008). Focus No 2/08. http://www.inforesources.ch

Khan, M. S. (2002). Inflation, financial deepening and economic growth. Paper prepared for *Banco de Mexico Conference on Macroeconomic Stability, Financial Markets and Economic Development*. November 12-13, Mexico City, Mexico.

King, R. G and R. Levine, (1993). Finance and growth: Schumpeter might be right. *The Quarterly Journal of Monetary Economics* 32: 513-542.

Levine, R. (1997). Financial development and economic growth: views and agenda. *Journal of Economic Literature* 35: 688-726.

Marr, A. and G. E. Onumah, (2004). Documenting and assessing the impact of the family savings product. *Report for CARE*: Bangladesh.

Murdock, J. (1999). The role of subsidies in microfinance: evidence from the Grameen Bank. *Journal of Development Economics* April.

Onumah, G. E. (2003). Improving access to rural finance through regulated warehouse receipt systems in Africa. Paper presented at *Broadening access and strengthening input market systems–Collaborative Research Support programme* (BASIS-CRSP) Conference on Paving the way forward for rural finance, 2-4 June 2003, Washington DC, USA.

Wangwe, S. and M. Lwakatare, (2004). Innovation in rural finance in Tanzania. Paper prepared for the *Third Annual conference on Microfinance* held from 15-17 March, AICC, Arusha.

World Bank (2006). *Improving access to finance for India's rural poor*. Washington DC: World Bank.

World Bank (2004). *Investments in rural finance for agriculture*. Agriculture Investment Sourcebook, Chapter 7 by Pearce, D., A. Goodland and A. Mulder. World Bank: Washington DC, USA.

World Bank (2008). Finance for all? Policies and pitfalls I expanding access. *A World bank Policy Research Report*. Washington DC: World Bank.