Public Disclosure Authorized

Public Disclosure Authorized

Document of
The World Bank

Report No. 44741-NG

RURAL FINANCE IN NIGERIA
Integrating New Approaches

April 4, 2008

Agriculture and Rural Development Unit
Sustainable Development Network
Western Africa Country Department 2
Africa Regional Office

ABBREVIATIONS AND ACRONYMS

Acronym	Meaning
ACGSF	Agricultural Credit Guarantee Scheme Fund
ACSS	Agricultural Credit Support Scheme
ADB	Asian Development Bank
AFRACA	African Rural and Agricultural Credit Association
AgDBs	Agriculture Development Banks
BAAC	Bank for Agriculture and Agricultural Cooperatives
BRI	Bank Rakyat Indonesia
CBN	Central Bank of Nigeria
CDA	Community Development Associations
DAI	Development Alternatives, Inc.
DEC	Development Exchange Centre
DfID	Department for International Development
DFIs	Development Finance Institutions
ECOWAS	Economic Community of West Africa
EoPSD	Employment-oriented Private Sector Development Program
ESW	Economic and Sector Work
FAO	Food and Agriculture Organization
FEAP	Family Economic Advancement Program
FGN	Federal Government of Nigeria
FMARD	Federal Ministry of Agricultural and Rural Development
FMoF	Federal Ministry of Finance
GDP	Gross Domestic Product
GTZ	German Cooperation Agency
IFAD	International Fund for Agricultural Development
ILO	International Labor Organization
LAPO	Life Above Poverty Organization
LGH	Local Government Headquarters
MAB	Microfinance Advisory Board
MARKETS	Maximizing Agricultural Revenues and Key Enterprises in Targeted Sites
MDF	Microfinance Development Fund
MFB	Microfinance Bank
MFI	Microfinance Institution
MIS	Management Information System
MIX	Microfinance Information eXchange
MOU	Memorandum of Understanding
MSME	Micro, Small and Medium Enterprise
NACB	Nigeria Agricultural Credit Bank
NACRDB	Nigeria Agricultural and Cooperative Rural Development Bank
NAIC	Nigeria Agricultural Insurance Corporation
NAPEP	National Poverty Eradication Programme
NGO	Non-governmental Organization
NGO	Non-Governmental Organization
NDIC	National Deposit Insurance Corporation
OFID	Other Financial Institutions Department
PBN	People's Bank of Nigeria
RBP	Rural Banking Program
RBP	Rural Banking Program
RCB	Rural Community Bank
RFI	Rural Financial Institution
RoSCAs	Rotating Savings and Credit Associations
RUFIN	Rural Finance Institutions Building Programme
SHG	Self-Help Groups
SMEEIS	Small and Medium Equity Investment Scheme
SSA	Sub-Saharan Africa
TFM	Trust Fund Model
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WDI	World Development Indicators

Vice President:	Obiageli Katryn Ezekwesili
Country Director:	Onno Ruhl
Sector Manager:	Karen Brooks
Task Team Leader:	Loraine Ronchi

This volume is a product of the staff of the International Bank for Reconstruction and Development/ The World Bank. The findings, interpretations, and conclusions expressed in this paper do not necessarily reflect the views of the Executive Directors of The World Bank or the governments they represent. The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

The material in this publication is copyrighted. Copying and/or transmitting portions or all of this work without permission may be a violation of applicable law. The International Bank for Reconstruction and Development/ The World Bank encourages dissemination of its work and will normally grant permission to reproduce portions of the work promptly.

For permission to photocopy or reprint any part of this work, please send a request with complete information to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, USA, telephone 978-750-8400, fax 978-750-4470, http://www.copyright.com/.

All other queries on rights and licenses, including subsidiary rights, should be addressed to the Office of the Publisher, The World Bank, 1818 H Street NW, Washington, DC 20433, USA, fax 202-522-2422, e-mail pubrights@worldbank.org.

RURAL FINANCE IN NIGERIA
Integrating New Approaches

TABLE OF CONTENTS

Page No.

ACKNOWLEDGEMENTS .... **VII**

EXECUTIVE SUMMARY .... **VIII**

1. INTRODUCTION **1**

FINANCIAL SECTOR OVERVIEW IN NIGERIA 1
OBJECTIVES OF THE STUDY 6
PARADIGM SHIFTS IN RURAL FINANCE: A FINANCIAL SYSTEMS APPROACH 6
OUTLINE OF THE STUDY 8

2. PAST LESSONS FROM RURAL FINANCE IN NIGERIA **9**

WHAT HAS WORKED 9
WHAT HAS NOT WORKED 13

3. RURAL FINANCE IN NIGERIA: NEW DATA **18**

THE STUDY APPROACH: SAMPLE AND CASE STUDY SELECTION 18
NIGERIAN RFIS: WHO THEY ARE AND WHAT THEY COST 19

4. NEW APPROACHES TO RURAL FINANCE IN NIGERIA **30**

REDUCING COSTS THROUGH BETTER OUTREACH 30
ORGANIZATIONAL REFORM OF THE AGRICULTURAL BANK MODEL 33
PART OF THE PACKAGE: FINANCING AGRICULTURAL ACTIVITIES 35

5. CONCLUSION AND RECOMMENDATIONS **46**

RURAL FINANCE IN NIGERIA: INTEGRATING NEW APPROACHES 46
CONCLUSION 54

REFERENCES **55**

List of Annexes

ANNEX 1: REQUIRED INFORMATION LIST FOR THE DEVELOPMENT OF SUSTAINABLE RURAL FINANCE 59

ANNEX 2: RURAL FINANCE INTERVENTIONS IN NIGERIA 60

ANNEX 3: RFI INDICATORS DEFINED 62

ANNEX 4: ESW STUDY SITE MAP 64

List of Figures

Figure 1. Demand for Financial Services in Developing Countries 3
Figure 2. Borrowers and Savers 22
Figure 3. Average Loan and Deposit Size for the Sample 23
Figure 4. Operating Expense Ratio 25
Figure 5. Cost per Borrower and Saver 26
Figure 6. Breakdown of Costs Underpinning Current Cost-recovering Interest Rates 28
Figure 7. Map of Cassava Supply Chain 40
Figure 8. Map of Rice Supply Chain 43

List of Tables

Table 1. Financial Sector Depth 1
Table 2. Key Rural Finance Institutions in Nigeria 2
Table 3. Benchmarking Data 19
Table 4. Key Indicators for Sample RFIs 21
Table 5. Estimated Cost-Recovering Rates for Sampled Institutions 28
Table 6. Net Profit Rates on Selected Smallholder Crop Production in Nigeria (2006) 35
Table 7. Rates of Return on Selected Agricultural Investments in Nigeria 36
Table 8. New Approaches for Nigeria's Rural Finance Strategy 52

List of Boxes

Box 1. Increasing Outreach, Reducing Costs and Achieving Profitability through Apex Organization and Computerization: The case of Ghana 30
Box 2. Credit Bureaus and Cost Reduction: The case of Crediref in Guatemala 31
Box 3. Reducing Costs Through Innovative Technologies: The case of Mobile Phone Banking32
Box 4. Reforming Agricultural Development Banks: The cases of Tanzania and Mongolia...... 34
Box 5. Access for the Rural Vulnerable Poor: The case of SHGs in India 37
Box 6. Success Stories in Term Finance: The case of Leasing in Madagascar 38
Box 7. Successful Supply Chain Finance in Zimbabwe: The case of Cottco 44

Acknowledgements

This report was prepared by a World Bank Task Team comprising members from the agricultural, rural, and financial sectors, including Loraine Ronchi (Task Team Leader), Renate Kloeppinger-Todd, Thomas Muller, Henry Bagazonzya, Lucas Akapa , Abimbola Adubi, Modupe Dayo Olorunfemi, Azra Lodi, and Hawanty Page. Valuable contributions were also made by the following World Bank colleagues: Nwanze Okidegbe and Carlos Cuevas in their capacity as peer reviewers as well as Michael Fuchs, Peter Mousley, Shireen El-Wahab, Sidi Jammeh, Foluso Okunmadewa and Stephen Mink. Karen McConnell Brooks, Francois le Gall, Hafez Ghanem, Galina Sotirova and, particularly, Simeon Ehui, provided strong support for the study. The Team is grateful for the early and sustained input of J.D. von Pischke (Frontier Finance) as external peer reviewer.

The Team was fortunate to have the active participation of colleagues in the Government of Nigeria and its partners. Early guidance was provided by Dr. Ingawa, Director of the Projects Coordination Unit, NFRA; Mrs.Aremu and Mr. Utsu of the Federal Ministry of Finance; Mr. Ekere and Dr. Oredipe of NFDO; and Mr. Abdulmajeed of NACRDB. The final draft of the study benefited greatly from the guidance and direction of the Steering Committee composed of representatives from FMARD, FMoF, and the Nigerian Office of Statistics as well as the university and donor communities. This report was also informed by the *Rural Finance in Nigeria Interim Stakeholder Workshop* held in Abuja in October 2007. The Team gratefully acknowledges the input and participation of workshop attendees. Valuable support and input into the interim stakeholder workshop were also provided by Bonnie Brusky and Debola Babalola (Consultants).

Our donor partners in Nigeria were very helpful in the study's development. Early guidance from DFID, IFAD, and GTZ are particularly acknowledged. Inputs from Michael Marx of FAO, Hamed Haidara and the IFAD Team were invaluable to the background portions of this study. Field work for the study was greatly assisted by Mr. David Zakka, Ms. Karen Losse, Mr. Imke Bolten, Mr. Ole Buch-Hansen of GTZ; Dr. Mohammed Arabi of NFRA (FMARD); and Mr Idachaba Aruwa of National Board for Community Bank, Kaduna. Profound thanks are due to all the interviewees who generously shared their time and thoughts for this study.

Funding was also provided by the Rural Finance Trust Fund of the Agriculture and Rural Development Department (ARD) of the World Bank. It is gratefully acknowledged.

Executive Summary

1. The rural space is home to 53 percent of Nigeria's population and more than 70 percent of its poor. While it is well understood in Nigeria that financial exclusion of the rural population stunts development, still **fewer than 2 percent of rural households** have access to any sort of institutional finance.[1] Access to financial services is a key ingredient to rural development: It increases incomes through productive investment; helps create employment opportunities; facilitates investments in health and education; and reduces the vulnerability of the poor by helping them to smooth their income patterns over time. A lack of rural access to financial services not only retards rural economic growth, but also increases poverty and inequality. While Nigeria's own long history with rural finance shows a clear appreciation for the importance of rural access, the persistent absence of sustainable access yields important lessons for the future.

LESSONS FROM THE PAST

2. An analytical review of Nigeria's history with rural finance provides lessons about elements of past interventions that have worked and those that have not worked. Taken all together, the sum total of rural finance interventions over the years has left a legacy—a backdrop—onto which the future for rural finance is to be painted. On the positive side, although it came at great cost and would not be efficient to reproduce, Nigeria's rural finance policies and practices have left behind a respectable (but diminishing) **rural branch network**. Nigeria also has a history of **public private partnerships** with commercial banks and other private sector actors, and positive experience with **community based approaches,** that have helped to lower risk and transaction costs. Successful interventions have typically been correlated with strong **M&E**. In terms of the more negative legacies, perhaps the most important ones are the **culture of non-repayment** among some borrowers that has been fostered by poor repayment methodologies and **subsidized interest rates,** charged as part of government agricultural finance initiatives**.** The **inconsistency of government policies** in rural finance has also hindered sustainable development in the sub-sector. The continuing **financial illiteracy** of many rural actors exacerbates the problem. While data shows that there are a number of very profitable rural sector investments in Nigeria, the opposite impression has been given by **targeted 'credit only' initiatives** that paid insufficient attention to the loan applications and the activities and applicants behind the loans. The focus on credit has omitted a large – and equally important –**unmet demand for savings** and other financial services like payments (remittance) services, which typically form the basis for profitable provision of rural finance. In this sense, the large unmet demand for these services in Nigeria can be turned into a 'positive' move for the development of viable rural finance institutions. Finally, there is a legacy of **financial unsustainability and operational inefficiency** of most government (and many non-governmental) rural finance institutions and programs, particularly of the nation's financially unviable agricultural development

[1] CBN (2005)

bank, the Nigeria Agricultural and Cooperative Rural Development Bank (NACRDB). Successful future interventions in rural finance must take place in the context of ongoing **strengthening of private and public institutions.** Most notably, IFAD's RUFIN aims to undertake a proposed **reform of NACRDB**. Similar institutional capacity building efforts have been underway by the UNDP, GTZ and with urban-based 'greenfield' microfinance institutions (MFIs) by the World Bank.

3. Looking at the wide array of rural finance interventions in Nigeria's past, a key feature underpinning persistent limited rural access (2 percent) is the **lack of a financial system approach.** The financial systems approach views initiatives in rural finance as part of the larger financial system. Viewing it this way necessarily implies financial viability of the rural financial service providers. Market interest rates, enterprise-orientation, and emphasis on repayment is what set 'the microfinance revolution' apart from traditional agricultural credit, and have become part of the new approach to rural finance. Such an approach has led to successful rural finance elsewhere in the world, despite facing the same challenges of *high costs*, *poor information*, and high levels of real and perceived *risk.* In contrast, most of Nigeria's experience with rural finance falls considerably outside the tenets of a financial systems approach. The bulk of Nigerian rural finance is essentially characterized by a supply-driven agricultural approach whereby finance is a means to allocate resources in rural areas. This is not to say that the Government, and others, are wrong in targeting rural areas (after all, finance schemes not specifically directed towards rural areas appear to inevitably end up on the 'easier' urban terrain), but a more integrated approach is needed if rural finance is to be sustainable.

STUDY OBJECTIVES

4. There has clearly been no lack of interest and effort on the part of Government in rural finance, both historically and at the present time. Incipient institution building work with partners joins other efforts in Nigeria that include overall financial sector framework development and access for micro, small, and medium enterprises (MSMEs). Each of these angles forms part of a multi-pronged (and multi-leveled) approach to rural finance in Nigeria. Within the tapestry of this approach, however, a number of key gaps remain. This study targets very specific areas of what is unknown and joins this to an analytical review of Nigeria's past efforts. The **objective** is to carry out an analysis of alternative options for increasing access to financial services for rural economic actors in Nigeria. The study, therefore, aims to provide the information required to inform on alternative rural finance instruments and policies suitable for Nigeria based on: its **own history**, its **specific context** and on **good practice** elsewhere in the world. It does this through a case study approach which examines: (i) the real (unsubsidized) costs of rural service providers across a range of institutional structures (i.e., ranging from 'comparator' commercial bank branches to NGO-MFIs); and (ii) the potential role of supply chain finance in the provision of financial services.

RURAL FINANCE IN NIGERIA: KEY STUDY RESULTS

5. It was seen that Nigeria's rich history with rural finance has left a mixed legacy which forms the backdrop for future rural finance. Building on this backdrop, the study found new data on rural financial institutions' costs and supply chain dynamics.

Nigeria's Rural Finance Service Providers

6. A representative survey of rural finance institutions (RFIs) [2] from Nasarawa and Kaduna states highlight a number of key features of the Nigerian rural finance landscape:

7. First, it finds that the NACRDB branches and NGO-MFIs in the sample appear to be serving the lower income segments of the population; community banks (currently in the process of transformation to Microfinance Banks), though profitable, are serving a salaried middle income segment.

8. Second, it confirms that the demand for savings is high.

9. Third, unsurprisingly, urban/rural status makes a difference in terms of efficiency in the sample. The data shows that some Nigerian RFIs would have to charge interest rates as high as 66 percent to recover unacceptably high costs—even as they show great promise in terms of outreach and in terms of their methodologies for lending to the rural poor. The sources of these costs are a combination of an expensive working environment (as evidenced by the clear rural/urban divide in the sample data on costs), institutional inefficiencies (NGO-MFIs, NACRDB), poor loan recovery (NACRDB, community banks), and high perceived risks (preventing most commercial banks and RFIs from furthering linkages with rural clients).

10. Fourth, best practice microfinance and basic data from Nigeria suggests that interest rates would *currently need to be in the range of 20 percent-30 percent for RFIs to sustainably maintain operations in rural areas*. While this figure is dynamic—costs could increase or decrease due to a number of exogenous factors—the data collected for this study make two things clear: (i) even for a difficult lending environment, those RFIs with the best rural outreach in Nigeria are inefficient and unsustainable for reasons that would most likely improve with training and capacity building—namely, poor loan recovery for NACRDB and high operating costs for the NGO-MFIs; (ii) interest rate policies that cap lending at single digit rates do not permit cost-recovery (institutional sustainability) *even for efficient rural institutions*. So, for example, rural clients will always prefer to access cheaper credit from NACRDB, leaving other RFIs to compete with a less diversified clientele. Together with an eroded financial discipline, this makes it difficult for other RFIs to expand access to financial services as per the objective of targeted subsidized interest rate policies in the first place.

---

[2] RFIs include NGO-MFIs; NACRDB; community banks (to be transformed into the new 'microfinance banks'); financial cooperatives; with commercial banks—operating in more rural states—acting as benchmarks.

11. Finally, it is important to identify those inhabitants that cannot pay interest rates in the 20 percent-30 percent range, or indeed even at an 8 percent level. Rather than use a blanket approach of targeted credit for agriculture, targeting this subgroup *specifically* would better guarantee they do not lose out to elite capture, while refraining from distorting rural finance markets. Specifically, assistance should be aimed at helping them engage in activities with higher returns and making them more credit-worthy.

Supply Chain Finance

12. Demands for financing along any given supply chain can be divided between term (or investment) finance and short-term (or crop) finance. 'Supply chain finance' is best suited to short-term finance, and does not address term (investment) financing needs of agricultural and non-farm rural entrepreneurs. The results from field interviews in cassava and rice supply chains in the case study states confirm a more generalized experience with supply chain finance elsewhere in the world. But three specific issues seem to stand out as particularly relevant in the Nigerian context.

13. For cassava, the first issue is incentive. The lack of incentive for cassava actors to provide financing is binding in Nigeria. They will only consider providing finance to procure produce, not to make money on the credit operation. Understanding this incentive is critical to making supply chain finance work as a source of crop-related credit for farmers. Agricultural policy must be careful not to generate *systemic* overproduction. The *cyclical* component of the current glut in cassava may call for intervention and investment into storage facilities. This would serve the dual function of also permitting the development of warehouse financing, for which Nigeria already has the legislative basis.

14. The second issue in Nigerian supply chain finance is less binding in cassava, but exists for rice. Liquidity is clearly a constraint for selected operators along the rice chain. Private sector development initiatives, that improve the financial literacy and linkages of these actors with formal financial institutions, hold the best promise of improving supply chain finance for farmers.

15. The third issue is side-selling and side-buying. Even where liquidity is not binding, once distortions to incentives have been corrected, the biggest potential obstacle to sustainability of supply chain finance in Nigeria is the threat of side-selling by farmers and side-buying (i.e., free riding) by competitors. The solution may not only lie in better contract registration and enforcement, but also through better incentives. That is, it should be clear to farmers that default will clearly make them worse off in a multi-year scenario.

16. In general, all three constraints would benefit from a better flow of information along the supply chains. What can Nigeria do to act on these issues?

17. In general, the data from this study show that rethinking the interest rate policy, providing institutional support, and investing in cost-reducing technologies and innovations in agricultural finance should be the first priorities for government and its partners. The study also outlines good practice in rural finance from around the world. Yet which specific approach(es) suit(s) Nigeria depend critically on the lessons (and legacy) from its own past, and the characteristics of its rural service providers. The most appropriate new approaches to be integrated into the rural finance scene—specifically chosen for their relevance to Nigeria—can be grouped under four key recommendations:

Recommendation 1: Institution Building and Training

18. The data collected on the representative sample of RFIs for this study indicate that the RFIs with the best rural outreach do not have operating costs anywhere low enough to have cost-recovering interest rates in the Nigeria-specific 'best practice' range of 20-30 percent. Even though this range could fall further (say, with improvements in the Nigerian financial sector and/or rural infrastructure), the fact is that few *RFIs* could currently achieve it. Transaction costs, particularly for loan recovery, are very high. Furthermore, despite numerous well-intentioned government interventions aimed at encouraging *commercial bank participation* in the sector, their outreach in rural areas remains low, partly due to inappropriate products and partly due to perceptions of high risk. This is not helped by widespread financial illiteracy of supply chain entrepreneurs and other *rural clients.* What do these three groups have in common? All require capacity building and training: To sustainably improve outreach and lower the risk for RFIs, it is imperative that performance-based capacity building take place and for organizational innovations to be introduced. Examples of successful MFI development in Nigeria itself confirms the role of institution-building and training in meeting RFI potential to operate efficiently and innovatively. Commercial banks, in turn, need assistance in finding appropriate products that will permit them to improve their outreach to a rural clientele, and thereby diversify their risk. Training for rural people must run in parallel to this institutional capacity building if that reduction in risk is to be real. Table 8 at the end of the study presents a number of practical initiatives to make this recommendation a reality, but much depends on the planned institutional reform of the NACRDB. All development partners should work together with IFAD and the participating government bodies to ensure that NACRDB can effectively fulfill its original objective of providing sustainable financial services to rural entrepreneurs. This may require more than just organizational reform and capacity building, which is why the planned diagnostic IFAD proposes under their 'RUFIN' program for NACRDB is critical.

Recommendation 2: Innovative Approaches to Agricultural Finance

19. While the lessons from success with a financial system approach requires that priority be given to building sustainable financial institutions offering a range of appropriate products (rather than just targeted subsidized credit), the particular challenges of agricultural finance must nevertheless be faced head on. In terms of crop finance, the lessons from the case studies point to a number of direct and indirect approaches. First, it

makes sense to leverage ongoing private sector development work aimed at strengthening selected supply chains in Nigeria, to include linkages to formal financial institutions and incentives to provide supply chain finance. Second, the supply chain data indicates that wider agricultural policies must be careful not to destroy the incentives for private sector participation in supply chain finance. In general, agricultural and trade policies should not generate *systemic* overproduction as they have for cassava in Nigeria. The *cyclical* component of the current glut in cassava, however, may call for more direct intervention through investments into storage facilities. This would also permit a further development in warehouse financing which would also improve access to credit for farmers. In Nigeria, this is not a generic recommendation: It would leverage the existing legal provision in Nigeria permitting the use of warehouse receipts as collateral. This would also reduce risk for potential supply chain financiers by providing information on farmers and their production. Improvements in contract enforcement would also relieve constraints on private sector participation in supply chain finance, as would 'brokering' or 'matchmaking' support for smallholder outgrower schemes. For longer term finance, one proven way to reduce the risk of RFIs in dealing with farmers is to engage in leasing. Here, the experience of some urban-based Nigerian commercial banks currently engaging in leasing can be extended to piloting the approach in rural Nigeria.

Recommendation 3: Investments in Rural Finance Infrastructure

20. Technology and innovation in rural finance has helped access to finance become a reality for the rural poor across the world. Innovations can be organizational, and have proven to dramatically reduce costs and improve outreach elsewhere in Sub-Saharan Africa (SSA) (e.g., Ghana—See Box 1). Investing in apex organization for financial cooperatives and/or the newly formed Microfinance Banks in Nigeria, therefore, is based on established good practice and can strike while the organizational iron is hot in Nigeria. In terms of technology, given the positive experience in Asia and SSA—and the lessons learned from their less positive experiences—with mobile phone technology, Nigeria's vast territory makes it a perfect candidate for piloting such initiatives. Finally, the case studies repeatedly reveal for both the RFIs and the interviewed supply-chain actors that asymmetric information contributes to high risk perceptions. Simple investments into rural credit bureaus could link rural client information from MFIs, NACRDB and other RFIs with other ongoing (urban) credit registry initiatives in Nigeria. This would make information available to potential rural finance participants, including commercial banks, thereby lowering their risk perception.

Recommendation 4: Alternative Approaches for the Less Bankable Rural Poor

Ending Capped Interest Rate Policy

21. It was seen that, under conditions of best practice microfinance, Nigerian RFIs could currently achieve cost-recovering interest rates only in the range of 20 percent-30 percent. This contrasts strongly with interest rate caps of 8 percent, currently in use in some programs in Nigeria. NACRDB alone lent some US $70 million at subsidized rates (fully a third of the commercial bank lending to the sector, by volume, despite smaller loan sizes). It is important to acknowledge that the interest rate caps are based on the

legitimate concern that there are swathes of the rural poor who simply cannot afford even efficient rates in the range of 20 percent-30 percent. Nevertheless, the interest rate cap has (at least) four negative consequences for building sustainable rural finance in Nigeria:

22. First, the single digit interest rate policy, along with poor recovery and institutional inefficiencies, undermines the important role NACRDB could play for the rural poor. The institution has a good branch network and targets smaller rural actors than the commercial banks, the leading lenders for the rural sector. NACRDB's lack of viability, however, limits a potentially high outreach and bodes ill for sustainability. On the other hand, successful agricultural development bank models in Indonesia, Tanzania and Mongolia have turned institutions very similar to NACRDB into viable and important rural finance actors.

23. Second, observers have repeatedly noted that the interest rate policy, binding on such a large player on the rural finance scheme (NACRDB), has translated into a sense of entitlement concerning 'free credit' among some borrowers. Combined with poor recovery, a culture of non-repayment continues to be abetted by the interest rate policy, eroding the financial discipline required by other rural finance providers to survive.

24. Third, in general, other RFIs can certainly compete with NACRDB in terms of timeliness and product offering. After all, interviews conducted for the study with informal providers show that, in fact, the rural poor can and do pay up to 120 percent *pa* for flexible loans suited to their livelihood strategies. This means that if at least as much attention is paid to developing more appropriate service and products for rural people (see Recommendation 1), the interest rate need not necessarily 'crowd out' competitors. But the single digit interest rate (and lax repayment) makes the NACRDB first port of call for would-be borrowers, leaving behind a less diversified clientele with which other RFIs must survive..

25. Finally, the interest rate policy distracts attention and resources from more sustainable approaches. In terms of attention, the case study data shows that there are consistently higher levels of savings as compared to loans. This at least partly reflects inadequate loan products or too rigorous collateral requirements, effectively driving potential borrowers to save rather than borrow. There are important lessons here for formal providers in developing appropriate products for the rural poor, but also for policy makers in their views on interest rates as the only obstacles to finance for farmers and the rural poor.[3] Nigeria is ripe for action and innovation in rural finance, which will require resources. While the total cost—over the years and currently—of the government's interest rate policy is unknown, in addition to the interest rate subsidization of almost US $200 million in loans[4] and the administration costs of these, poor repayment of the portion channeled through NACRDB has meant that the policy is potentially very expensive indeed. It may be possible to pay for the alternative approaches recommended here

[3] For example, to what extent is lending to SMEs and rural inhabitants constrained by provisioning rules, requirements for loan portfolio composition, loan portfolio documentation, restrictions on foreign currency transactions and secured transactions regimes?

[4] Through the Agricultural Credit Support Scheme (ACSS), NACRDB, and the Interest Drawback Program of the Agricultural Credit Guarantee Scheme Fund (ACGSF).

through a redirection of resources from the interest rate subsidization programs to innovative approaches that can more effectively achieve government's objectives for rural finance.

Specifically Targeting the Rural Poor Who Cannot Afford Cost-recovering Interest Rates

26. The existence in Nigeria of economically active rural poor[5], who can and do pay upwards of 120 percent *pa* interest on loans and the negative effects of an interest rate cap on sustainable rural finance, does not grant permission to skirt the issue of high interest rates altogether. The reality is that Nigeria does have rural citizens that simply cannot pay 30 percent, or 20 percent, or even 8 percent on loans, but this is not a problem solved by cheap credit, as Nigeria's own experience proves. Poor repayments on targeted subsidized agricultural credit programs have meant that these targeted 'credit' programs are *de facto* grants. If this is the case, the objectives of FGN and partners in providing access to credit for those who cannot afford debt might better be served by well designed grants programs that avoid elite capture and target only this segment of the rural poor. Everyone else—farmers and other rural entrepreneurs—should access their financing needs through strong and innovative RFIs (see Recommendations 1 to 3).

27. An effective alternative to subsidizing the interest rate is to support livelihoods through an asset acquisition matching grants scheme that help the very poor to build up their income to a level where they will be able to access unsubsidized financial services. Grant programs must have three characteristics if they are to achieve their objectives:[6] (i) grants must target the extremely poor who are too vulnerable to take on the risk of a loan or who have some assets but cannot absorb downside risk; (ii) grants must have a rigorous targeting strategy and monitoring system, using participatory mechanisms to identify the poorest members of the community; and (iii) grants should be made on a matching basis, either in cash or in kind, requiring the highest contribution that is reasonable for the participant.

28. Another approach is to actively promote savings groups, with emphasis on the quality of group formation. This will more accurately target the rural poor who cannot afford efficient market rates. Savings will reduce the vulnerability of this target population and provide small amounts of own capital for rotating savings schemes, similar in many ways to the *adashis* already found across the nation. Savings groups can eventually be linked into formal financial systems. Nigeria's advantage is that FGN has had some experience and lessons learned from its Self-Help Group (SHG) Bank Linkage program to build upon. Furthermore, its loosely formed 'cooperative societies' are ubiquitous and share similarities with very successful Indian SHGs (i.e., self-formed, linked with some external entities, etc.). Finally, both matching grants and savings groups need to be linked with ongoing livelihood support such as those provided by the various income generation and private sector development initiatives currently underway in

[5] See Figure 1 for a division of the demand for financial services among different segments of the population.
[6] World Bank (2007c).

Nigeria. After all, grants alone cannot improve access to finance (what happens at the end of a grant scheme?)—they must, therefore, be used under conditions which promote sustainable access by: (a) increasing incomes for the very poor; and (b) providing participants with collateral. Only when the rates of return on their productive investments start to rise will they be able to graduate to accessing finance from more formal providers.

29. There is much potential for RFIs in Nigeria to survive sustainably with adequate capacity building and encouragement to widen the scope of rural finance. The study provides a number of new approaches, innovations, and organizational reforms specifically suited to Nigeria, leveraging as they do, the country's own experience with rural finance and recent selected reforms. Consistent and non-distortionary policies, an appetite for innovation in rural and agricultural finance and strong capacity building will permit the survival of different RFIs in Nigeria which together can offer a full range of financial services to all of Nigeria's rural citizens.

Introduction

1. The absence of efficiently operating rural financial markets is a serious constraint on sustainable rural development in Nigeria. The rural space is home to 53 percent of the nation's population and more than 70 percent of its poor. Rural financial access is important for both poverty alleviation and the non-oil growth agenda, a fact recognized by the Nigerian government and its partners. In 2007, the contribution of agriculture to non-oil GDP was fully 53 percent. A recent World Bank study on agricultural growth in Nigeria cites the improvement of financial systems as a key growth pillar for the sector.[7] Lack of rural access to financial services in Nigeria not only retards rural economic growth, but also increases poverty and inequality. Financial access increases incomes through productive investment, helps create employment opportunities, facilitates investments in health and education, and reduces the vulnerability of the poor by helping them to smooth their income patterns over time. Overall, financial depth has been associated with strong pro-poor effects.[8] While it is well understood in Nigeria that financial exclusion of the rural population stunts development, fewer than 2 percent of rural households in Nigeria are estimated to have access to any sort of institutional finance.[9]

FINANCIAL SECTOR OVERVIEW IN NIGERIA

2. Despite considerable growth and development[10] in recent years, Nigeria's financial system remains shallow compared to the size of the economy (see Table 1). Access to finance remains a major obstacle for both rural and urban private sectors.

Table 1. Financial Sector Depth

Indicator (% GDP)	Nigeria	Sub-Saharan Africa	Low income	Ghana	Indonesia	Brazil	South Africa
Domestic credit to private sector	14	18	16	18	25	36	78
Money and quasi money (M2)	18	30	30	29	39	55	60

Source: WDI/GDF database, WB Financial Structure Database, CBN

Nigeria's financial system is broad and comprises banks, institutional investors, and other non-bank financial institutions. Commercial banks dominate the financial sector, accounting for 91 percent of financial system assets. The recent consolidation in the banking sector reduced the number of banks from 89 to 24.

[7] World Bank (2006a)
[8] Beck *et al* (2000), Beck *et al* (2004), Honohan (2004), World Bank (2006a)
[9] Bagazonzya *et al* (2005), IFAD (2004, 2006a)
[10] The CBN, Ministry of Finance, the NDIC and other key regulatory authorities and stakeholders have recently embarked on major financial sector reform based on the Financial System Strategy 2020.

3. Rural credit represents less than 2 percent of total credit from formal, deposit-taking institutions, including the commercial banks, the community banks and the Nigerian Agricultural, Cooperative, and Rural Development Bank (NACRDB). Data on credit provision from semi-formal and informal providers, including cooperatives, is not available in Nigeria.

Table 2. Key Rural Finance Institutions in Nigeria

Institutional Type	Total Branches	Rural Branches	% Rural Branches	Rural Credit N (millions)	% Total Credit
Commercial Banks	3487	722	21	24,274.6*	1.0
Community Banks	750	500	66	2,053.8**	12.4
NACRDB	201	150	75	8,860.9	n/a
NGO-MFIs	500	350	70	n/a	n/a
Cooperatives	n/a	n/a	n/a	n/a	n/a

* CBN data for Dec 2006; loans to rural customers only (Total Agricultural Sector N49,393.4 million)
**CBN data for Dec 2006, Loans to Agriculture and Forestry and Manufacturing only, excluding Mining & Quarrying, Real Estate & Construction, Commerce, Transportation & Communication and others.

4. Nigeria represents the largest potential market for micro and small business finance in all of Sub-Saharan Africa (SSA), but development of the microfinance industry lags behind its peers in other parts of Africa. The CBN has provided an important impetus for the development of a more dynamic supply of microfinance services through its 2005 Microfinance Policy and Regulatory Framework. 'The Microfinance Policy' provides a regulatory window for newly created microfinance banks (MFBs) and at the same time forces the conversion of a large number of existing community banks into MFBs. By December 2006, there were seven newly created MFBs. In addition, there were 40 applications for MFB licenses from new investors, 1 application for the transformation of an existing NGO-MFI, and 144 applications from existing community banks.

5. Retail banking activities by commercial banks focus on salary advances and Naira-denominated credit cards targeting salaried employees, and not the—largely informal—micro-enterprise sector. Banks would prefer to gain exposure to microfinance through investments in newly created MFBs, providing wholesale services rather than utilizing their own infrastructure, even though branches outside the urban centers are often not fully utilized. Some of the larger players are already shareholders in an MFB or have received an approval in principle to operate their own microfinance bank.

6. Despite the short track record of the "greenfield" MFBs, several of which are backed by experienced international investors, the sector is expected to deliver very dynamic growth in the future. But this growth will, for the foreseeable future, be limited to the large markets in the big cities, followed by smaller urban conglomerations. Furthermore, geographic restrictions imposed by the Microfinance Policy are likely to obstruct the emergence of strong pioneers that could lead to outreach in rural areas and smaller towns. Finally, there is some concern regarding the converted community banks. While some of these institutions are serious about adopting best practice microfinance standards, it is unclear how the majority of those that have applied for MFB licenses will

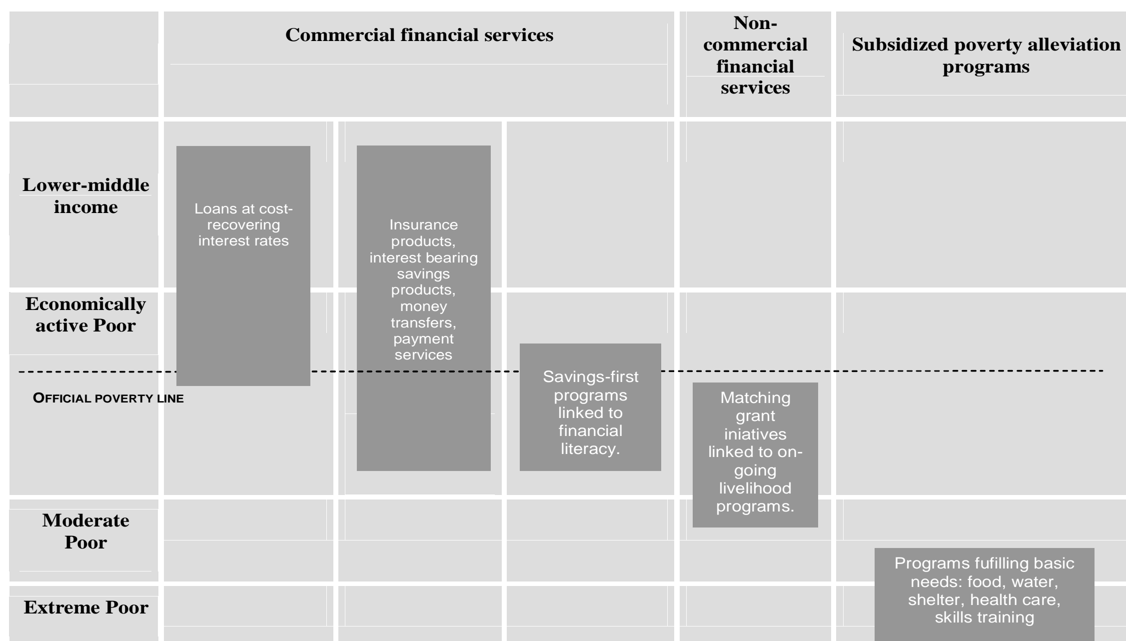
be able to fund the considerable investments required to strengthen their operations and lending performance and acquire the necessary capital to grow.

7. At the current time, the onsite and off-site capacity to supervise the several hundred transformed community banks anticipated (as well as new entrants) is limited, raising further concerns about the sustainability of the sector. Failures, bad governance and unsound business practices of the new MFBs carry significant reputational risk for the developing microfinance bank sector. A clear supervision mechanism needs to be established, including effective reporting and offsite supervision systems and possibly some form of self-regulation within an apex organization. It is, therefore, imperative that supervisory capacity for the MFB sector be strengthened.

Demand

8. Estimates by the CBN put the rural demand for financial services at some 40 million clients—but the paucity of rigorous data on the demand for financial services in Nigeria[11] make it impossible to know what fraction of rural demand for finance is currently served by the institutions detailed in Table 2, let alone to what degree different segments of that demand are currently being met (see Figure 1).

Figure 1. Demand for Financial Services in Developing Countries



Source: Adapted from Robinson (2001) and Cohen (2003)

Supply

9. On the Nigerian financial services landscape, the national average banking density is estimated at one financial institution outlet to 32,700 inhabitants. For rural areas—covering much of Nigeria's 'economically active poor', 'moderate poor' and most of its

[11] An upcoming DFID/FinScope financial access survey aims to estimate demand for financial services.

'extreme poor' in Figure 1—the density is closer to 1:57,000—2 percent. This contrasts with national average estimates of financial access on the order of 15 percent.[12] The financial access gap is to a large extent rural.

10. The evidence therefore suggests that financial markets in Nigeria are fragmented and unable to meet the rural demand for financial services.[13] Rural financial markets in Nigeria are characterized by a range of formal, semi-formal, and informal providers[14] that address different segments of demand between them (see Figure 1). **Commercial banks** have greatly reduced their level of activity in rural areas since the end of compulsory agricultural lending. While most rural branches mobilize deposits, they have limited outreach and low levels of lending (see Table 1). Commercial banks are still the biggest provider of rural credit by volume, but high average loan sizes[15] provide some indication that the rural poor are not their primary clientele. Furthermore, the post-consolidation rise seen in agricultural lending (on the order of an 82 percent increase between 2005 and 2007) primarily targets larger scale urban agro-processing, while outreach to rural clients remains flat.

11. **NACRDB**, jointly owned by the Federal Government of Nigeria (FGN) and the Central Bank of Nigeria (CBN), plays a key role on the rural finance scene. Formed by a merger of three institutions, NACRDB was given a rural mandate, but in practice, its deposit mobilization and credit services are also extended to urban clients. NACRDB is required to lend 70 percent of its loan portfolio at single digit interest rates through loans of N250,000 or less. The very low repayment rates and the interest rate cap have both been found to undermine the viability of the institution as well as restricting its ability to satisfy the demand for loans from its target client population. Relative to its good (but declining) rural branch network, its current loan outreach is limited at little over 45,000 clients. IFAD has been preparing a Rural Finance Institutions Building Programme (RUFIN) with the Government to address some of these constraints. The project is intended to provide financing for the complete assessment of the NACRDB business model, with a view to recommending the way forward for that institution. Once the assessment has been completed, the government institutions, departments and ministries concerned are meant to evaluate the recommendations and take the necessary steps to facilitate the commercialization of the operations of the bank, and to carry out the reforms needed to achieve this objective. The work proposed under RUFIN is essential to ensure that NACRDB can effectively fulfill its original objective of providing sustainable financial services to rural entrepreneurs, especially farmers.

12. There are approximately 750 **community banks**, present in both urban and rural communities. Community banks have undergone close scrutiny as of late[16] and have benefited from closer supervision since 2000. As discussed above, they are now in the process of conversion into effective microfinance banks. While community banks/MFBs

---

[12] Honohan (2006)

[13] See also World Bank (2002, 2006b), IFAD (2004, 2006a)

[14] By 'formal' is meant **registered and regulated** providers, by 'semi-formal' is meant registered **but not regulated** and by 'informal' is meant **unregistered and unregulated**.

[15] Loans rarely fall below N250,000 (World Bank 2007c)

[16] IFAD (2006), FAO (2004)

could become, with adequate capacity building, an important source of rural finance, at present their contribution to rural credit is limited both in volume and number of clients reached. Total assets of the existing 750 community banks amount to only N46 billion, less then 0.5 percent of total commercial bank assets and an even smaller share of these assets supports the agricultural sector. Loan/deposit ratios averaged 50.6 percent at the end of 2006 with most of the deposits being on-lent to commercial banks or invested in treasury bills. On average, they serve 1430 savers and only 106 borrowers.

13. **NGO-MFIs** in Nigeria have an average of 42,000 borrowers and are important financial providers for the rural poor, although their overall impact remains small. Prohibited from mobilizing deposits, NGO-MFIs are still able to request mandatory savings as loan collateral.

14. Well-organized **financial cooperatives** are rare in Nigeria and these tend to be found in the Northern states of Gombe and Bauchi, where experience with cooperatives appears to be quite positive. Very little is known about them however, including their total number. While small-scale, registered "cooperative societies" are common throughout the country (since most formal financial providers will only lend to farmers through this vehicle), they are usually stand-alone entities and are not federated under an apex entity.[17] Each society is represented by four elected members who come to weekly meetings during which they bring their society's savings and/or request loans.

15. The rural finance landscape is, in fact, dominated by **informal providers** such as *adashi* and itinerant bankers, which are discussed in this study, but into which the data exercise does not enter.

16. Policy formulation and supervisory responsibilities do not always lie with the same agency. So, for example, NACRDB is supervised by CBN, but policy is largely determined by the Federal Ministry of Agriculture and Rural Development (FMARD). Supervision of the community banks (and future MFBs) is determined by CBN and the National Deposit Insurance Corporation (NDIC) as are the commercial banks. Microfinance policy and regulation of microfinance banks are the sole responsibility of the CBN. MFIs are registered with CBN, but in the absence of deposit mobilization they do not receive supervision. Informal providers are clearly unsupervised and unregulated.

17. This institutional context arises from a long history of rural finance initiatives on behalf of the FGN and its partners. Federal and state initiatives include the creation of specialized financial institutions, such as, the Nigerian Agricultural Insurance Corporation (NAIC), compulsory agricultural sector lending targets for commercial banks, compulsory rural branch openings, on-lending schemes for cooperatives societies, CBN's Self-Help Group (SHG) Bank Linkage program, guarantee schemes such as the Agricultural Credit Guarantee Scheme Fund (ACGSF), and targeted subsidized credit programs like the recent Agricultural Credit Support Scheme (ACSS, also known as the '50 Billion

[17] The cooperative in the sample for this study, however, does unite 30 registered cooperative societies into its union.

Fund').[18] In addition to these direct interventions, a number of wider government programs have also had rural finance components. Yet, with few exceptions, best efforts have not resulted in sustainability of finance for agriculture, and even less so for rural activities outside the agricultural sphere.

OBJECTIVES OF THE STUDY

18. The objective of the study is to carry out an analysis of alternative options for increasing access to financial services for rural economic actors in Nigeria. As targeted subsidized credit is the most ubiquitous form of rural finance in Nigeria, the ultimate goal is to develop alternative approaches that can enhance access to financial services by the majority of the rural population, including (but not exclusively) farmers and non-farm entrepreneurs. The study, therefore, aims to provide the information required to inform on alternative rural finance instruments and policies suitable for Nigeria based on its own history, its specific context, and on best practice elsewhere in the world.

19. Concerns about the lack of rural access to finance continue to figure prominently in the FGN's agenda, and in the programs and initiatives it supports with its partners. While subsidized credit, both historically and currently, is often seen as a ready solution to this problem, other efforts also ongoing in Nigeria include overall financial sector framework development, micro, small, and medium enterprise (MSME) work and institution-building support from donor partners. Each of these angles forms part of a multi-pronged (and multi-leveled) approach to rural finance in Nigeria. Within the tapestry of this approach, however, a number of key gaps remain. The ESW targets very specific areas of what is unknown, and undertakes a new analysis using what is known from Nigeria's past. As can be seen from Annex 1, it does not attempt to fill all gaps, but focuses on two key areas of research. First, it collects data to examine the real (unsubsidized) costs of rural service providers across a range of institutional structures (i.e., ranging from commercial bank branches to small NGO-MFIs). Second, through a case study approach, the study examines the potential role of supply chain finance in the provision of financial services in rural areas. These two topics: (i) represent gaps in Nigeria's rural finance scene; and (ii) inform on current government priorities and approaches with respect to agricultural and rural finance.

PARADIGM SHIFTS IN RURAL FINANCE: A FINANCIAL SYSTEMS APPROACH

20. There is growing consensus among long-time experts of agricultural finance that a paradigm shift is underway.[19] Indeed, that the term 'agricultural finance' has given way to rural finance is an expression of this shift. The lack of access persisting after years of the traditional approach, characterized by the notion that subsidized and targeted credit could promote agricultural production and improve the lives of smallholders, has become increasingly in evidence over the last couple of decades. At the same time, the "microfinance revolution" has been paving the way for a new conception of pro-poor financial services provision. The *financial systems approach* to rural finance is as much

[18] This refers to the mobilization and commitment of N50 billion to an agricultural trust fund, of which little is known and little has been disbursed so far.

[19] ADB (2006), Ford Foundation (2006)

the consequence of lessons learned from a failed model as it is from those learned from a new one.

21. The poor performance of agricultural credit projects that characterize the traditional approach have been amply reviewed in the rural finance literature since early days,[20] and are not the object of this analysis. Suffice to say that, experience from the rest of the world has shown that most supply-led government interventions to channel targeted and subsidized credit to farmers have proved almost universally to be ineffective. Furthermore, there is relative consensus around the various elements that spelled failure for the directed agricultural credit approach. These include ineffective incentives by which excessive subsidization of interest rates leads providers to ration credit based on transaction costs, which are higher for smaller borrowers. Eventually, rising transaction costs weeded these borrowers out altogether. Combined with nepotism, it often was nearly impossible for poor farmers with limited social capital to access finance. Poor performance of the traditional approach has also been pinned on the exclusive emphasis on agriculture. Agricultural credit that effectively ignored the income-generating potential of off-farm activities, not to mention social and life-cycle (e.g., weddings, funerals) events that create financial pressure on rural households, meant that money from agricultural loans did not necessarily go towards productive activities. The old approach also neglected deposit mobilization. This affected rural clients with a demand for savings services and banks, who had no incentive to mobilize deposits as a source of funds, since they could depend on subsidies. When subsidies were eventually reduced, many institutions found themselves insolvent. Market "pollution" through the predominance of government programs not only led to a culture of non-repayment, it also discouraged private financial intermediaries from getting involved in rural finance.

22. In sum, by the 1980s, it became clear that the directed approach had not managed to reach the poor, let alone meet their financial access needs; it was extremely costly and ultimately detrimental to overall financial development. Around the same time, successful examples of microfinance were emerging using a diametrically different approach that would eventually evolve into the financial systems paradigm. The financial systems approach views microfinance as part of the larger financial system and thus necessarily implies financial viability of the microfinance service providers. Market interest rates, enterprise-orientation, and emphasis on repayment are among the characteristics that set this approach apart from the traditional agricultural credit approach. Other distinguishing features include a more client-focused perspective that calls for product development and capacity building at the financial institutional level, and consumer and financial education at the client level. Gradually, these elements have also become part of the new approach to rural finance. The tenets of the new paradigm include a broader view of rural; a more realistic perspective on the role of finance; an enabling policy environment; a diverse product offering; financial viability; and well-directed subsidies. Finally, minimal political interference enables directors and managers to make decisions that are in the interest of the institution's financial health.

[20] USAID (1973), McKinnon (1973), Shaw (1973), Adams, Graham and von Pischke (1984)

OUTLINE OF THE STUDY

23. In their multiple interventions over the years, Nigeria has built up a rich history concerning rural finance, from which key lessons can be drawn. Section 2 below reviews which elements of those interventions in Nigeria have worked—and which have not—and evaluates to what extent Nigeria currently falls into the traditional or the financial systems approach. Widespread recognition of the persistent lack of access to finance in rural areas—seen in the ongoing efforts of the Nigerian government and its partners—is examined in Section 3 using new data on RFIs. Drawing on the results of Section 3 and using successful examples of good practice from the rest of the world, Section 4 explores new relevant approaches pertaining to RFIs, and to non-institutional finance through supply chains. The analytical review of Nigeria's experience and the new data collected for this study lead to four key recommendations discussed in Section 5. Section 5 also articulates a number of specific rural finance interventions that fall under these recommendations, many of which are new to Nigeria. Sections 4 and 5 operate from the financial systems approach to rural finance, an approach that has led to successful rural finance elsewhere in the world, despite facing the same challenges of *high costs*, *poor information*, and high levels of real and perceived *risk.*

Past Lessons from Rural Finance in Nigeria

24. The FGN, its States, and donor partners have long recognized the importance of increasing rural populations' access to finance, usually under the more restrictive guise of 'agricultural finance'. As early as 1973, FGN, through the Federal Ministry of Agriculture and Rural Development (FMARD), launched the Nigerian Agricultural and Cooperative Bank (NACB) in the hope of increasing outputs and encouraging the adoption of new agricultural technologies. Many other initiatives have followed over the years (see a summary in Annex 2), demonstrating the commitment of the Nigerian government and its partners to providing financial services to its rural citizens. Yet, more than thirty years later most would agree that the rural financial sector is fragmented and access to finance for rural people remains very low.

25. Much can be learned from reviewing Nigeria's rich experience with rural finance, whether government-led or donor-led. While Annex 2 is not completely exhaustive, it highlights the main interventions that have marked the rural finance landscape in Nigeria. Rather than enter into the *minutia*e of each intervention, a review of these is used to extract the essential ingredients for future efforts in rural finance. This section, therefore, looks at the specific elements of past rural finance interventions in Nigeria to pick out both what has worked and what has not.

WHAT HAS WORKED

26. **Community based models** have been sporadically employed over the course of Nigeria's history with rural finance, with some success, particularly for outreach and repayment. The most notable examples include the National Poverty Eradication Programme (NAPEP), the People's Bank of Nigeria (PBN), the Community Bank system, the so-called Trust Fund Model (TFM), and the SHG Bank Linkage Program. The SHG-Bank Linkage Program was based on group lending (to farmers' associations and cooperative societies) by commercial banks participating in the Government's credit guarantee scheme (ACGSF—see below). Poor monitoring and group selection led to the demise of the program, but the model seems to work in Nigeria if done properly. Even after the official government support for the program waned, some commercial banks continued to use the SHG methodology for lending (e.g., Platinum Habib Bank). Group lending is also the methodology of choice for the TFM: SHGs deposit 25 percent of what they intend to borrow in a partner bank's savings account. A trust fund (from oil companies, state/local governments and NGOs) secures the other 25 percent. The remainder is guaranteed by the FGN. After only four years, nine trust funds have been set up with a total value of US$3.7 million.

27. The community bank system was set up in 1990 by FGN decree with the objective of allowing rural communities to own and manage their financial institutions. The goal was to encourage locally-owned savings and loans institutions to meet the needs of rural populations unserved by the commercial banks and government-owned banks. At the onset, community banks were established with individuals, community development associations, and trade associations serving as shareholders. Most community banks are

set up in local government headquarters (LGHs), which may be small or large rural towns. Over time, the level of community involvement has fallen. As a result, so has "the proportion of community banks fulfilling their developmental role, as funds [are] placed in universal banks in preference to the creation of credits".[21] With the conversion of community banks to MFBs under the Microfinance Policy, there are to be no restrictions regarding shareholders. This is less a departure from the community model than it seems. Only 30 percent of the community banks still have active community development associations as shareholders. The lesson from the community bank experience is, therefore, that 'community-based' needs mean something more than mere location ('rural') or semantics ('community' banks): *Profit maximizing behavior will lead to investments outside the community as long as information on profitable investment (lending) within rural communities remains poor*.[22]

28. The National Poverty Eradication Programme (NAPEP) currently has several micro-credit initiatives underway. From the onset, the program recognized the tendency for delinquency rates among borrowers to be higher for those who access government funds than for those who access funds from commercial financial intermediaries. Building on the success with community approaches in the past, NAPEP loans are channeled through community-based commercial financial intermediaries. A micro-credit scheme is underway in twelve states and provides funds to MFIs. By the end of 2005, over N450 million had been released through 54 groups and MFIs for disbursement to end users.

29. The People's Bank of Nigeria (PBN), modeled after Grameen Bank, was set up in 1989 to improve access to financial services for un-banked, marginalized populations in rural and urban areas (roughly 80 percent of branches were rural). It aimed to reach the un-banked with credit and deposit services. The PBN also worked to improve opportunities for self-employment, improve the productive base of the economy, create a banking culture at the grass-roots level and reduce rural-urban migration. A 20 percent "service charge" (rather than interest rate) was levied on loan amounts. All but the smallest agricultural loans had to be insured by the Nigerian Agricultural Insurance Company (NAIC). In addition, credit officers offered financial advisory services to borrowers. Owned 100 percent by the CBN, PBN's management had significant autonomy compared to other development banks in Nigeria at the time (e.g., NACB), but was subject to government interest rate policies. In addition to the semi-autonomy given to the management, community involvement was relatively high. Attempts were made at branch level to monitor operations via community-based committees. As a result, PBN reported repayment rates of 87 percent, an improvement over the 60 percent-85 percent registered at the NACB. Furthermore, the PBN achieved good outreach, with 279 branches as of December 1998, located throughout Nigeria. It served some 3.2 million clients, largely composed of the rural poor. Performance deteriorated with rapid growth, however, and management was changed in 1995. Even so, FGN interest rates policies prevented the PBN from earning financial revenues sufficient to cover the high expenses associated with its micro-lending. PBN never achieved financial sustainability. So, while

[21] CBN Annual Report (2005)

[22] See discussion of profitable agricultural investment for rural Nigeria in Section 3.

the community-based model resulted in good outreach and relatively good repayment, the lack of a 'financial systems' approach that focused on financial viability brought an end to the PBN in this form.

30. The PBN was also the first government bank to offer both credit and **savings services**.[23] Savings were linked to lending, where potential borrowers wishing to access loans had to deposit one third the amount in mandatory savings six months prior to loan application. But in addition to mandatory savings, various savings products were offered, remunerated at 3 percent-8 percent. For the PBN, as elsewhere in the SSA and the world, when deposit services were offered, people used them extensively. This observation is further supported by the fieldwork findings of this study, which suggest that when deposits are remunerated, rural populations save even more: The data on RFIs in Table 4 show a jump in the level of savings with the MFI in the sample that remunerates them.

31. The Nigerian experience in rural finance provides some interesting lessons on the role of **monitoring and evaluation** (M&E).[24] There appears to be a correlation between relatively successful interventions and the presence of an M&E system of some sort. As an example, the NAIC is one of the few rural finance interventions that have an actual M&E system in place. NAIC started providing insurance to Nigerian farmers in 1988 with a view to encourage lending, promote agricultural production, and minimize ad-hoc government assistance in the event of agricultural disasters. NAIC covers crops, livestock and commercial business, but the coverage is limited: In the event of a disaster, NAIC pays out the bank, not the farmers. The banks in turn will cancel the farmer's debt, but farmers are not compensated for loss of income (NAIC insures the loan, not the crop). Crop and livestock contracts are subsidized 50 percent by the FGN. All agricultural lending from FGN funds must be insured by NAIC. NAIC has been profitable since 1996, after an intervention by FAO that helped restructure operations and put an M&E system into place. Two subcommittees, formed under NAIC for Nigeria, were responsible for assessing NAIC's operations and impact, and submitting reports. By 2006, business was looking up: some N43 billion worth of operations were insured annually; total premiums collected was N555 million; and 156 claimants had been satisfied. Despite the government failing to honor obligations to pay subsidy on premium and operating costs,[25] NAIC maintains profitability, thanks to its commercial operations, which account for about half of premium income. NAIC is only one example of a positive legacy associated with Nigeria's history of **public private partnerships** with commercial banks. This has also been true under the Agricultural Credit Guarantee Scheme Fund (ACGSF) (with 11 banks) and the Trust Fund Model (TFM).

32. CBN monitors the government's ACGSF and publicly releases state-level and aggregated statistics on number and volume of loans guaranteed, loan usage, and loan

[23] Deposit services were also provided under the Rural Banking Program (RBP) which mandated commercial banks to open rural branches from 1977-1990. There is no data on savings from RBP.

[24] Indeed, these lessons are already being applied. The most recent example is the National Poverty Eradication Programme (NAPEP) which incorporated M&E into its design at inception in 2001. NAPEP was set up to coordinate direct poverty eradication efforts in Nigeria and one of its mandates is to provide zero interest loans.

[25] IFAD (2007)

repayment per state. The ACGSF was set up in 1977 to encourage banks to engage in agricultural lending by guaranteeing 75 percent of loans disbursed. The ACGSF guarantees loans from N100,000 (individual farmers) up to N1 million (for cooperative societies). Loans above N20,000 require collateral of 25 percent of the desired loan amount. The partnership with the private sector takes the form of farmers or cooperative societies who are required to open an account in a participating bank and provide the collateral to apply. All loans must be insured by NAIC. From 1978 to 1986, the loans were made at subsidized rates. After deregulation, market interest rates prevailed. The number and volume of loans guaranteed have been on the rise since 1999, averaging 17 percent growth in number and nearly 50 percent growth in volume between 1999 and 2004. In 2004, an Interest Drawback Program (IDP) was implemented. Farmers borrow at the market discount rate and a rebate is provided through the IDP when loans are repaid on time. According to the CBN, "a trend analysis of the loan repayment performance of the ACGSF over the years shows that the IDP has impacted positively as it induced clients to repay on time." Nevertheless, even after 30 years, the program does not function flawlessly. Banks have complained about onerous procedures and incomplete settlements. Furthermore, the ACGSF is financially unsustainable, but operating, thanks to regular FGN injections. Despite the laudable effort to move away from directly subsidizing credit, the ACGSF's exclusive focus on agricultural credit, as well as financial unsustainability, limits this program.

33. Despite these limitations, the ACGSF has undoubtedly induced provision of agricultural credit, and existing M&E data indicate a high level of smallholder participation. Certainly, without it, most banks would not engage in lending to smallholders. Strong M&E continues to be emphasized, and the most recent reform recommendation for the ACGSF hinge, among other things, on better monitoring. A recent review of the ACGSF suggests that extending *the quality of monitoring* to the borrower level by the participating banks is a key step forward. The idea is to focus on borrowers' overall production activities (not just the credit operation) to better understand what constitutes an efficient (or non-efficient) agricultural production system. Such focused monitoring could produce information that could lead to changes that improve agricultural efficiency, which in turn would enhance the sustainability of credit provision.

34. Whereas the presence of M&E seems, in Nigeria's experience, to accompany relative success stories, its absence has equally led to failure. The most telling example perhaps is that of the high potential SHG Bank Linkage Program, which can be seen to have suffered from the lack of systematic M&E. Designed in close collaboration with the African Rural and Agricultural Credit Association (AFRACA) and GTZ, the SHG Bank Linkage Program was launched under the ACGSF as a response to high default rates of ACGSF guaranteed loans. The idea was to encourage cooperative societies and farmers groups to mobilize savings as a pre-condition to borrowing from partner commercial banks. When it began, the program attracted eight commercial banks and was rolled out in 22 states. It was initially greeted with enthusiasm but over time interest waned. Many banks did not carefully select groups, nor put sufficient efforts into post-disbursement *monitoring*.

35. Funding **capacity building** and providing **technical assistance** have underpinned Nigeria's most successful MFIs. For example, the UNDP (one of the longest-standing actors in Nigerian microfinance) has engaged in capacity building for NGO-MFIs through its MicroStart Program since 2000. The top MFI performers in this program—Development Exchange Center (DEC), Justice Development and Peace Commission (JDPC), and Life Above Poverty Organization (LAPO)—continue to receive support to help expand their operations. While MicroStart does not have a specifically rural vocation, DEC and JDPC have a primarily rural client base, while LAPO has just recently started an initiative to channel more financial resources to rural communities. With between 15,000 to 20,000 clients each, these are by far the most successful MFIs in Nigeria. Clear vision and strong leadership with committed and competent staff have been underlined as key factors in their success—all of which result from capacity building and technical assistance. In fact, IFAD—the undisputed donor heavyweight in rural finance for Nigeria—conducted an extensive review of their projects and concluded that the lack of staff experience, transparency, insufficient knowledge of enterprise finance and poor financial management—to wit, low capacity—were key contributors to failed rural finance interventions in Nigeria.[26]

36. Finally, in recognition of the limitations to some of these efforts, there are a number of past and ongoing donor initiatives on the scene. These initiatives cover both demand and supply side development and include programs and studies by development partners such as IFAD, USAID, DFID, GTZ and the World Bank. On institution building with semi-formal and formal providers of rural services, a number of programs aimed at strengthening service providers are underway in Nigeria. Among these, IFAD's RUFIN programme, in addition to its work on NACRDB reform, also aims to strengthen rural MFIs and establish linkages between these and more formal financial institutions. On the demand side, USAID recently undertook a demand survey for financial services by micro, small and medium enterprises (MSMEs) in Nigeria. The USAID work complements DFID and World Bank efforts on the interface between private sector development and, among other things, access to finance. The World Bank's MSME project also supports urban-based 'greenfield MFIs'. Most of these efforts, however, do not extend substantially (if at all) beyond urban centers and their peripheries.

WHAT HAS NOT WORKED

37. The current **Agricultural Development Bank (AgDB) model** in Nigeria, seen in NACRDB, provides a number of lessons going forward. NACRDB was formed from a merger of NACB with the PBN, and with the risk assets of the Family Economic Advancement Programme (FEAP).[27] NACB was noted for having the largest branch network in Nigeria and very competent senior staff. The bulk of its lending went to

[26] IFAD (2007)

[27] The FEAP was a government program channeling credit to rural groups and cooperatives through participating banks. Loans of up to N500,000 (double the PBN limit) were made to groups at a subsidized rate of 10 percent. As early as 1997, concerns were raised about FEAP political ties and design features such as excessively low interest rates, lack of M&E, insufficient focus on deposit mobilization and poor organizational structure. While FEAP reached some 20,000 cooperatives, it is remembered for crowding out legitimate cooperatives and undermining the rural banking culture.

smallholders at a soft interest rate of 15 percent (compared to the prime lending rate at the time of 18.9 percent). It was not permitted to mobilize deposits. A combination of foreign exchange woes and poorly trained new staff led to serious financial difficulties in 1993.

38. Like NACB, the newer NACRDB is dedicated to agricultural finance. Its ambitious objectives include the provision of affordable credit to less-privileged populations who lack access to conventional banks; deposit mobilization; provision of opportunities for self-employment in view of reducing rural exodus; diversification of the economy's productive base; inculcating banking habits at the grassroots level; fostering growth and development of the agricultural and rural economy. NACRDB, therefore, melds the agricultural focus of NACB, the savings-focused group lending methodology of PBN, and the cooperative focus of FEAP (although NACB and PGN also lent to cooperative societies). It is owned 60 percent by the FGN and 40 percent by the CBN, but the institution's reins are with FMARD. NACRDB does not operate under a commercial license, but rather is supervised by the Other Financial Institutions Department (OFID) of the CBN. In November 2006, NACRDB had 201 branches throughout Nigeria, 829,195 savers and 46,732 borrowers. Savings appear to be a welcome service as savers far outnumber the borrowers, even controlling for the compulsory deposits required to access a loan. This is true despite the fact that deposits held by NACRDB are not insured, given that it never received its commercial banking license. Interest rates are fixed by the FGN at 8 percent pa for all micro and macro loans, and deposits are remunerated at 3 percent pa. NACRDB respects its mandate to dedicate 70 percent of its loan portfolio to micro loans (maximum N250,000) and the remaining 30 percent to macro lending. Some 46,551 microloans and 181 macroloans were outstanding at the end of 2005, with an average microloan size of N133,307 (US$1,066) and N14.7 million (US$117,000) for macroloans.

39. NACRDB is monitored by the CBN and has consistently shown poor performance. CBN 2005 Annual Report notes that fully 68 percent of NACRDB's credit portfolio is delinquent. The NACRDB recorded losses of roughly N250 million in 2004 and 2005.[28] In 2005, it had negative equity on the order of just under N2 billion. The institution survives, thanks to injections from the Government. The CBN blames the poor performance of NACRDB on weak credit policies, weak loan administration, poor funds management, deviation from core operations and weak human resource capacity. NACRDB suffers from—and due to its poor loan recovery, contributes to—a culture of non repayment among some borrowers in Nigeria. Entirely unsustainable, heavily subsidized and directly managed by the government, NACRDB's business model does not reflect the good practice in rural finance elsewhere in SSA and the world (see Section 4 below). Interest rates are insufficient to cover costs (even its predecessor, NACB, could lend at 15 percent, as opposed to NACRDB's 8 percent). The top-heavy, centralized management structures have made them slow and unresponsive. Attachment to FMARD lends a political flavor to the institution rather than a full-fledged actor in the financial sector. FGN's refusal to let NACRDB function under a commercial banking license further confirms this impression. Furthermore, agriculture credit is the unique focus of activities (branches started phasing out non-agricultural loans in 2006) and NACRDB is,

[28] IFAD (2006c)

therefore, far from being a rural finance institution in the holistic sense of serving all types of rural economic agents. Despite all this, NACRDB harbors potential: (i) It has a branch network already in place; and (ii) an untapped rural market whose demand for savings and other financial services is almost certainly sufficient to support the institution if it were to reform. Experience from the rest of the world shows that these are two important pre-conditions for successful reform (see Box 4 below). IFAD's RUFIN program with FGN is expected to provide the required direction for NACRDB reform.

40. One prominent area of intervention in rural finance is the **interest rate policy**. The good intentions behind the interest caps imposed on much of government-supported lending in Nigeria (e.g., 8 percent for NACRDB, 10 percent for FEAP, and 9 percent for SMEEIS[29]) have not resulted in sustainable access to finance for Nigeria's poor. First, this is partly because low interest rates have made it impossible for Nigerian development financial institutions to cover costs incurred by working with high-risk rural populations (e.g., PBN before merger), thereby limiting their outreach. Second, while in general, other RFIs can certainly compete with subsidized government loans in terms of timeliness and product offering, the single digit interest rate (and lax repayment) makes government supported institutions, like NACRDB, the first port of call for would-be borrowers, leaving behind a less diversified clientele for other RFIs to survive with. Third, excessive subsidization de-emphasizes the need for savings. As a result, if and when subsidies are withdrawn institutions find themselves insolvent and its clients once more left without access to funds. Finally, the interest rate policy distracts attention and resources from more sustainable approaches. Interest rate subsidies have characterized most of the government's interventions, including NACRDB, ACGSF, the '50 Billion Fund' (see below), Family Economic Advancement Program (FEAP), SMEEIS (see footnote 29), and the SHG program. While the total cost—over the years and currently—of the government's interest rate policy is unknown, in addition to the interest rate subsidization of almost US$200 million in loans[30] and the administration costs of these, poor repayment of the portion channeled through NACRDB has meant that the policy is potentially very expensive indeed.

41. While it is true that some of Nigeria's rural poor cannot afford higher interest rates, or indeed interest rates as low as 8 percent, millions of other Nigerians—including poor farmers—can and do pay interest rates upwards of 10 percent *monthly* to borrow from agile informal mechanisms that meet their financial needs (see Section 3 below). Moreover, projections on farm and non-farm agricultural investments suggest that there are many agricultural investments for which the returns on investment are amply sufficient to cover interest rates considerably higher than official rates (see Table 6 and Table 7 below). The coexistence of different types of agricultural clients (see also Figure 1) suggests that blanket target subsidization for agriculture may not be the best way to target poor farmers. Indeed, anecdotal evidence from within and beyond Nigeria indicates that such programs are plagued by elite capture and **poor repayment**. While interest rates

[29] The Small and Medium Enterprises Equity Investment Scheme (SMEEIS) was started in 2001 and has financed 248 projects, over half of which were located in Lagos State alone.
[30] Through the Agricultural Credit Support Scheme (ACSS), NACRDB, and the Interest Drawback Program of the Agricultural Credit Guarantee Scheme Fund (ACGSF).

have been deregulated for a number of programs (e.g., ACGSF in 1986), the policy continues its hold on Nigeria's rural finance interventions. The most recent example is the Agricultural Credit Support Scheme (ACSS) or '50 Billion Fund', which shares the same ambitions for the agricultural sector as all its predecessors, and attempts to fulfill these with the provision of credit available at an effective interest rate of 8 percent.

42. Looking at the wide array of rural finance interventions in Nigeria, a key feature underpinning their lack of success in providing sustainable finance is the **lack of a financial systems approach.** It was seen that a number of rural finance interventions in Nigeria are **financially unsustainable**. Furthermore, it is clear that the overt focus on one service (e.g., credit) or one target (e.g., farmers) has not worked. So, for example, although there are positive features to the ACGSF, it is an expensive program that is providing a certain category of farmers (subsistence level) with restricted service (credit) that not only does not add value to production activities, but moreover does not necessarily meet more pressing needs for savings, payments, or insurance services. The identical is true for the '50 Billion Fund' that states its intention to provide cheap credit for a sub-category of rural inhabitants at interest rates that continue to undermine rural financial institutions who could provide a wider set of services. In yet another example, it is questionable whether the agricultural loans like those extended under the NACRDB are really adding value. Are the right activities being financed? Can the farmers save? Can rural inhabitants easily receive remittances from their migrant family members? Do farmers have access to the other elements required for developing his or her activities, such as extension services, market information and access, and financial literacy? A comprehensive rural finance strategy under a financial systems approach must take these into account, and then this strategy must be adhered to in order to minimize policy instability. In Nigeria, this has not been the case thus far.

43. Overall, most of Nigeria's experience with rural finance falls considerably outside the tenets of a financial systems approach. The bulk of Nigerian rural finance is essentially characterized by a supply-driven agricultural approach whereby finance is a means to allocate resources. The government-led initiatives are, for the most part, politicized and financially unviable. Product offering by all providers—savings, loans, and some insurance—is limited and although the targeted beneficiaries of most interventions (smallholder farmers) seem to be reached, it is on a very limited basis (low outreach). There is replication and redundancy (guarantees for farmers: ACGSF, ACSS, TFM) in many respects and lack of attention to key rural sector actors (input, equipment suppliers). Admittedly, there have been shifts from the traditional targeted, interventionist approach over the last decade in Nigeria: Compulsory lending was abolished in the mid-1990's, closure of failed programs and important policy changes have taken place including the partial liberalization of interest rates and the adoption of the Microfinance Policy. Furthermore, Nigeria has had a positive experience with community based approaches, selected M&E, public private partnerships and performance-based capacity building for MFIs. But overall, targeted subsidized credit and compulsory savings remains the most ubiquitous form of formal finance in Nigeria's experience with rural finance. This is not to say that the government and other actors are wrong in targeting rural areas (after all, finance schemes not specifically tailored or directed towards rural areas appear to inevitably end up on the 'easier' urban terrain—see SMEEIS in Footnote 29 for a recent

example), but a more integrated approach is needed if rural finance efforts are to be sustainable. The following sections provide data on Nigerian RFIs and supply chain actors as well as world best practice in rural finance. These are combined with this review of Nigeria's experience to provide recommendations to help with just such an 'integrated approach' to rural finance.

Rural finance in Nigeria: New Data

44. Against the backdrop provided by the analytical review of Nigeria's experience with rural finance, this section will look at data collected for a sample of Nigerian RFIs. The data is analyzed to characterize the outreach of the sampled RFIs and to highlight some of their key characteristics in terms of financial performance and costs. After this overall look at the rural finance scene, the data is then used to calculate the interest rates that RFIs would have to charge in order to recover their current costs. This analysis is undertaken using a case study approach from Nasarawa and Kaduna states.

THE STUDY APPROACH: SAMPLE AND CASE STUDY SELECTION

45. Nigeria, spanning almost 1 million km^2, is home to around 130 million people in a federation of 36 states and a capital territory. To examine the persistent lack of sustainable rural finance through formal and semi-formal institutions, data was collected from a representative sample of RFIs from Nasarawa and Kaduna states. These states are quite different from each other and were chosen in an attempt to represent some of the huge variation found across states in Nigeria. Located in the Middle Belt, Nasarawa is a medium-sized state, ranking 15th out of the 36 in terms of area, and one of the least densely populated (34th out of the 36). The economy is dominated by agriculture, as with most of the Middle Belt. Kaduna, on the other hand is one of the largest states (ranked 4th) and one of the most densely populated (again, 4th out of the 36). Kaduna is an industrial center for the northern part of Nigeria and the economy is based on manufacturing and agriculture. The two case studies, therefore, represent two substantially different states in terms of geography, population densities, and economic bases. They were chosen so as to permit some (non-statistical) generalization to other states that share similar characteristics to either. In actual fact, despite the differences, the findings were very similar for the RFIs in the two states, which may make the results more generalizable.

46. The most important criterion in choosing the RFIs in the sample was their 'rural' nature. In the context of this study, rural service provision is defined according to geographic, infrastructural, and beneficiary characteristics. Geographically, the starting point was any place outside of large urban centers. With the exception of one NGO-MFI located on the outskirts of a very small town some 3 hours from the Kaduna capital, all the RFIs in the sample were located on the outskirts of capital cities or in local government headquarters (LGHs) (see **Error! Reference source not found.** in Annex 3 for the case study site map). Consultation with other Nigerian rural finance actors confirms that, throughout Nigeria, RFIs are generally based in small market towns or even state capitals, with branches in LGHs. While some NGO-MFIs use credit officers, who travel from village to village to visit client groups, most providers simply serve clients who come to their branches. Despite their peri-urban location, therefore, the institutions in this sample are representative of rural providers throughout Nigeria. One urban MFI (located in Kaduna city, serving market hawkers) is included in the sample for comparative purposes.

47. The sample spans the continuum of RFIs described in Section 1. It includes two NACRDB branches, four NGO-MFIs, four community banks, one cooperative society as

well as several informal groups. Data for one commercial bank was collected for three branches located in the capitals of Katsina State, Kaduna State and Borno State. [31] These are not RFIs as defined for this study and are, therefore, not directly comparable to the other RFIs in the sample. Rather they are included in the discussion below as an example of the current efficiency frontier in Nigeria.[32] With the exception of community banks, the institutions studied only offer savings and loans. The NACRDB branches provide obligatory loan insurance through the NAIC. The community banks offer a broader range of services, although it was not possible to collect disaggregated operational data on all services during the course of this study. Comparisons are, therefore, confined to savings and loans. It is possible to benchmark the RFIs in the sample against recent data from the Microfinance Information Exchange (MIX) Market (see Table 3).[33]

Table 3. Benchmarking Data

Comparative Indicator	MIX Regional Category: Central África (Cameroon, Congo, Congo DR, Nigeria, Rwanda)	MIX Scale Category: Small	Average of study sample[34]
Total Assets (mill USD)	4.2	1.5	0.4
Personnel	97	65	13
Active Borrowers	11,292	9821	2107

It is clear from Table 3 that the institutions in the study sample are smaller than the MIX 'small category' average in every respect. This partly reflects the rural nature of the study's sample as well as the nature of the MFIs that report to the MIX.[35]

NIGERIAN RFIS: WHO THEY ARE AND WHAT THEY COST

48. The data used for this analysis comes from unaudited and audited financial statements. When such statements were not available, the information was reconstructed in interviews. It is adjusted[36] for subsidies, inflation, and provisioning, [37] when necessary. Unless otherwise noted, data refers to December 2005 for branch offices. The indicators and ratios reported in Table 4 follow the same methodology as those used by the MIX

[31] Katsina and Bornon are not study states. They are included for efficiency comparison purposes only.

[32] Data on rural commercial bank braches was aggressively sought over the course of 10 months for the study. Field visits to Nasarawa, Kaduna and to commercial bank headquarters in Lagos did not yield any of the required data, despite official assistance.

[33] The MIX Market collects and processes data from MFIs around the world and regularly analyzes this data to establish benchmarks for comparison.

[34] Not including data for the commercial banks, which are reported in the study for comparison only.

[35] In fact, when the three largest MFIs are removed from the MIX regional category used in Table 3, about half of the RFIs in the sample are in line with the MIX in terms of Gross Loan Portfolio and Active Borrowers.

[36] Cost of Funds Adjustment: (MFI's funding liabilities * 19 percent prime market lending rate) - actual financial expense. Inflation: (net financial assets (assets denominated in currency [cash, investments, loans, but not buildings or equipment]) – liabilities) * 11 percent. In-kind subsidies were added to financial expenses.

[37] All but three NGO-MFIs are provisioning at least 5 percent of their loan portfolio. Adjustments were made on this 5 percent basis, although it is debatable whether provisions should be higher (10-15 percent).

market to permit benchmarking with the MIX. Indicators are grouped in terms of **outreach**, **financing structure**, **financial performance**, and **profitability** (see also Annex 4 for precise definitions of the indicators used in Table 4).

Table 4. Key Indicators for Sample RFIs

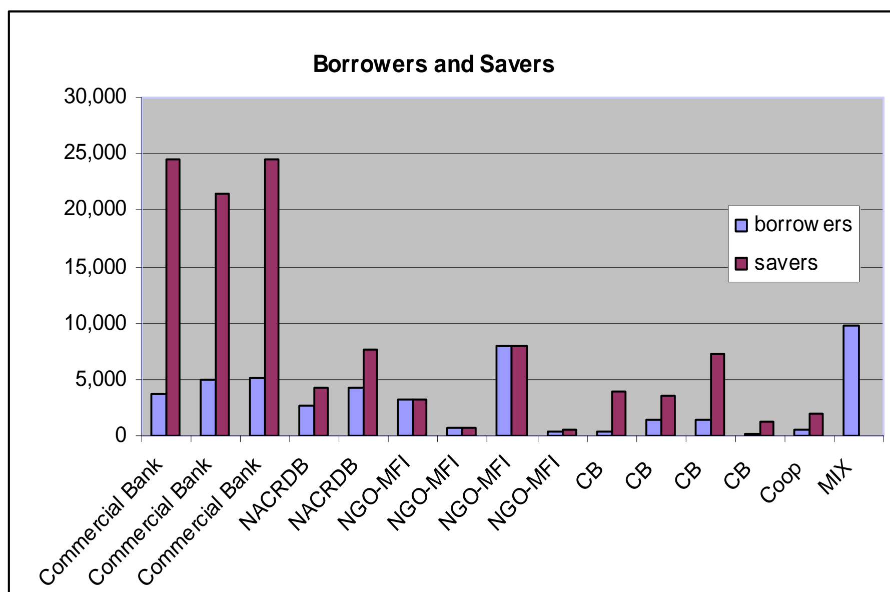
Financial Indicator	Commercial Bank ('Efficiency Frontier')			NACRDB		NGO-MFIs				Community Banks				Coop	MIX AF SM
				NACRDB		Nasarawa MFI[38]	Nassarawa MFI[39]	Kaduna (urban MFI)[40]	Kaduna MFI[41]	Nasarawa	Nasarawa[42]	Kaduna[43]	Kaduna	Kaduna	
	Katsina	Kaduna	Borno	Nasarawa	Kaduna	1993	2003	1996	2001	1993	1993	1993	1993	1994	
Outreach															
Total Clients	25,652	22,897	27,481	4,272	7,600	3,200	716	8,000	600	15,000	8,000	13,064	3,000	1,950	
Total Borrowers	3,687	4,958	5,213	2,678	4,272	3,200	716	8,000	400	407	1,500	1,413	140	450	9,821
Average Loan	***$5,277***	***$1,229***	***$1,700***	***$43***	***$35***	***$40***	***$65***	***$83***	***$91***	***$118***	***$174***	***$172***	***$353***	***$267***	***$104***
Average loan (% GNI per capita)	*2639%*	*615%*	*850%*	*22%*	*18%*	*20%*	*33%*	*41%*	*46%*	*59%*	*87%*	*86%*	*176%*	*133%*	*66%*
Average Deposit	***$736***	***$212***	***$373***	***$43***	***$43***	***$12***	***$6***	***$26***	***$48***	***$118***	***$67***	***$63***	***$54***	***$70***	***$14***
Financing Structure															
Debt/Equity	NA	NA	NA	NA	NA	0.3	0.0	5.9	0.6	5.6	3.3	2.5	2.1	NA	1.0
GLP/Assets	98%	90%	94%	26%	25%	82%	98%	80%	23%	9%	85%	35%	44%	NA	66%
Financial Performance															
PAR > 30 days[44]	NA	NA	NA	NA	100.0%	NA	4.0%	5.0%	1.0%	72%	50.0%	5.0%	26.0%	NA	4.3%
AROA	0.35%	0.23%	0.93%	-14.24%	-12.51%	-25.96%	-24.24%	0.39%	-42.33%	7.08%	1.08%	4.44%	2.82%	NA	-10.20%
Op Exp Ratio	5%	9%	5%	18%	17%	43%	51%	10%	54%	17%	21%	14%	25%	NA	29.70%
OSS	141%	123%	156%	54%	56%	60%	83%	119%	23%	166%	119%	174%	121%	127%	81%
Efficiency															
Cost p/ borrower	*$22*	*$8*	*$19*	*$23*	*$13*	*$14*	*$21*	*$9*	*$203*	*$143*	*$30*	*$43*	*$141*	*$12*	*$40*
Cost p/saver	*$3*	*$2*	*$4*	*$14*	*$8*	*$14*	*$24*	*$9*	*$135*	*$15*	*$13*	*$8*	*$15*	*$3*	*$29*
Cost p/unit lent	*.01*	*.01*	*.02*	*.24*	*.31*	*.35*	*.33*	*.11*	*2.25*	*1.28*	*.22*	*.34*	*.52*	*.05*	

38 Data from both MFI branches.
39 Data is not based on audited financial statements; operating costs reported are very low for this type of institution, and should be viewed with caution.
40 Data from all eight MFI branches.
41 Client data June 2006, portfolio data December 2005.
42 Client data October 2006, portfolio data December 2005.
43 Client data October 2006, portfolio data December 2005.
44 PAR data is self-reported and efforts were made to triangulate the data with donor reports or CBN information. Although the data is insufficient for perfect comparability, they are included in Table 4 due to the importance of non-recovery in the costs analysis (see below).

Outreach

49. In terms of outreach, there is major variation in the size of RFIs in the sample. Of the sample RFIs (that is, not including the commercial bank data), community banks have the most significant scale and, with the exception of NGO-MFIs which cannot legally mobilize savings, all the institutions have more savers than borrowers. For community banks (and the commercial bank benchmarks), lending is a particularly small part of operations. Borrowers account for only 14 percent-22 percent of total clients at the commercial bank branches and they account for only 1 percent-19 percent of total clients at the community banks. To a lesser extent, NACRDB branches and the cooperative also have more savers than borrowers, while NGO-MFIs necessarily have a nearly equal numbers of savers and borrowers.

Figure 2. Borrowers and Savers

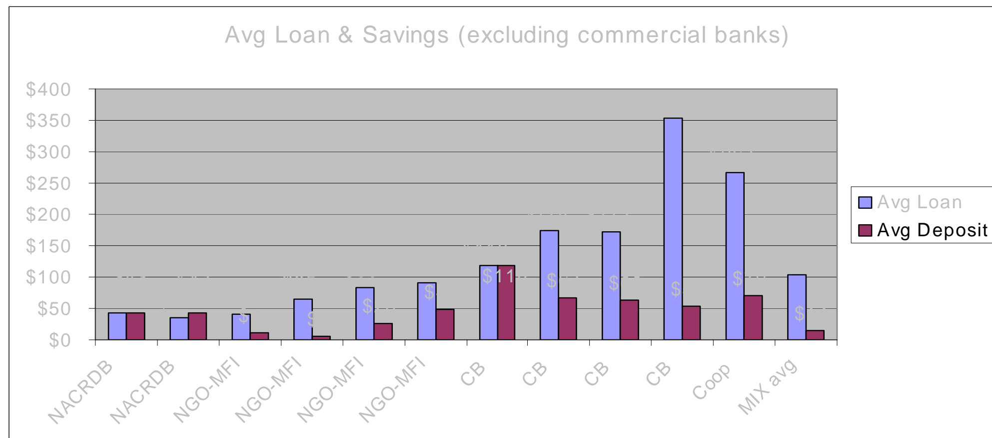


50. The commonly posited assertion that there is a greater demand in developing countries for savings than credit, appears to hold true in Nigeria, but lending is also low for a number of other reasons. First, simple profit-maximizing behavior by the RFIs leads them to prefer the high remuneration paid by the FGN on treasury bills (at the time of the study) over loan operations. Second, the higher levels of savings may reflect inadequate loan products and/or inappropriate collateral requirements, effectively driving potential borrowers to save rather than borrow.

51. While average loans and savings cannot "prove" if an institution is working with rich or poor clients (a breakdown of the range of loans would offer a more faithful picture), it does give a sense of what segment of clients are being served (see Figure 3). Average loan sizes are smallest at NACRDB ($35 and $43). These figures are much lower than the national NACRDB averages (e.g., national average microloan size for NACRDB is US$1,066) since the branches in the sample are NACRDB Category 'C' branches (outright rural). NGO-MFIs also have small average loans in the range of $40-

$91. The community banks and cooperative are lending much bigger amounts ($172-$353). The comparator commercial banks on the efficiency frontier have by far the largest average loan size ($1700-$5277) and deposit size ($212-$736) (not shown in Figure 3).

Figure 3. Average Loan and Deposit Size for the Sample



52. The NGO-MFIs collect compulsory deposits only, which explains in part the small average deposit size ($6-$26) seen in Figure 3. One NGO-MFI forms an exception ($48), perhaps because it is the only NGO-MFI that remunerates deposits. NACRDB ($43) accepts voluntary deposits, although savings is also a loan pre-requisite, so that at least some of the NACRDB savers in Figure 3 are obligatory savers. Deposit sizes are higher at the community banks and at the cooperative ($54-$70), with the Nasarawa community bank showing a significantly higher deposit size than the others. This is because it is the only financial institution in the LGH, and captures all the deposits of the Federal Polytechnic (for both staff and the institution itself).

53. The wide differences among average loan and deposit sizes of the different institutions suggest something about the general characteristics of their clients. Commercial bank benchmark branches appear to be servicing higher income clients than NACRDB and NGO-MFIs, who seem to serve lower income clients. The community banks, by nature of their salaried client base, appear to serve a medium-income level segment, as does the cooperative. This variation in outreach incidence reflects the different segments of demand for financial services outlined in Figure 1. While it is, therefore, normal that different segments of demand for financial services exist, the health and effectiveness of those institutions dealing with the poor that make up the majority of the Nigerian rural space is of paramount importance. This is informed by the following indicators.

Financing Structure

54. The community banks and the one urban NGO-MFI included in the sample are the most leveraged, relying mostly on client deposits and private investments, respectively. The remaining NGO-MFIs rely heavily on grants to fund their operations. The reasons for this are varied: they are not allowed to engage in large-scale deposit mobilization and many do not have the level of professionalism to access financial markets. Insufficient

data from the cooperative made it impossible to determine the debt/equity ratio, but staff attested that deposits are the main source of funds for the cooperative. The commercial bank branches do not report equity. NACRDB branches finance operations through client deposits and funds from Head Office, which represent about around half of each branch's total assets.

55. According to MIX, low asset allocation is the norm among African MFIs, especially MFI banks, where just over half (55 percent) of total assets are used for loans. Most of the community banks in the sample are not lending at very high levels, but this seems to reflect the profit-maximizing behavior of the leadership: Investment in treasury bills is simply more profitable. With one exception, the community banks gave the impression that lending was a necessary nuisance they had to deal with as bankers. As the chairman of one community bank interviewed stated, the "real money" is to be had with Local Purchasing Orders[45] (LPOs) and overdraft facilities. Discussions with commercial bank staff echoed this sentiment, if more subtly. Lending, especially to farmers, is perceived as highly risky, costly and unattractive unless the bank can be subsidized for its efforts. The remaining community bank, all the NGO-MFIs, the cooperative and the efficiency-frontier commercial banks show higher levels of asset allocation, in some cases close to 100 percent.

Portfolio Quality and Financial Performance

56. No institution tracks its Portfolio at Risk (PAR), so that the figures in Table 4 are estimates. One of the NACRDB branches could not even make an estimate, while the other declared that 100 percent of the loan portfolio was over 30 days late. The NGO-MFIs reported having good repayment rates (95 percent and above), and three of the five reported PAR that are in line with, or better, than the MIX benchmark. Portfolio quality among the community banks is generally very poor. One community bank estimates 50 percent of its portfolio is at risk, primarily due to some outstanding LPOs (see footnote 45). They intend to write-off these amounts this year. Another community bank reported a particularly low PAR of 3 percent, but triangulation with a GTZ report found the PAR was closer to 47 percent at the close of 2006.[46] The relatively high PAR for the third community bank (see Table 4) reflects poor repayment of 2005's agricultural loans, due to inadequate recovery techniques.

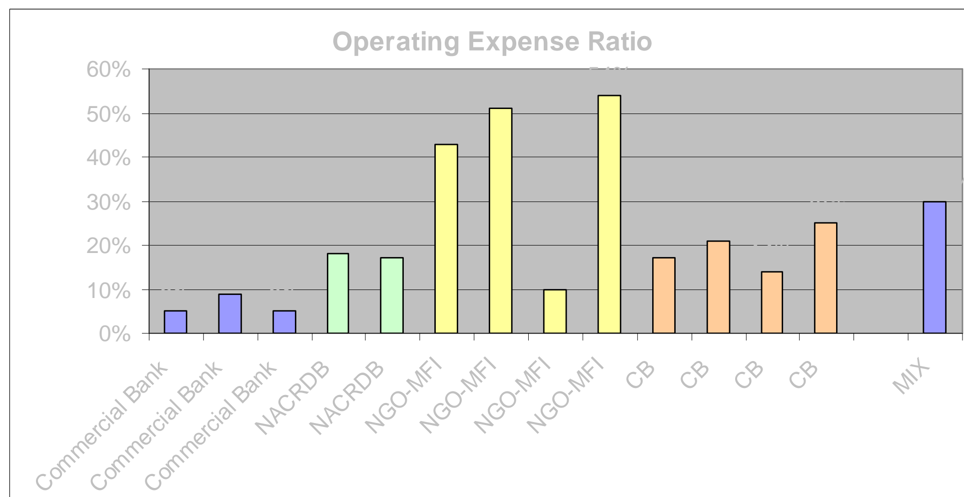
57. It can be seen in Table 4 that NACRDB and the rural NGO-MFIs—those institutions dealing with the poorer rural segments—are not operationally self-sustainable (OSS) and have negative returns on assets. Despite the myriad of fees and commissions levied on loans, NACRDB branches are particularly inefficient, primarily due to lack of loan recovery (lost interest income). NACRDB and the rural NGO-MFIs essentially survive with injections from government and donors, respectively, and the data shows this. In contrast, the cooperative, community (and commercial) banks demonstrate some

[45] LPOs are service contracts between local government and a third party. A community bank can serve as the financial channel for these contracts. They are considered very lucrative, although with risk of non-repayment.

[46] The GTZ review took place earlier than interviews. Since a large portion of the late repayments were due to the local government defaulting on LPOs, the bank may have written these off in the interim and reported their "clean slate" situation in interview for this study.

profitability. The MIX analysis confirms that operating costs are high across Africa due to weak infrastructure, challenging rural environments, and high labor costs. While it is, therefore, unsurprising that the urban-based commercial banks and the one urban MFI in the sample are operationally self-sustainable, it is encouraging that community banks and the cooperative in the sample are also covering their operating expenses with financial revenues, as can be seen in their OSS ratios. The fact that savings deposits are remunerated at a very low rate (3 percent pa, while inflation is 11 percent), if at all, keeps financial expenses low.

Figure 4. Operating Expense Ratio

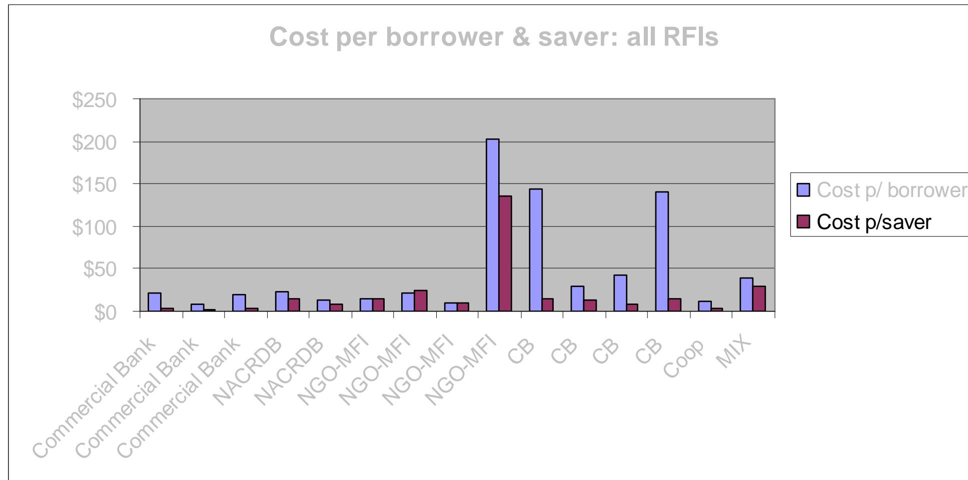


58. Analysis of operating expense ratios reveals distinct trends according to institutional type. NGO-MFIs are the most costly, with the exception of the urban MFI. Community banks have operating costs that are lower than the MIX average, and NACRDB falls somewhere in between. Unsurprisingly, given their limited rural outreach, the commercial banks are the most efficient. These results are the same across Kaduna and Nasarawa.

Efficiency

59. In terms of costs per borrower and saver (Figure 5), the rural/urban divide is much more obvious than the subtle differences by institutional type.

Figure 5. Cost per Borrower and Saver



60. The more urban institutions in Table 4 (i.e., NACRDB branches in rural towns and two peri-urban (outskirts of capital) MFI-NGOs) are situated in the low middle ($12-$23) part of the spectrum; the two community banks (small rural town location), despite a significant number of borrowers, are in the high-middle ($30-$43); and the other two community banks (smaller rural towns) and most rural of the NGO-MFIs are the least cost-efficient in terms of lending (over $141-$339). The latter may also be due to its extremely high operational expenses as a multi-purpose NGO. While the analysis reveals some variation across institutional types, apart from the rural/urban divide, it is difficult to attribute the precise source of cost variations with the data in hand. For example, loan methodology differs across the sample but not in a way that correlates with costs: Individual lending is used both by commercial and community banks, but community banks have consistently higher costs. Again, a Grameen-inspired compulsory savings group approach is used at NACRDB, the NGO-MFIs, and the cooperative, but these share no consistent cost pattern. Scale in lending appears related to costs: Of the three commercial banks, the two with the lowest operating margins and cost per borrower are also those which are lending more aggressively. Likewise, the two community banks with the highest cost per borrower also engage in very few credit operations. With respect to savings, the commercial banks and cooperative are the most efficient ($2-$4 per saver). NACRDB, the community banks, and two NGOs-MFIs are in the middle ($2-$15). The multipurpose NGO-MFI is the least cost efficient in terms of saving, once again due to high operational expenses. The exact same pattern is observed for costs per unit lent (based on unadjusted expenses).

Informal mechanisms

61. In addition to the data collected with the RFIs in the sample, a number of participatory discussions and interviews took place with informal providers and users in Kaduna and Nasarawa. Foremost among these was the 'itinerant banker' who offers savings services, and informal access to credit from rotating savings and credit schemes (ROSCAs) or *adashi*. Both mechanisms observed for this study can provide financial services, sometimes at quite a high cost to the client. In *adashi,* borrowing costs are

expressed in formulas such as "take 1000 pay 1100," i.e., 10 percent. Terms are generally monthly, making per annum rates 120 percent. The rate is high, but the methodology is appropriate for the borrower (i.e., savings-based, small amounts, easily available, rotation ensures reliable systematic access with little hassle). Costs might in fact be lower than 120 percent depending on the *adashi* group: These mechanisms generate financial revenues (interest revenue). If the revenues are fully redistributed at the end of the cycle (often 12 months) on a *pro rata* basis, the only cost of credit to members is inflation. This appears to be the case only some of the time. Some *adashi* remunerate their treasurer or keep the interest revenue as a cushion in case of default or fraud. Furthermore, individuals outside the *adashi* can and do borrow from the group at a rate of 120 percent *pa* without any 'redistribution' at the end of the cycle (since they are not members). What is clear is that at least some rural citizens borrow at interest rates far above what they are commonly thought to be able to pay. This observation holds for savings services as well. A savings-only itinerant banker collects deposits daily and charges the saver one contribution of the 30 deposits made during the month. Contribution size is fixed, making the cost to saver about 3 percent. Users of itinerant bankers, therefore, pay 36 percent *pa* for a safe place to save. Adding the cost of inflation (11 percent), savers are paying over 45 percent a year. Despite elevated interest rates and costs, rural inhabitants use these mechanisms extensively because: (i) there are few barriers to access; and (ii) repayment schedules and amounts suit their livelihood patterns. This bears important lessons for more formal providers in developing appropriate products for the rural poor and for policy makers in their views on interest rates as the only obstacles to finance. The case study interviews indicate clearly that other product attributes besides the interest rates are making a difference to rural inhabitants in Nigeria.

Cost-recovering Interest Rates

62. The data reported in the previous sub-sections is used to calculate the interest rate that an RFI would have to charge in order to recover its *current* operational costs *without subsidies*. To establish a cost-recovering interest rate and fee structure:[47]

Cost-recovering interest rate
= Total cost of funds + Estimated loan loss + Operating Margin

[47] **Cost of funds**: the direct costs of resources used in the loan portfolio, including financial costs of borrowed funds and cost of inflation on the institutions' own equity; **Loan loss reserve**: income that must be reserved for eventual loan write-offs. Loan loss reserves were estimated based on the PAR data and recovery rates. The operation margin is expressed as a percentage of assets, unless noted otherwise. Other assumptions: (1) Savings is the first source of funding for loan portfolio with cost = (savings portfolio – 30 percent liquidity requirement / total loan portfolio) * 3 percent, i.e. cost of remunerating client savings; (2) Reimbursable grants or soft loans are the second source of funding for loan portfolio = (total volume of soft loan or reimbursable grants / total loan portfolio) * 19 percent prime lending rate and (3) The remaining portion of loan portfolio is funded with own funds at a cost of inflation (11 percent).

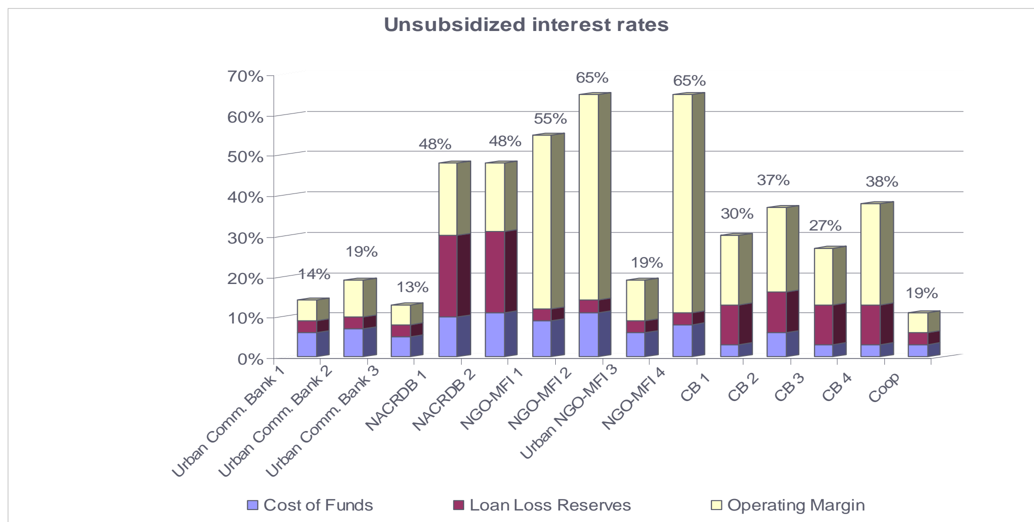
Table 5. Estimated Cost-Recovering Rates for Sampled Institutions

	Commercial Banks			NACRDB Nasarawa	NACRDB Kaduna	MFI Nas.	MFI Nas.	urban MFI Kaduna	MFI Kaduna	CB Nas.	CB Nas.	CB Kad.	CB Kad	Co-op Kad.
	Katsina	Kaduna	Borno											
Cost of Funds	6%	7%	5%	10%	11%	9%	11%	6%	8%	3%	6%	3%	3%	3%
Loan Loss Reserves	3%	3%	3%	20%	20%	3%	3%	3%	3%	10%	10%	10%	10%	3%
Operating Margin	5%	9%	5%	18%	17%	43%	51%	10%	54%	17%	21%	14%	25%	5%[48]
Estimated cost-recovering interest rate	13%	19%	13%	48%	48%	55%	65%	19%	66%	30%	37%	27%	38%	11%
Current rate *pa*	19%	19%	19%	8%	8%	30%	48%	20%[49]	39-40%	25%	25%	19-20%	23-28%	18%

The cost-recovering interest rates reported in Table 5 are undisputedly high, despite a high reliance on savings remunerated at a rate that is inferior to inflation (providing further evidence that clients are willing to pay for a safe place to save). Breaking down the sources of these high rates shows that the underpinning costs vary across institutions.

63. The factors behind divergent cost-recovering interest rates vary importantly by institutional type (see Figure 6).

Figure 6. Breakdown of Costs Underpinning Current Cost-recovering Interest Rates



inefficiencies, the rural poor cannot be expected to pay for them through interest rates upwards of 50 percent-60 percent. Second, Figure 6 shows that cost of funds is lowest for community banks—unsurprising given their extremely low levels of lending. All other RFIs have cost of funds somewhat higher than the efficiency frontier commercial banks. Finally, loan loss reserves are highest for NACRDB and the community banks, reflecting poor loan recovery. In contrast, the NGO MFIs have loan loss reserves that reflect their superior loan recovery performance at par or better than the commercial banks. This is despite the fact that MFIs have a similar clientele to that of the NACRDB and a riskier one than the commercial banks.

64. Based on this analysis, current effective interest rates for most of these institutional types are less than what is needed in order to cover their costs. But these costs are indisputably too high. What is interesting is to see whether prevailing government interest rate policies would permit sustainability if these RFIs were to become efficient. As a starting point, note from Table 4 that only the urban institutions (commercial bank comparators and the urban MFI) can sustainably lend at the current prime lending rate of 19 percent. At 8 percent, current official interest rates for lending are far too low even for these urban 'efficiency frontier' institutions. This is truer still for the institutions focused on agricultural lending and providing services for low-income rural populations. Using data parameters for best practice microfinance[50] permits the calculation of cost-recovering interest rates for efficient Nigerian RFIs. These calculations indicate that *even a relatively efficient rural client-focused RFI would currently need to charge between 20 percent-30 percent in Nigeria*.

[50] Accepted benchmarks for good MFI practice in a rural environment include: operating expenses of 10 percent-15 percent of total assets; primary reliance on client savings; (cost of funds in the Nigerian context of 5 percent-8 percent); with a good quality loan portfolio (PAR 5 percent-7 percent).

New Approaches to Rural Finance in Nigeria

65. Nigeria's rich history with rural finance has left a mixed legacy which forms the backdrop for future rural finance. Based on this backdrop and on the new data on RFI costs, what can good practice rural finance elsewhere in SSA and the world offer Nigeria?

REDUCING COSTS THROUGH BETTER OUTREACH

66. Much more detailed research into why RFI operating costs are so elevated is required in order to target interventions accurately. Nevertheless, output from the study specifically suggests that scale in lending was found to be positively correlated with costs. Improving outreach through more appropriate products for rural people, better organization, better products, and simple efficiency technologies has proven effective elsewhere in SSA (see Box 1).

Box 1. Increasing Outreach, Reducing Costs and Achieving Profitability through Apex Organization and Computerization: The Case of Ghana

In Ghana, a network of rural and community banks (RCBs) founded the ARB Apex Bank in 2001, with the support of government and donors. Apex Bank provides, among other services, money transfer services nationwide, fast check-clearing, specie movements to all rural banks, and, importantly, implementation support for computerization, training and capacity-building. The table below shows the resultant increase in the number of clients reached.

	2001	**2005**	**2006**
Number of RCBs	115	121	122
Number of agencies	228	460	463
Number of depositors	1,129,316	2,116,428	2,493,004
Number of borrowers	139,325	293,499	358,092

The increase in outreach resulted from solid training and capacity building. This in turn led to lower costs and higher profits for RCBs in the project (see table below). Cost savings and increases in revenue are also due to the efforts put into check clearing, provision of species (cash) by Apex Bank to the rural banks and new procedures for loan recovery introduced to the banks.

	2000	**2005**	**2006**	**March 2007**
Total assets	316.62	2,260.83	2,987.54	3,223.40
Total deposits	236.49	1,688.02	2,264.61	2,453.20
Net worth	45.19	320.89	384.28	416.70

Source: World Bank 2007a, 2007e

67. In addition to better organization, case study interviews clearly show that non-repayment accounts for much of the transaction costs of those Nigerian RFIs with the best rural outreach (NACRDB and the community banks) (see Figure 6 on page 27). In addition to capacity building and training in loan recovery, initiatives like a credit bureau have helped with loan recovery elsewhere in the world, even for rural areas (see Box 2). Credit bureaus help decrease appraisal costs and reduce risk for rural and urban providers alike.[51] Since both costs and risks are higher in rural areas, the potential payoff of such an

[51] CGAP 2006

initiative is higher, particularly given the culture of non-payment that has arisen in Nigeria. In a study of the impact of credit bureaus on MFIs, it was found that the use of credit bureaus led to large efficiency gains for the MFI through significant decreases in arrears for individual loans.[52] The development of rural credit registries can be as simple as exchanging client 'blacklists', which has been used with some success in Haiti, but almost certainly require some legal reform and public support. Legislation passed in Russia, Kazakhstan, Ghana, Kenya and Uganda mandating information sharing has paved the way for active credit bureaus in these countries. In Nigeria, two independent credit providers and a bank-owned credit bureau are already in the process of being set up while FGN works in parallel on the legal framework.[53] Nigeria is also involved with other countries in the region to establish MFI credit bureaus. While some provide the necessary context, none of these initiatives target the 'tougher' market of rural areas, and a rural credit registry initiative that links MFI information to wider credit bureau efforts in the country could fill the gap.

Box 2. Credit Bureaus and Cost Reduction: The case of Crediref in Guatemala

In Guatemala, making available credit information from rural borrowers who were experienced with NGO-MFIs, increased the financial access of rural entrepreneurs. The growing business needs of rural borrowers in Guatemala required them to access finance beyond the microfinance institutions with whom many had been operating. The collateral requirements of formal sector banks were very real deterrents, made more acute by the lack of credit history banks had with the rural poor. MFIs developed a system for credit referrals which supported some 100 of Guatemala's 2000 MFIs. This provided the basis for the formation of a universal database (Crediref) containing the data from formal, agricultural and microfinance institutions covering upwards of 120, 000 people in its first few years of operation. By making the reputation privately held by one MFI a public good, the credit registry can reduce risk and lending costs for rural finance providers.

Experts warn that there are also risks associated with the introduction of credit reporting: Misinformation about individuals who have weak recourse can worsen their access to loans. Also, if credit information is used to concentrate energies on the 'good borrowers', this may reduce access by new borrowers with no history.

Source: de Janvry et. al. (2003)

68. The clear rural/urban divide observed in the case study data merely reflects an almost universal fact that the rural environment for financial services is simply more expensive. Interviews for this study suggest that infrastructure (cost of generators for electricity, poor roads) can contribute to the high operating margins observed in the data. To the extent that this is true, overall investment in rural infrastructure remains important. In addition, since such infrastructure constraints--and low densities in rural Nigeria—make 'bricks and mortar' branch investments costly and hard to recover, there is a strong role for remote or mobile banking technologies. This has been the experience in both Asia and Africa, where successful access for rural people has been partially achieved through mobile phone banking (see Box 3).

[52] USAID 2006
[53] World Bank (2007c)

Box 3. Reducing Costs through Innovative Technologies: The case of Mobile Phone Banking

Mobile phone technology is emerging as a promising channel for providing a range of financial services to isolated populations in a way that is faster, cheaper, and more secure than conventional methods.

Mobile phone banking is perhaps nowhere as developed as the **Philippines,** where two mobile phone networks (SMART Communications and Globe Telecoms) offer payment platforms that allow mobile phone customers to repay microloans, receive salaries, send remittances, pay bills and make deposits and withdrawals. The Philippine Central Bank has been proactive in issuing resolutions that recognize both payment platforms. It has also created a supervisory group to review and analyze the various mobile phone banking applications that have been developed, and conducts inspections of SMART and Globe to review procedures.

In **South Africa,** the mobile phone banking company WIZZIT offers money transfers, bill payments, deposits and withdrawals, in addition to debit card access to its clients. Users do not need to have a bank account, and the WIZZIT platform is designed to work with even the most basic mobile phone technology.

In **Kenya,** Vodafone has been testing the waters of e-banking since 2005. After piloting an e-banking initiative with MFIs, Vodafone launched M-Pesa in partnership with Kenyan telecom leader Safaricom in early 2007. M-Pesa is a mobile phone payment solution aimed at reaching mobile phone customers who do not have bank accounts. Customers can access M-Pesa transfer services by registering their Safaricom mobile phone number and identification card with an M-Pesa agent.
These early successes offer lessons for Nigeria: While the technology is both available and appropriate, implementing e-banking demands more than technological infrastructure. Like the development of any financial product, thorough understanding of the users' profiles and needs is key to success. Moreover regulatory issues must be addressed, and require close coordination between communications and central bank authorities.

Sources: Isern et. al. (2005), Wright et al. (2006)

69. Nigeria is at the doorstep of mobile phone banking. With high mobile penetration (an estimated 26.6 million phones in Nigeria in 2006) the potential is great. First Inland Bank has already joined forces with Nigeria's second biggest mobile operator to introduce a prepaid debit card in September 2006. The prepaid card allows users who do not have bank accounts to perform electronic transactions via the network. First Inland Bank has also entered this market with a system which allows account holders to send and receive money using their phone and to download recharge vouchers online. Once a consumer requests a payment via the system, they receive a text message on their mobile phone, which they take with their ID to any First Inland Bank branch to receive payment. Zenith Bank also has a system that uses SMS technology that permits customers to carry out transactions via a GSM handset.[54] The extension of efforts such as these to a rural clientele will require special efforts.[55] The currently high cost of mobile phone operations, high levels of illiteracy and relatively poor mobile phone penetration in rural areas means that private public partnership will have to be forged to overcome these

[54] The Banker (2007)
[55] These efforts could, and should, leverage ongoing initiatives like the IFC rural telephone project, which hopes to eventually include a mobile banking (m-banking) service.

obstacles—partnerships that have proven well worth the while elsewhere in the world (see Box 3).

ORGANIZATIONAL REFORM OF THE AGRICULTURAL BANK MODEL

70. Nowhere does institutional reform hold more promise than for NACRDB. NACRDB's poor performance as an institution has been amply documented[56] and the branch visits made for this study confirm the poor state of operations. NACRDB and FGN already recognize that the institution is ripe for reform and have engaged with IFAD on a capacity building program (RUFIN) as discussed earlier in the document. Furthermore, as a result of recent policy changes in April 2006, all branches are separate cost centers and must manage to cover their operating costs in six months or face closure.[57] Similar institutions elsewhere in the world have already been where NACRDB is now, and have transformed themselves—through a program of reform and capacity building—to become the effective rural and agricultural financial institutions desired by FGN and its stakeholders. The dismal performance of most AgDBs set up in the 1960s and 1970s under the old paradigm of 'agricultural finance'—characterized by the notion that subsidized and targeted credit could promote agricultural production and improve the lives of smallholders—convinced many that AgDBs had little to offer. With few exceptions, most have been privatized or liquidated, or simply "limp along" with just enough government funding to stay afloat. Nevertheless, there have been a number of successful turn-arounds that have lent credence to the idea that the development financial institutions like NACRDB present significant potential. Two turn-arounds (Mongolia and Tanzania) involved insolvent AgDBs who failed privatization attempts. They both served hundreds of thousands of clients and shutting them down was not an option their governments wanted to consider (see Box 4).

[56] IFAD (2004); World Bank (2000).
[57] While this is NACRDB's desire, it is unknown whether the FGN would really permit closure of branches in areas where NACRDB is the only financial institution.

Box 4. Reforming Agricultural Development Banks: The cases of Tanzania and Mongolia

The **National Microfinance Bank of Tanzania** had 100 branches and processed government payments throughout the country when in 1999 the World Bank brought in a management team from the consulting firm Development Alternatives, Inc. (DAI). The overhaul strengthened the transfer products, improved credibility of the institution (and consequently deposit mobilization) and introduced microcredit, including loans for small-scale farmers. Within three years, the bank was profitable, the operating expenses ratio dropped drastically, and the bank was successfully privatized.

In the case of **AgBank Mongolia**, the government of Mongolia, World Bank, and USAID came together to bring in a management team from DAI to take over management in July 2000. The goal was to prepare the bank for privatization. The government agreed to give the management team control over day-to-day operations and spearhead the decision-making process for major policy changes. The overhaul was extremely successful; it focused on management reform and the introduction of new products. Within three-and-a-half years, the bank was not only profitable but it also grew to 379 branches and was serving about 98 percent of Mongolia's rural communities. It was privatized in March 2004.

The consulting firm that assisted with the reforms in both cases distilled some very clear lessons from their experiences. First, a set of "pre-conditions" are deemed essential before endeavoring a turnaround. These include: (i) the presence of an underserved market whose demand for financial services is sufficient to support the restructured institution; (ii) a management team that has the power to work independently, free of political interference; and (iii) a government prepared to bring the bank's capital to an acceptable minimum level and to support the bank as a client, paying for services (transfers, payments, work orders, placement of government deposits, for example) until the bank can diversify.

Source: Dressen, Zayer and Northrip (2002)

71. Privatization is not the only avenue for ailing state development finance institutions, as the rural finance component (now known as the Microbanking Division) of Bank Rakyat Indonesia (BRI) proves. The dramatic and rapid (2 year) turnaround of BRI from a highly subsidized agricultural credit program to a profitable, subsidy-free profit center has been the object of in-depth study (Robinson 2001). The lessons distilled from the BRI experience can be of great relevance to NACRDB.[58] The turnaround centered on reform of borrower eligibility requirements that extended beyond agriculture, inclusion of voluntary savings, appropriate lending products and a return to cost-recovering interest rates. Each rural branch increased their client base to include profitable rural enterprises in addition to farmers, lowering costs and spreading risks. The bank did not make savings compulsory since compulsory savings tends to obscure both the cost of credit to the borrower and the actual net credit outstanding. While branches are legally obliged to take collateral, they are flexible in doing so. Loan products are better tailored for rural people. Branches offer a variety of term and repayment schedules to correspond to the cash flow of different activities it finances. To improve communication, standardized loan tables are provided to clients, detailing each loan payment, broken down into interest and principal. Loan size minimums and maximums were established to ensure low-income clients are reached. Finally, interest rates were initially set with the intention of reaching sustainability within two years. Branches do not charge any other fees to avoid corruption. Borrowers are actively incentivized to pay on time, receiving a refund that is equivalent to about 12 percent *pa* measured against a declining loan balance if they pay on

[58] This summary draws heavily on Yaron (2005).

time. For NACRDB, as for agricultural development banks around the world, more appropriate products and techniques hinges upon good governance and professional management. Technical assistance, staff training and MIS support proposed by the IFAD RUFIN Project cover exactly these aspects.

PART OF THE PACKAGE: FINANCING AGRICULTURAL ACTIVITIES

Issues in Agricultural Finance

72. Even if institutional and organizational reform, better information, new technologies and infrastructural investments help Nigeria's RFIs to achieve lower cost operations, the high risk/low return perception for the agricultural sector remains a daunting obstacle. Yet, a quick look at the rates of return on common agricultural investments in Nigeria shows that the returns in many cases are adequate to cover cost of financing even in the 'cost-recovering' range of 20 percent-30 percent (see Table 6 and Table 7). A recent study has found that even smallholder production,[59] largely viewed as unprofitable in Nigeria, can enjoy profit rates that make lending in the 20 percent-30 percent range a profitable endeavor (see Table 6).

Table 6. Net Profit Rates on Selected Smallholder Crop Production in Nigeria (2006)

Commodity	Net profit rate (after depreciation)
Cassava	113%
Cotton	37%
Maize	96%
Rice	383%
Soybean	64.6%
Sugar	2%

Source: Based on World Bank (2008)

Table 7 below shows the profitability of a wider range of agricultural sector activities, primarily in agro-processing, which makes it very important that rural finance solutions have a broader scope than targeting just farmers. Doing so will help RFIs diversify risk and to become sustainable partners for farmers and other rural citizens alike.

[59] In this World Bank (2008) study, smallholder production is characterized by agriculture operations where family members double as managers. These operations have no permanent full-time hired workers and may rely only on seasonal labor hired at peak production times

Table 7. Rates of Return on Selected Agricultural Investments in Nigeria

Activity	Conditions	Total Investment (N)	Return to Capital
Agro-processing			
Aquaculture	Pond Size: 100m2 x 1.5 in. deep	155,125	900%
Rice Milling fro 3 years	period of 3 years	417,040	47%
Palm Fruit Processing	period of 3 years	669,820	134%
Mellon Threshing	period of 3 years	262,817	108%
Cassava Processing to Garri	period of 3 years	656,128	102%
Cereal Processing	period of 4 years	441,135	107%
Fish Processing	period of 3 years	3,775,870	16%
Irrigated production			
0.25ha of 2.5 Ha irrigation module using 3" Honda petrol water pump and surface water supply		98,452	45%
1 ha irrigation module package with 2" honda water pump and wash bore		152,448	107%
0.5 ha irrigation module using 2" Honda water pump and wash bore		76,224	107%
0.25 ha irrigation module using 2" Honda water pump and wash bore		37,919	107%
1 ha irrigation module using 2" Honda water pump and tube well		188,398	78%
0.5 ha irrigation module using 2" Honda water pump and tube well		94,199	78%
0.25 ha irrigation module using 2" Honda water pump and tube well		47,100	78%
1ha of 2.5 ha irrigation module using 3" Robin diesel water pump and surface water supply		203,988	119%
0.5ha of 2.5 ha irrigation module using 3" Robin diesel water pump and surface water supply		101,994	119%
0.25ha of 2.5 ha irrigation module using 3" Robin diesel water pump and surface water supply		50,997	119%
1 ha of 2.5 ha irrigation module using 3" Honda petrol water pump and surface water supply		196,881	42%
0.5 ha of 2.5 ha irrigation module using 3" Honda petrol water pump and surface water supply		98,452	45%
Rainfed production			
1 ha rainfed production (millet, maize, sorghum, cowpea)		61,236	25%
1 ha rainfed production (yam, maize, cassava)		103,513	53%
Livestock			
Pig Fattening	24 weaner piglets	243,810	22%
Layer hens	250 day old chicks	525,677	39%
Layer hens	200 lay birds	502,911	13%
Layer hens	200 growers	485,921	17%
Cockerel production		96,326	42%
Bull Fattening		190,808	43%
Broiler Production		141,586	71%
Ram Fattening		147,393	22%

Source: Yaro (2004)

73. The profitability of agricultural and non-farm investments, however, do not grant permission to skirt the two key issues for rural finance policy makers in Nigeria: *How* to lend to farmers and what to do for the rural poor who cannot afford efficient—or indeed—subsidized interest rates. The vulnerable poor who simply cannot bear the risk of debt do not require lower interest rates, but rather livelihood assistance to enable them to participate in some of the productive activities with higher rates of return. This assistance is ongoing in various FGN and donor projects and should link with wider rural finance

developments. In some cases (e.g., World Bank Fadama II Project), matching grants for productive assets may be necessary to permit the very poor to graduate to more formal financial access. Other approaches to providing access for the very poor start with savings that are then lent among group members and eventually linked to formal financial institutions, similar to the SHG-Bank Linkage Program already attempted in Nigeria. In India, the approach has met with considerably more success due to a few critical factors (Box 5).

Box 5. Access for the Rural Vulnerable Poor: The case of SHGs in India

Over the past 15 years, the average annual growth of Self-Help Groups (SHGs) in India has topped 80 percent. One of the most important initiatives guiding this development is the SHG Banking Linkage Program, launched in 1992 by the government-owned National Bank for Agriculture and Rural Development (NABARD). Working with 620,109 SHGs in 2006, it integrated more than nine million households into the financial sector.

Indian SHG's have between 15 and 20 members and are autonomous groups that collect savings and then deliver loans to members. Emphasis is on **voluntary and high quality group formation.** SHGs are usually formed with the assistance of a promoting institution (governmental or non-governmental). Most SHGs are federated to help with financial **monitoring** and accessing finance from external sources. Most Indian SHGs reach the very poor, a population that is both landless and illiterate. A CGAP study of 150 of the more successful SHGs in India finds that the majority of members live in very remote areas (far from paved roads and other infrastructure). Initial loan sizes are very small (US$2.50–US$45.00), and **livelihood support services** (health care, literacy training, mid-day meal, skills training) are often offered in tandem by the promoting institution. Members join to get loans and access these other services.

There are other lessons from the Indian success story for Nigeria: *Member participation and group solidarity is critical to an SHG's sustainability as are good organizational support and social mobilization techniques on behalf of the promoting institution*. Groups formed to respond to immediate incentives (like accessing government gas connections) tend to disband once the member's short-term goal in achieved.

Sources: CGAP (2007), Fouillet (2007).

74. While off-farm revenues play an important role in rural households, particular challenges of agriculture must be faced head on. In agricultural lending, there is a need for both term finance (for acquisition of land or capital for value added activities) and short-term credit and cycle-smoothing savings services. Helping RFIs to tap into remittance payments and into non-farm activities to diversify risk could be a major step forward for rural financial institutions offering services to farmers. But there is also a call for innovative agricultural financing outside traditional RFI loan products and, indeed, beyond subsidized agricultural credit. For example, agricultural term finance needs have been successfully met elsewhere in the world by leasing (see Box 6). In the case of short-term crop finance, it may well be that harvest cycle needs can be met through alternative channels at lower costs than can ever be achieved by an RFI. One such example is that of supply chain finance.

Box 6. Success Stories in Term Finance: The case of Leasing in Madagascar

The Caisse d'Epargne et de Credit Agricole Mutuel (CECAM) is an agricultural finance cooperative in Madagascar. CECAM introduced leasing in 1993 for a range of assets, including farm implements, draft animals, dairy cows, irrigation equipment, bicycles, and sewing machines. Flexible payment schedules are adapted to the crop cycle and the leased asset is the main security and source of payment. Given the lack of collateral of many rural households, this was an ideal option for CECAM. Factors critical to CECAM's success include the selection of clients with good experience and skills in handling the asset. So, for example, CECAM's clients will tend to already have some equipment or animals and the lease represents an upgrade. CECAM also requires down payments and involves farmers groups in the assessment of the lease application and prospective lessee. CECAM originally made the group jointly liable for the lease, but this requirement faded away with experience and a reduction in the perception of risk. Other factors contributing to CECAM's success include strong monitoring and supervision using community groups. Default is immediately dealt with, maintaining the credibility and profitability of the intervention.
Source: Hollinger (2004)

The Potential of Supply Chain Finance

75. Supply chain finance can fill a gap for short term crop-related financing. It has been used with some success in SSA and elsewhere in the world, for supply chains ranging from bulk commodities to specialty niche products. In Mozambique supply chain finance in the cotton sector reached some US$2 million for inputs in 2003. In Kenya, company credit for horticulture inputs is successfully extended to some 20,000 smallholders annually.[60] Supply chain finance is often in the form of a credit advance, or an input credit package and a market channel, as opposed to a generalized loan. Supply chain finance may be linked to the procurement of crop (e.g., crop buying advances, outgrower, or contract farming) or may not (e.g., input suppliers providing credit). Above all, it is short term, usually lasting a crop cycle. It needs to be distinguished from finance provided for investments in equipment, land, or other term financing needs. IFAD, in a comprehensive review of supply chain finance in Africa, notes that despite the comparative advantage of supply chain actors in terms of outreach, the research on rural financial institutions abounds, while that of supply chain finance is sadly lacking.

76. To explore new approaches for rural finance in Nigeria, this study, therefore, undertook original research with rice and cassava supply chain finance in Kaduna and Nasarawa states, respectively. The objective of the supply chain research was to inform on the potential role of supply chain finance in the provision of financial services to both farmers and non-farm entrepreneurs in rural Nigeria. Research was conducted with supply chain actors in the main market towns of the two states (see Annex 3) and surrounding areas. Semi-formal interviews and focus group discussions with farmers were also used. The selection of Nassarawa and Kaduna as case studies was reviewed in Section 3—their characteristics differ sufficiently from each other so as to represent different points in the great range of diversity found among the Nigerian states.

77. Cassava was chosen as a case study, given the huge potential outreach for this commodity if supply chain finance were successfully introduced. Nigeria is the world's largest producer of cassava. Almost all of its 38 million metric tons (MT) is used

[60] IFAD (2003).

domestically. In Nigeria, cassava is the largest crop in terms of output and sixth largest in terms of planted area. It is cultivated across the country, but concentrated in southern and north central zones. Cassava is a major source of rural employment. Smallholders are the primary producers, representing some 87 percent of total land area under cassava cultivation. As such, it is also a source of food security for rural families. In Nigeria, 85 percent of production is used for food, while livestock feed and starch represent only 10 percent and 5 percent, respectively.

78. Similarly, Nigeria is the 2nd largest rice producer in Africa. The country is the largest importer of rice in the world, bringing in 1.4 million tons in 2004. Demand for rice has increased considerably over the last couple of decades for reasons related to population growth, urbanization and a shift in eating habits. Rice is the 7th largest crop in terms of planted area. It is cultivated across the country, but concentrated in the eastern and middle belt states. Kaduna State is the largest producer of rice, accounting for 22 percent of Nigeria's annual rice production and 30 percent of Nigeria's agricultural GDP. Produced mainly by smallholders, rice is a chain with high potential outreach for crop-finance.

Cassava

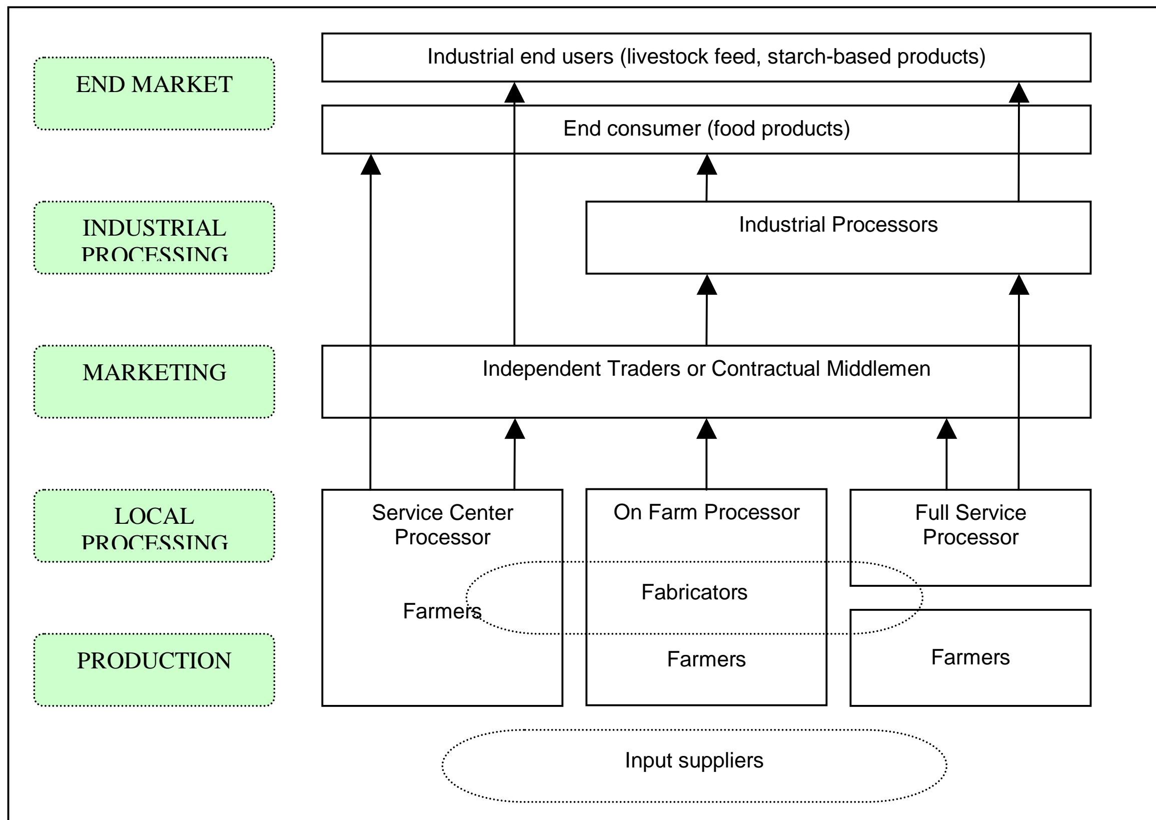
79. Demand for cassava has increased considerably in the last five years, mainly due to a drop in purchasing power which has led urban dwellers to look for a cheaper staple than rice. Other demand stimulants include the Presidential Initiative that calls for the use of 10 percent of cassava flour in bread-making, a ban on importation of livestock feed, and encouragement for the demand for ethanol. As a result, production has increased, but mainly due to increased area of cultivation rather than increases in productivity. Productivity is low and even declined between 1999 and 2004.

80. In Nasarawa State, cassava is cultivated and processed for food use. The market trades in traditional products (e.g., *gari,* chunked, dried cassava, and basic starch). There is no sign of minimally processed products (e.g., dehydrated *fufu* for reconstitution) or agro-industrial products (e.g., complex starches, ethanol). Smallholder farmers in Nasarawa produced some 1 million tons of cassava in 2005, roughly 3 percent of Nigerian output. Smallholders in Nasarawa cultivate about 80,000 ha of cassava, representing 2 percent of the total 4.1 million hectares cultivated in the country.[61] Smallholder cassava yields in Nasarawa are higher than average, at 14 tons per ha, compared to 12.5 for smallholders nationwide. The farmers interviewed for this study do not use fertilizer but do receive cuttings from the Nasarawa State Agriculture Development Program. Men have been the traditional producers of cassava, but an increasing number of women are now planting. Women (and children) continue to be the main processors. In Nasarawa, the study team identified three forms of processing: (i) On-farm processing of own production by larger scale farmers with sufficient capital for a grater and/or presser; (ii) service center processing that charge a fee to small- or medium-scale producers who bring their cassava tubers by the truckload for processing into *gari;* (iii) full-service processing under private or cooperative ownership. If private, the owner purchases cassava from

[61] World Bank (2005b)

small- or medium-scale producers and then has it peeled, washed, pressed, dried, and packaged in basins. If cooperative, members process their own cassava or may process others' produce for a fee. End-product (*gari*, starch or chunked cassava) is then sold to marketers. Industrial processing represents a fourth form of processing, although not identified in Nasarawa. Industrial processors work with sophisticated equipment to create starch-based end-products like livestock feed and ethanol. As noted above, such products represent only 5 percent of cassava usage in Nigeria. The remaining actors in the chain include marketers who may be independent traders or middlemen working for firms that buy in large quantities. In Nasarawa, independent traders tend to be locals, and conduct transactions either directly with producers who process their own cassava or at the weekly market. Middlemen resemble traveling salesmen who cover various regions of the country, purchasing produce directly from processors, large-scale producers, or in the marketplace. The following figure represents the cassava supply chain as observed in Nasarawa.

Figure 7. Map of Cassava Supply Chain



81. Interviews reveal that most cassava chain financing is informal. That is, it does not involve written contracts or legally-binding terms. Among interviewees, trader credit to farmers is the most prevalent form of supply chain finance, but outreach is low. For small-scale farmers, the extension of credit seems occasional, occurring only when the demand for cassava is high. Under these circumstances, processors and marketers might extend credits in the range of N50,000-N150,000, and reimbursement is in kind.

Establishing the cost of these arrangements is difficult, since there is no stated interest rate. The marketers and processors interviewed for this study insist that when the time comes for farmers to reimburse credit offered at planting, produce is valued at market prices. Interviewees were clear that they lend because they have to secure produce, rather than to generate income for themselves. With the prevailing glut due to the Presidential Initiative, incentives to provide supply chain finance are low, resulting in the low current levels of supply chain finance observed. Furthermore, given that very few small-scale producers are accessing improved inputs, demand for (input) credit is also low. If current efforts to boost productivity are successful, the demand for inputs will rise.

82. Larger scale farmers, who have a greater need for working capital for improved crop inputs and labor, do obtain cash advances from marketers in the range of N1 M-N5 M. They reimburse the loan in kind, with cassava valued at prevailing market prices. For investment needs, these farmers must turn to NACRDB and other sources of term finance, or not at all. Similarly, processors in the chain have financing needs for machinery and equipment upgrades. These needs clearly fall outside the gambit of what is understood as 'supply chain finance' and rather represent term finance needs that are more likely met by more formal rural finance institutions (provided that processors have the financial literacy to qualify and apply), or through leasing arrangements. In this sense, there is much synergy with ongoing private sector development work, such as that pursued by USAID in their 'Maximizing Agricultural Revenues and Key Enterprises in Targeted Sites' (MARKETS) program or FGN's SMEEIS. Certainly, developing stronger and more vibrant supply chain actors can in turn feed the potential supply of credit to producers for crop-related activities, and this is part of any supply chain finance strategy.

83. Interestingly, interviews confirmed that liquidity is much less of an obstacle to providing financing to farmers than expected. Furthermore, contrary to experience elsewhere in the world, side selling was not cited as a particular concern in interviews. This is perhaps because the fundamental incentive (securing produce) to participate in supply chain finance was missing for cassava at the time of interviews, so that issues like side-selling were not relevant. With a scaling up of supply chain credit in Nasarawa, fieldwork observations suggest that side-selling would be a particular risk for cassava, where there are many potential buyers on the move at harvest time. Some form of contract enforcement would then clearly be needed to reduce the perception of risk. More immediately, in light of the fundamental disincentive in cassava (glut), it might be more worthwhile to examine storage issues. First, in the cassava sector, where quality of chunked cassava is an issue and gluts are cyclical, a warehouse system could be particularly beneficial. Second, Nigerian law currently recognizes warehouse receipts as a document of title, and permits a pledge to be made over moveable goods. The law gives the pledge full control over pledged goods, indicating that warehouse receipts could serve as collateral. Indeed, commercial banks are already currently accepting warehouse receipts from large commodity buyers. This would, therefore, expand the scope of financial access for smallholder cassava producers beyond supply chain finance and into longer term finance: *with storage and warehouse receipts in the picture, the potential for communal storage spaces to be linked with financial institutions exists*. This involves several externalities as well. In addition to formalizing trade transactions, warehousing contributes to the gradual development of an information system that tracks the

production of farmers, provides protection against post-harvest losses, and improves the consistent quality of commodities. Warehouse receipts also make it possible for farmers to plan cash flow more easily. Even so, basic marketing fundamentals, including consistent and non-distortionary agricultural policies, need to be developed in each chain if there is to be a solid foundation for supply chain finance.

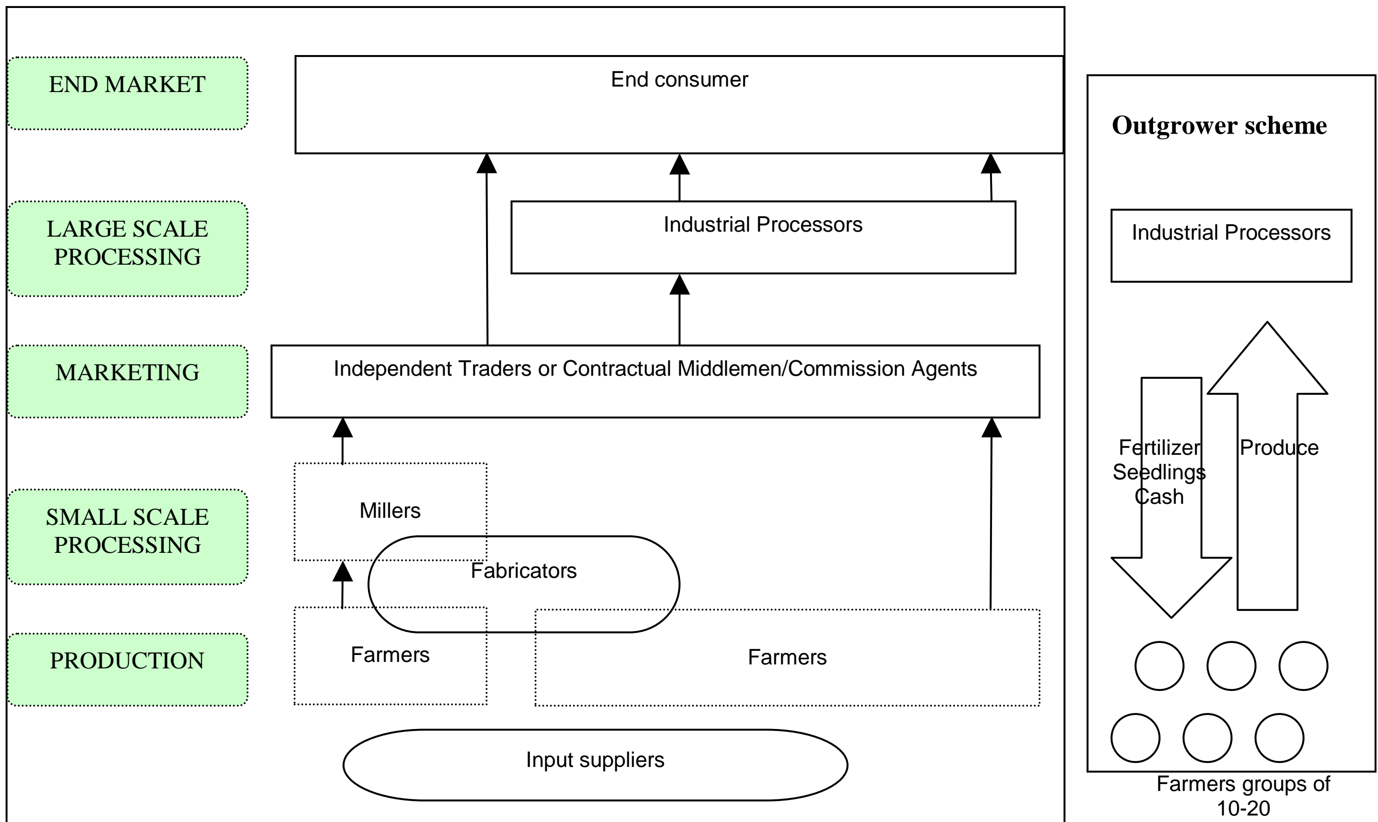
Rice

84. The case study of supply chain finance for rice in Kaduna differs in two important respects from cassava. First, there is a stronger potential presence of outgrower schemes in the rice sector in Kaduna. Second, commodity conditions differ so that liquidity of processors and input agents is more of an obstacle to supply chain finance than for the 'gluts' observed for cassava. As in cassava, trader credit is the most prevalent form of supply chain finance. The rice commodity chain (see Figure 8 below) in Kaduna comprises some 300,000 smallholders and 50 large-scale farms, which produce rice with mechanized techniques. Few smallholders use inputs or improved seeds due to financing constraints; the exception are those who received one of the few'R-boxes' distributed throughout the state for the 2006 planting season. Storage facilities are virtually nonexistent. Despite high production levels, processors in Kaduna State are relatively small scale, as paddy is usually purchased by traders from farmers and taken outside the state to major processing centers in Abakaliki, Lafia and Kano.62 The local processing that does exist is mainly carried out by millers who for the most part belong to an association. They work with simple equipment to parboil and mill the rice, and drying is usually done on the ground. Rice is then sold at the marketplace or directly from the processing site to traders. Larger farmers may engage in on-farm processing if they have the equipment. As with cassava, marketers may be independent traders or middlemen working for firms that buy in large quantities. No marketers were interviewed in Kaduna, but secondary sources report that middlemen generally come from other states to purchase paddy (and, to a lesser extent, milled rice) from the small processing groups. A grain merchant with established outgrower schemes63 was identified in the larger LGH of Zaria, who does not work with rice. This merchant is nonetheless included in the analysis, given his potential interest to move into rice. One of Nigeria's major input suppliers, Premier Seeds, is located in Zaria. Several equipment fabricators are also established in the state, in Kaduna town and Zaria.

[62] These are essentially rice importers who have received the authorization of FGN to import unfinished rice for final processing. These rice merchants do not serve local rice producers (personal communication with WB MSME specialist).

[63] Outgrower schemes refer to an integrated form of contract farming, whereby a processor or buyer provides inputs (in kind (e.g., fertilizer) or in cash) to a group of farmers in exchange for their produce. In an outgrower scheme, smallholders are offering their land and labor in return for a package of inputs and/or extension services. (Pearce, 2003).

Figure 8. Map of Rice Supply Chain



85. As for cassava, the demands for financing along the chain can be divided between term (or investment) finance and short-term (or crop) finance. Producers require crop finance, for insecticides (and for larger farmers, other crop chemicals), labor for land preparation, planting and harvesting. Supply chain finance for this short-term agricultural activity currently comes from two sources: trader credit and a limited outgrower scheme for seedlings (see below). Marketers and traders in the chain interviewed did not express any particular financing needs. Given that marketers and traders are the primary source of supply chain finance that does take place for rice in Kaduna, it is interesting to note from this that liquidity does not appear to be the issue for them. Further research into a scaling-up of financing activities would have to revisit the liquidity scenario. Indeed, all producers interviewed reported receiving cash advances from traders at planting, in return for their commitment to sell their harvest to the traders at the end. Traders purchasing paddies from farmers extend credit in sums ranging from N10,000 to N1 million. Further research is needed to gauge whether better contract enforcement would scale up this activity.

86. Despite positive results from the 2005 'R-box initiative', producers do not widely use improved crop inputs and input suppliers presently do not sell on credit. To wit, rice farmers in Kaduna have no access to finance for inputs. Outgrower schemes may be an interesting avenue in Kaduna. First, the rice sector there has some experience with

outgrower schemes—not for output, but for inputs. To maintain seedling quality, one company provides fertilizer and credit to 500 producers at an annual cost of N35 million. The outgrower scheme appears to work well. Similar schemes for paddy could be an important source of supply chain finance for farmers. Experience elsewhere in Africa of successful outgrower schemes for supply chain finance confirm the strong potential of this avenue, with failures providing cautionary lessons (see Box 7).

Box 7. Successful Supply Chain Finance in Zimbabwe: The case of Cottco

A credit scheme was established with the Zimbabwe Cotton Company (Cottco) under the World Bank Agricultural Credit and Export Promotion Project. Credit is extended to farmer groups who are jointly liable for repayment. The company also provides extension services. Since 1996, over 50,000 smallholders have benefited from credit that they put towards crop inputs. Average yields among participants are higher than the national average and repayment rates are upwards of 98 percent. The supply chain actor's source of financing, however, is an issue. In Zimbabwe, there is dissatisfaction about Cottco's exclusive access to concessional government financing while competitors do not.
Elsewhere in the world, actors obtain liquidity from formal financial providers, who in turn are provided incentives by government to participate. Over time, both supply chain actors and financial providers gain confidence in providing supply chain finance, and profit motives take over both in the financing of processors and the financing of farmers. Finally, experience in SSA with failed attempts at outgrower schemes highlight the importance of *client selection* and *sanctions* for default.
Source: World Bank (2004), IFAD (2006)

87. While no such schemes exist in Kaduna for rice (output) thus far, it does exist for other grains in the state. There is private sector interest in setting up outgrower operations in Kaduna. In interviews, one company expressed some interest in including rice farmers in their existing outgrower schemes, but maintained a high degree of risk aversion. This is partly due to the general issue of side selling (also cited as a risk by traders in interviews). In addition to contract enforcement, government and non-governmental organizations can play a role in reducing the perceptions of risk of supply chain actors. In a market with little supply chain finance (such as Nigeria) there is a definite role for a 'broker' who helps strengthen producer groups, introduces farmers to supply chain actors and facilitates the negotiation of contracts. This role has been held by governments (e.g., Ministry of Agriculture in the Philippines), agribusiness development centers (e.g., ZATAC in Zambia) or by local NGOs (e.g., NGO FAIDA in Tanzania). [64]

88. The results from field interviews in cassava and rice supply chains in Nigeria confirm a more generalized experience with supply chain finance elsewhere in the world, but three specific issues seem particularly relevant in the Nigerian context. For cassava, the issue is **incentive.** The lack of incentive for cassava actors to provide financing is binding in Nigeria. They will only consider providing finance to procure produce, not to make money on the credit operation. From their perspective, low recovery rates on credit extended do not necessarily imply failure if they manage to secure the produce.[65]

[64] See World Bank (2004) for a description of these initiatives.
[65] IFAD 2003

Understanding this incentive is critical to making supply chain finance work as a source of crop-related credit for farmers. Agricultural policy must be careful not to generate *systemic* overproduction. The *cyclical* component of the current glut in cassava may call for intervention and investment into **storage facilities**. This would serve the dual function of also permitting the development of warehouse financing. The second issue is less binding in cassava, but exists for rice. **Liquidity** is clearly a constraint for selected operators along the rice chain. Private sector development initiatives that improve the financial literacy and linkages of these actors with formal financial institutions hold the best promise of improving supply chain finance for farmers. Even where liquidity is not binding, once distortions to incentives have been relaxed, the biggest potential obstacle to sustainability of supply chain finance in Nigeria is the threat of **side-selling** by farmers and side-buying (i.e., free riding) by competitors.[66] The solution can be better contract registration and enforcement, but also by better incentives so that default clearly makes farmers worse off in a multi-year scenario. To this end, establishing credit bureaus or some kind of easily accessible credit information on farmers, provides traders with the information needed to reduce risks and farmers with the incentive needed not to side-sell. To complete the information failure approach, farmers would need up-to-date price information, particularly at the time of repayment-in-kind (harvest sale).

[66] For evidence of this from Kenya, Zambia and Mozambique, see IFAD (2003).

Conclusion and Recommendations

89. Nigeria's rich history with rural finance has left a mixed legacy which forms the backdrop for future rural finance. Based on this backdrop and on the new data on RFI costs and supply chain dynamics, a number of evidence-based alternative approaches suggest themselves for Nigeria. In particular, the data from Section 3 reveal an interesting number of points, which suggest some direction for removing obstacles from the path of sustainable rural financial service provision in Nigeria. First, NACRDB and the NGO-MFIs appear to be serving the lower income segments of the population: Community banks, though profitable, are serving a salaried middle income segment. Second, the demand for savings is high. Third, unsurprisingly, urban/rural status makes a difference in terms of efficiency in the sample. Fourth, best practice microfinance and basic data from Nigeria suggests that interest rates would currently need to be in the range of 20 percent-30 percent for RFIs to sustainably maintain operations in rural areas. While this figure is dynamic—costs could increase or decrease due to a number of exogenous factors—the data collected for this study make two things clear: (i) Even for a difficult lending environment, those RFIs with the best rural outreach in Nigeria are inefficient and unsustainable for reasons that would most likely improve with training and capacity building—namely, poor loan recovery for NACRDB and high operating costs for NGO-MFIs; and (ii) interest rate policies that cap lending at single digit rates do not permit cost-recovery (institutional sustainability), *even for efficient rural institutions*. Rural clients will always prefer to access cheaper credit from NACRDB, leaving RFIs to compete with a less diversified clientele. Together with an eroded financial discipline, this makes it difficult to expand access to financial services as per the objective of targeted subsidized interest rate policies in the first place. Rethinking the interest rate policy, providing institutional support and investing in cost-reducing technologies and innovations should, therefore, be first priorities for government and its partners. Finally, it is important to identify those inhabitants that cannot pay interest rates in the 20 percent-30 percent range, or indeed even at an 8 percent level. Rather than use a blanket approach of targeted credit for agriculture, targeting this subgroup *specifically* to help them engage in activities with higher returns and to help make them more credit-worthy would guarantee they do not lose out to elite capture. What can Nigeria do to move in these directions?

RURAL FINANCE IN NIGERIA: INTEGRATING NEW APPROACHES

90. The study outlines good practice in rural finance from around the world. Yet which approach(es) will suit Nigeria depend critically on the lessons (and legacy) from its own past and the characteristics of its rural service providers. A number of new approaches to be integrated into the rural finance scene, specifically chosen for their relevance to Nigeria, can be grouped into four key recommendations:

Recommendation 1: Institution Building and Training

91. The data collected on the representative sample of RFIs for this study indicate that the RFIs with the best rural outreach do not have operating costs anywhere low enough to have cost-recovering interest rates in the Nigeria-specific 'best practice' range of 20 percent-30 percent. Even though this range could fall further (say, with improvements in the Nigerian financial sector and rural environments), the fact is that few *RFIs* could currently achieve it. Transaction costs, particularly for loan recovery, are very high. Furthermore, despite numerous well-intentioned government interventions aimed at encouraging *commercial bank participation* in the sector, their outreach in rural areas remains low, partly due to inappropriate products and partly due to perceptions of high risk. This is not helped by widespread financial illiteracy of supply chain entrepreneurs and other *rural clients.* What do these three groups have in common? All require capacity building and training: To sustainably improve outreach and lower the risk for RFIs, it is imperative that performance-based capacity building take place and for organizational innovations to be introduced. Examples of successful MFI development in Nigeria itself confirms the role of institution building and training in meeting RFI potential to operate efficiently and innovatively. Commercial banks, in turn, need assistance in finding appropriate products that will permit them to improve their outreach to a rural clientele, and thereby diversify their risk. Training for rural people must run in parallel to this institutional capacity if that reduction in risk is to be real. Table 8 presents a number of practical initiatives to make this recommendation a reality, but much depends on the planned institutional reform of the NACRDB. All development partners should work together with IFAD and the participating government bodies to ensure that NACRDB can effectively fulfill its original objective of providing sustainable financial services to rural entrepreneurs. This may require more than just organizational reform and capacity building, which is why the planned diagnostic that the RUFIN program is undertaking with NACRDB is critical.

Recommendation 2: Innovative Approaches to Agricultural Finance

92. While the lessons from success with a financial systems approach requires that priority be given to building sustainable financial institutions offering a range of appropriate products (rather than just targeted subsidized credit), the particular challenges of agricultural finance must nevertheless be faced head on. In terms of crop finance, the lessons from the case studies point to a number of direct and indirect approaches. First, it makes sense to leverage ongoing private sector development work aimed at strengthening selected supply chains in Nigeria, to include linkages to formal financial institutions and incentives in providing supply chain finance. Second, the supply chain data indicates that wider agricultural policies must be careful not to destroy the incentives for private sector participation in supply chain finance. In general, agricultural and trade policies should not generate *systemic* overproduction, as they have for cassava in Nigeria. The *cyclical* component of the current glut in cassava, however, may call for more direct intervention through investments into storage facilities. This would also permit a further development of warehouse financing, which would also improve access to credit for farmers. In Nigeria, this is not a generic recommendation: It would leverage the existing legal provision in Nigeria permitting the use of warehouse receipts as collateral. This would

also reduce risk for potential supply chain financiers. More effective policy and implementation that improve contract enforcement would also relieve constraints on private sector participation in supply chain finance, as would ‘brokering’ or ‘matchmaking’ support for smallholder outgrower schemes. For longer term finance, one proven way to reduce the risk of RFIs in dealing with farmers is to engage in leasing. Here, the experience of some urban-based Nigerian commercial banks currently engaging in leasing can be extended to piloting the approach in rural Nigeria. That is, it is not only leasing success stories from elsewhere in the world that support such an intervention, but there is the potential to leverage Nigeria’s incipient ‘home grown’ experience with leasing as well.

Recommendation 3: Investments in Rural Finance Infrastructure

93. Technology and innovation in rural finance has helped access to finance become a reality for the rural poor across the world. Innovations can be organizational and have proven to dramatically reduce costs and improve outreach elsewhere in SSA (e.g, Ghana). Investing in apex organization for financial cooperatives and/or the newly formed Microfinance Banks in Nigeria, therefore, is based on established good practice and can strike while the organizational iron is hot in Nigeria. In terms of technology, given the positive experience in Asia and SSA—and the lessons learned from their less positive experiences—with mobile phone technology, Nigeria’s vast territory makes it a perfect candidate for piloting such initiatives. Finally, the case studies repeatedly reveal for both RFIs and interviewed supply chain actors that asymmetric information contributes to high risk perceptions. Simple investments into rural credit bureaus could link rural client information from MFIs, NACRDB, and other RFIs with other ongoing (urban) credit registry initiatives in Nigeria. This would make information available to potential rural finance participants, including commercial banks, thereby lowering their risk perception.

Recommendation 4: Alternative Approaches for the Less Bankable Rural Poor

Ending Capped Interest Rate Policy

94. It was seen that under conditions of best practice microfinance, Nigerian RFIs could currently achieve cost-recovering interest rates only in the range of 20 percent-30 percent. This contrasts strongly with interest rate caps of 8 percent, currently in use in some programs in Nigeria. NACRDB alone lent some US$70 million (fully a third of the commercial bank lending to the sector, by volume, despite smaller loan sizes). It is important to acknowledge that the interest rate caps are based on the legitimate concern that there are swathes of the rural poor who simply cannot afford even efficient rates in the range of 20 percent-30 percent. Nevertheless, the interest rate cap has (at least) four negative consequences for building sustainable rural finance in Nigeria.

95. First, the single digit interest rate policy, along with poor recovery and institutional inefficiencies, undermines the important role that NACRDB could play for the rural poor. The institution has a good branch network and targets smaller rural actors than the commercial banks, the leading lenders for the rural sector. NACRDB’s lack of viability, however, limits a potentially high outreach and bodes ill for sustainability. On the other

hand, successful agricultural development bank models in Indonesia, Tanzania, and Mongolia have turned institutions very similar to NACRDB into viable and important rural finance actors. This is the proposed work of the IFAD RUFIN Project, which needs to accomplish its reform objectives for NACRDB.

96. Second, observers have repeatedly noted that the interest rate policy, binding on such a large player on the rural finance scheme (NACRDB), has translated into a sense of entitlement concerning 'free credit' among some borrowers. Combined with poor recovery, a culture of non-repayment continues to be abetted by the interest rate policy, eroding the financial discipline required by other rural finance providers.

97. Third, in general, other RFIs can certainly compete with NACRDB in terms of timeliness and product offering. After all, interviews with informal providers show that, in fact, the rural poor can and do pay up to 120 percent *pa* for flexible loans suited to their livelihood strategies. This means that if at least as much attention is paid to developing more appropriate service and products for rural people (see Recommendation 1), the interest rate need not necessarily 'crowd out' competitors. But the single digit interest rate (and lax repayment) makes the NACRDB first port of call for would-be borrowers, leaving behind a less diversified clientele for other RFIs to survive with.

98. Finally, the interest rate policy distracts attention and resources from more sustainable approaches. In terms of attention, the case study data shows that there are consistently higher levels of savings as compared to loans. This at least partly reflects inadequate loan products or too rigorous collateral requirements, effectively driving potential borrowers to save rather than borrow. There are important lessons here for formal providers in developing appropriate products for the rural poor, but also for policy makers in their views on interest rates as the only obstacles to finance for farmers and the rural poor.[67] Nigeria is ripe for action and innovation in rural finance, which will require resources. While the total cost—over the years and currently—of the government's interest rate policy is unknown, in addition to the interest rate subsidization of almost US$200 million in loans[68] and the administration costs of these, poor repayment of the portion channeled through NACRDB has meant that the policy is potentially very expensive indeed. It may be possible to pay for the alternative approaches recommended here through a redirection of resources from the interest rate subsidization programs to innovative approaches that can more effectively achieve the Government's objectives for rural finance.

Specifically Targeting the Rural Poor Who Cannot Afford Cost-recovering Interest Rates

99. The existence in Nigeria of economically active poor (see Figure 1) who can and do pay upwards of 120 percent *pa* interest on loans and the negative effects of an interest

[67] For example, to what extent is lending to SMEs and rural inhabitants constrained by provisioning rules, requirements for loan portfolio composition, loan portfolio documentation, restrictions on foreign currency transactions and secured transactions regimes?

[68] Through the Agricultural Credit Support Scheme (ACSS), NACRDB, and the Interest Drawback Program of the Agricultural Credit Guarantee Scheme Fund (ACGSF).

rate cap on sustainable rural finance does not grant permission to skirt the issue of high interest rates altogether. The reality is that Nigeria does have rural citizens that simply cannot pay 30 percent or 20 percent, or even 8 percent on loans, but this is not a problem solved by cheap credit, as Nigeria's own experience proves. Poor repayment in targeted subsidized agricultural credit programs have meant that these targeted 'credit' programs are, *de facto*, grants. If this is the case, the objectives of the FGN and partners, in providing access to credit for those who cannot afford debt, might better be served by well designed grant programs that avoid elite capture and target only this segment of the rural poor. Everyone else—farmers and other rural entrepreneurs—should access their financing needs through strong and innovative RFIs (see Recommendations 1 to 3).

100. An effective alternative to subsidizing the interest rate is to support livelihoods through an asset acquisition matching grants scheme that help the very poor to build up their income to a level where they will be able to access unsubsidized financial services. Grants programs must have three characteristics if they are to achieve their objectives:[69] (i) they must target the extremely poor who are too vulnerable to take on the risk of a loan or who have some assets but cannot absorb downside risk; (ii) they must have a rigorous targeting strategy and monitoring system, using participatory mechanisms to identify the poorest members of the community; (iii) grants should be made on a matching basis, either in cash or in kind, requiring the highest contribution that is reasonable for the participant.

101. Another approach is to actively promote savings groups, with emphasis on the quality of group formation. This will more accurately target the rural poor who cannot afford efficient market rates. Savings will reduce the vulnerability of this target population and provide small amounts of own capital for rotating savings schemes, similar in many ways to the *adashis* already found across the nation. Savings groups can eventually be linked into formal financial systems. Nigeria's advantage is that the FGN has had some experience and lessons learned from its SHG-Bank Linkage program to build upon. Furthermore, its loosely formed 'cooperative societies' are ubiquitous and share similarities with very successful Indian SHGs (i.e., self-formed, linked with some external entities, etc.). Finally, both matching grants and savings groups need to be linked with ongoing livelihood support, such as that provided by the various income generation and private sector development initiatives currently underway in Nigeria. After all, grants alone cannot improve access to finance (what happens at the end of a grants scheme?)—they must, therefore, be used under conditions which promote sustainable access by: (a) increasing incomes for the very poor; and (b) providing participants with collateral. Only when the rates of return on their productive investments start to rise, will they be able to graduate to accessing finance from RFIs and more formal providers.

Integrating New Approaches

102. How can these four key recommendations be practically implemented in Nigeria? Table 8 breaks down the key recommendations into high potential alternative interventions for rural finance that represent new approaches for Nigeria. Table 8 also articulates the

[69] World Bank (2007c).

justification and identifies the relevant obstacles and key actors in implementation. The justifications in Table 8 refer to the good practice *financial systems approach.* Such an approach has led to successful rural finance elsewhere in the world, despite facing the same challenges of *high costs, poor information*, and high levels of real and perceived *risk*.

103. The success of new approaches depends on their integration into the rural finance scene. It also depends critically on the continuation of ongoing efforts at institutional and legal reform, and private sector development in Nigeria. The interventions in Table 8, particularly those on supply chain finance, access for the very poor and tackling financial illiteracy, also rely on the ongoing private sector development work by FGN and its partners (e.g., USAID's MARKET, SMEEIS, GTZ's EoPD, World Bank MSME, etc.) where these extend to rural areas. Wherever possible, the interventions in Table 8 should be leveraged by these ongoing initiatives in order to maximize impact.

Table 8. New Approaches for Nigeria's Rural Finance Strategy

Intervention	Justification	Potential Obstacles/Risks	Key actors
1. Institution Building and Training			
Capacity building with RFIs for better loan recovery mechanisms and streamlined operations (complementing RUFIN, UNDP, IFAD, GTZ and other efforts)	cost reduction (loan loss is a key cost driver for the community banks in the sample, and for NACRDB)	③A risk[70] exists if the RUFIN program does not achieve this for NACRDB, leaving a large gap in the capacity building needs for Nigerian rural finance ③Another risk is that increasing the number of RFIs may strain current supervisory constraints	FGN, CBN, donors, RFIs[71]
Capacity building with commercial banks on products appropriate for rural populations (e.g. appropriate payment schedules, alternative collateral, community based loan recovery techniques, etc.); 'learning tours' with successful NGO-MFIs	improved outreach reduced risk (e.g. capacity building on successful loan recovery and community based initiatives will lower risk)	③There is a risk that commercial banks simply will not perceive the rural population as bankable, and therefore refrain from participating	FGN, CBN, NGO-MFIs, Commercial Banks, donors
Improve the financial literacy of rural citizens (independent education campaigns, educational activities linked with other livelihood projects/initiatives)	financial systems approach improving financial literacy		FGN, RFIs, commercial banks, donors
2. Innovative Agricultural Finance			
Investments in a warehouse receipting system	risk reduction (if receipts can be used for collateral)	③There are risks associated with poor governance and potential mismanagement/dishonesty among certain actors	FGN (legal and regulatory framework) private sector, donors
'Brokering' outgrower schemes	risk reduction (overcoming information failure)	③There is a risk associated with the current inadequate legal enforcement of contracts	FGN, NGOs, donors
Completing legal system reform for the enforcement of contracts, possibly using traditional mechanisms.	risk reduction cost reduction (reduction in transaction costs associated with traditional loan recovery)		FGN, donors
Support pilot leasing schemes (possibly linked with credit registry initiatives—see below)	risk reduction (RFIs are in a stronger position for recovery as the legal owner of the asset)		Commercial banks, MFBs, NACRDB, donors
3. Investing in Rural Finance Infrastructure			
Creating rural credit registries linking MFI	risk reduction	Obstacles include:	FGN (regulatory

[70] Risks and obstacles in this column were identified by stakeholder participants in the Rural Finance in Nigeria ESW Workshop in Abuja in October 2007.
[71] In almost each of the alternative interventions cited in the table, the potential role of State governments should be explored, going forward.

Intervention	Justification	Potential Obstacles/Risks	Key actors
information with ongoing credit bureau initiatives in Nigeria (e.g. IFC's regional credit bureau initiative—which does not target rural areas, and the World Bank's MSME Project efforts in (urban) credit registries)	(overcoming failure in information) (transaction) cost reduction	③the potential reluctance of clients to provide detailed information for the registry—this may create a climate of mistrust. ③the absence of a National ID or other form of registered identification to ensure correct names are given ③lack of capacity for MIS in RFIs ③necessary legislation	framework) RFIs, donors, IFC
Invest in pilot mobile technologies e.g. mobile phone banking	cost reduction improved outreach	③mobile banking technology that involves a vehicle with money roaming the country side is subject to the risk of armed robbery ③illiteracy can be an obstacle ③Regulatory issues which must be dealt with ③Regulatory capacity for supervision may be binding	FGN, CBN (policy and regulation) private sector, donors (CGAP, IFC)
Invest in apex bank organization for financial co-ops and/or the new MFBs	cost reduction improved outreach	③A risk is the lack of capacity at both the apex level and for the institutions in the apex	FGN, financial co-ops, MFBs, donors
4. Alternatives to Targeted Subsidized Credit for Agriculture and the Rural Poor			
Phasing out targeted subsidized credit for farmers (to avoid elite capture) and enabling all RFIs to charge efficient, cost-recovering interest rates	financial sustainability (financial systems approach)	③There is a risk that this policy be subject to political interference and instability ③The strong prevailing notion that agricultural and rural finance is unattractive at any interest rate is a potential obstacle	FGN, NACRDB
For the poor that cannot afford efficient cost-recovering interest rates: link well-targeted and well-monitored matched grants with new and ongoing livelihoods programs (see below).	improved access risk reduction	Risks include: ③inadequate attention to monitoring ③matching grants might crowed out other providers if not carefully targeted	FGN, donors
Pilot a 'savings-first' program for the rural poor who cannot afford interest rates in the range of 20-30 percent. This should put strong emphasis on good group formation and financial literacy	improved access		FGN, NACRDB, NGO-MFIs
Build or link matching grant schemes with a livelihoods program that supports income generation or private sector development in micro businesses	financial systems approach		FGN, donors with PSD or livelihood programs

CONCLUSION

104. Thorough documentation found in this and preceding studies and reports, lays the empirical path for action in improving rural access to finance in Nigeria. Nevertheless, gaps in our knowledge on rural finance remain. The results of an impending financial access survey in Nigeria[72] are essential to understanding the true size and nature of the demand for financial services in rural areas. Such an understanding is critical to the recommendations that aim at involving new and more efficient actors in the rural finance scene. Furthermore, from a planning perspective, the exact cost -- over the years and currently -- of the Government's interest rate subsidization program would need to be known in order to understand the resource scenario for a new and revitalized rural finance sector.

105. There is much potential for RFIs in Nigeria to survive sustainably with adequate capacity building and encouragement to widen the scope of rural finance. The study provides a number of new approaches, innovations and organizational reforms specifically suited to Nigeria, leveraging as they do, the country's own experience with rural finance and recent selected reforms. Consistent and non-distortionary policies, an appetite for innovation in rural and agricultural finance and strong capacity building will permit the survival of RFIs in Nigeria that can offer a full range of financial services to all of Nigeria's rural citizens.

.

[72] DFID/FinScope (see also Footnote 11)

References

Adams, D., D. Graham and J.D. Von Pischke (eds).1984. *Undermining Rural Development with Cheap Credit.* Boulder: Westview Press.

ADB. 2006. *Beyond Rural Finance: building inclusive financial markets in Central Asia.* Manila: Asian Development Bank.

Anyanwu, C.M. 2004. *Microfinance Institutions in Nigeria: Policy, Practice and Potentials.* Paper presented at the G24 Workshop, Pretoria: "Constraints to Growth in Sub Saharan Africa".

Bagazonzya, H. and M. Marx. 2005. "Rural Financial Institutions and Services" in *Getting Agriculture Going in Nigeria: Framework for a National Growth Strategy.* Annex. Washington,D.C.: IBRD.

Beck, Thorsten, Asli Demirgüç-Kunt and Ross Levine. 2004. Finance, Inequality and Poverty. World Bank Policy Research Working Paper 3338. Washington, D.C.: IBRD.

Beck, Thorsten, Ross Levine and Norman Loayza. 2000. Finance and Sources of Growth. *Journal of Financial Economics* 58, 261-300.

CBN. 2005a. *Banking Supervision Annual Report.* Abuja: Central Bank of Nigeria.

CBN. 2005b. *Microfinance Policy, Regulatory and Supervisory Framework for Nigeria.* Abuja: Central Bank of Nigeria.

CGAP. 2007. *Sustainability of Self-Help Groups in India: Two Analyses.* Occasional Paper No.12. Washington, D.C.: IBRD.

CGAP. 2006. *Access for All: Building Inclusive Financial Systems*. Washington, D.C.: IBRD.

Cohen, M. 2003. *The Impact of Microfinance*. CGAP Donor Brief no. 13. Washington, D.C: IBRD.

De Janvry, A., Sadoulet, E., McIntosh, C., Wydick, B., Luoto, J. 2003. *Credit Bureaus and the Rural Microfinance Sector: Peru, Guatemala and Bolivia.*

Dressen, R., Dyer, J., and Northrip, Z. 2002. "Turning around state-owned banks in underserved markets." *Small Enterprise Development Journal*, Vol. 13. No. 4, pp. 58-67.

FAO. 2004. *Federal Republic of Nigeria: Assessment of Community Banks.* FAO/WB/IFAD/UN/CIDA/DFID.

Ford Foundation. 2006. *Rural Finance: Recent Advances and Emerging Lessons, Debates and Opportunities*. New York: Ford Foundation.

Fouillet, C. 2007. "Spread of the SHG Banking Linkage Program in India". *International Conference on Rural Finance Research: Moving Results.* FAO, Rome: IFAD.

Hollinger, F. 2004. *Financing Agriculture: Term Investments*. Rome: FAO/GTZ.

Honohan, P. 2006. *Making Finance Work for Africa*. Washington, D.C.: IBRD.

Honohan, P. 2004. Financial Development, Growth and Poverty: How Close are the Links? In Charles Goodhart, ed. *Financial Development and Economic Growth: Explaining the Links.* London: Palgrave.

IFAD. 2007. Strategies for Enhancing the Sustainability of the Agricultural Credit Guarantee. Presentation for the CBN Repositioning the Agricultural Credit Guarantee Scheme as a Vehicle for Economic Growth and Development Retreat. Rome: IFAD.

IFAD. 2006a. *Federal Republic of Nigeria: Rural Finance Institution Building Programme.* Appraisal Report. Rome: IFAD.

IFAD. 2006b. *Member-Based Microfinance Institutions and Key Training Service Providers.* Rural Finance Institutions Building Programme. Working Paper 2. Rome: IFAD.

IFAD. 2006c. *Rural Financial Institutions.* Rural Finance Institutions Building Programme. Working Paper 4. Rome: IFAD.

IFAD. 2004. Federal *Republic of Nigeria: Rural Finance Institution Building Project.* Draft Report. Rome: IFAD.

IFAD. 2003. *Agricultural Marketing Companies as Sources of Smallholder Credit in East and Southern Africa: Experiences, insights and potential donor role.* Rome: IFAD.

Isern, J., Deshpande, R. and Van Doorn, J. 2005. Crafting A Money Transfers Strategy: Guidance For Pro-Poor Financial Service Providers. CGAP Occasional Paper No. 10. Washington, D.C: IBRD.

McKinnon, R.I. 1973. Money and Capital in Economic Development. Washington, D.C: Brookings Institution.

Microfinance Information eXchange. 2006.. Benchmarking African Microfinance 2005. MIX.

Nair, A. and R. Kloeppinger-Todd. 2006. *Buffalo, Bakeries, and Tractors: Cases in Rural Leasing from Pakistan, Uganda, and Mexico.* Agriculture and Rural Development Discussion paper 28. Washington, D.C.: IBRD.

Pearce, D. 2003. Buyer and Supplier Credit to Farmers: Do donors have a role to play? Rural Finance Innovation Case Study, Paving the Way Forward for Rural Finance: An International Conference on Best Practices.

Robinson. 2001. *The Microfinance Revolution.* Washington, D.C.: IBRD.

Shaw, E. 1973. *Financial Deepening in Economic Development.* New York: Oxford University Press.

The Banker. 2007. *Nigerian Banks Are Beginning To Realise That They Can Build Their Customer Bases*. (www.thebanker.com).

USAID. 2006. *Better Lending and Better Clients: Credit Bureau Impact on Microfinance.* Basis Brief No. 45. Washington, D.C.:USAID.

USAID. 1973. *Spring Review of Small Farmer Credit*. Washington D.C.: USAID.

World Bank. 2008. *Competitive Commercial Agriculture In Africa (CCAA): Synthesis Of Quantitative Results*. Washington, D.C.: IBRD.

World Bank. 2007a. *ARB Apex Bank Ltd and Rural Financial Service Project*: Proceedings of the Ghana Study Tour, March 26 – 30, 2007. Agriculture and Rural Development Department Internal Report. Washington, D.C.: IBRD.

World Bank. 2007b. *Developing Credit Reporting in Africa: Opportunities and Challenges.* Access Finance. Issue No. 19. Washington, D.C.: IBRD.

World Bank. 2007c. *Grants for Income Generation.* ARD Notes. Washington, D.C.: IBRD.

World Bank 2007d. *Issues and Development of Outreach and Banking Sector Efficiency*. mimeo. Washington, D.C.: IBRD.

World Bank. 2007e. *The experience computerizing the Ghanaian rural banking network: A status assessment* (Draft). Agriculture and Rural Development Department Internal Report. Washington, D.C.: IBRD.

World Bank. 2006a. *Making Finance Work for Africa*. Washington, D.C.: IBRD.

World Bank. 2006b. *Getting Agriculture Going in Nigeria: Framework for a National Growth Strategy*. AFTS3. Washington, D.C.: IBRD.

World Bank. 2005a. *Meeting Development Challenges: Renewed Approaches to Rural Finance*. Washington, D.C.: IBRD.

World Bank. 2005b. *Nigeria: Value and Supply Chain Study.* Washington, D.C.: IBRD.

World Bank. 2004. Agricultural Source Book. Washington, D.C.: IBRD.

World Bank. 2002. *Financial Sector Assessment Program. Selected Financial Sector Issues: Nigeria*. Washington, D.C.: IBRD, IMF.

World Bank. 2000. *Financing Nigeria's Rural Micro and Small Enterprises.* Washington, D.C.: IBRD.

Wright, G.A.N., et al. 2006. "Mobile Phone-Based E-Banking: The Customer Value Proposition," MicroSave Briefing Note No. 47. Nairobi: Microsave.

Yaro, M. 2004. *Loan Management.* Edited by FAO and FMARD. Abuja: FGN.

Yaron, J. 2005. "State-Owned Development Finance Institutions (SDFI): The Political Economy and Performance Assessment". *International Conference on Rural Finance Research: Moving Results.* Rome: FAO and IFAD.

Annex 1: Required Information List for the Development of Sustainable Rural Finance
(*adapted from the Country Diagnostic Matrix of World Bank (2005a)*)

REAL SECTOR

Rural Demographic

- ☉ Population density
- ☉ Mix of cities, towns and villages in rural areas
- ☉ Prevalence and influence of natural disasters and HIV
- ☉ Number of rural HHs per region/state
- ☉ Income distribution across rural HHs per region/state
- ☉ Predominant sources of income across rural HHs per region/state
- ☉ Presence and role of natural resources
- ⑤ Degree monetization of rural incomes per region/state (balance between subsistence and cash in HH)
- ☉ Soil fertility by region/state
- ☉ Rainfall and irrigation by region/state

Infrastructure (overall and by region/state)

- ☉ Transportation
- ☉ Communication
- ☉ Water and sanitation
- ☉ Electricity
- ☉ Market infrastructure
- ☉ Availability and affordability of quality inputs

Production and Processing

- ☉ Predominant agricultural activity by region/state and productivity
- ☉ Predominant rural non-farm activities by region/state
- ▭ Profitability of agricultural and non-farm activities
- ☉ Presence of MSMEs
- ☉ Activities/crops with important supply chains
- ☉ Structure and size of those supply chains, main actors
- ⑤ Degree of commercialization (vs. subsistence activity) in agricultural and non-farm activities
- ☉ Access to agricultural extension and/or business support

Other

- ⑤ Rural finance for real sector activities
- ☉ Relevant donor-financed real sector activities/projects

ENABLING ENVIRONMENT

Policy and Enabling Environment

- ☉ Macro economy
- ☉ Political stability (nationally, state-wise)
- ☉ Direct government participation in rural finance
- ☉ Subsidies in rural financial markets
- ☉ Presence of credit information, registries, training institutes

Legal

- ☉ Laws for secured transactions
- ☉ Bankruptcy laws
- ☉ Leasing laws
- ☉ Land rights
- ☉ Degree of enforcement

Regulatory and Supervisory

- ☉ Banking regulations in general
- ☉ Regulation and supervision of non-bank rural finance institutions
- ⑤ Impact of the above on rural access

Other

- ☉ Relevant donor-financed activities and projects on the macro and meso levels

FINANCIAL SECTOR

Banking Sector

- ☉ Financial sector depth and breadth
- ☉ Financial institutions' efficiency/soundness
- ☉ Presence of large banks in rural areas
- ▭ Costs of service delivery in remote rural areas
- ⑤ Outreach figures across a range of services for different actors in the banking sector to farmers and low-income rural people

Non-Bank Financial Institutions (NBFI)

- ☉ Presence and composition of NBFIs in rural areas
- ▭ Costs of service delivery in remote rural areas
- ⑤ Outreach figures across a range of services for NBFIs to rural people, farmers, etc.
- ☉ Financial institutions' efficiency/soundness
- ☉ Grants subsidies

Products and services

- ⑤ Availability of and access to HH saving and credit facilities
- ▭ Extent of supply chain financing
- ▭ Potential for supply chain financing
- ☉ Availability of rural leasing products
- ⑤ Potential for rural leasing
- ☉ Availability of risk management instruments
- ⑤ Potential for risk management instruments for farm and non-farm activities
- ☉ Prevalence of warehouse financing facilities
- ⑤ Potential for warehouse financing facilities

Other

- ▭ Relevant donor-financed activities and projects at the institutional level

Legend:

- ☉ Likely known, can be consolidated from secondary sources if desired
- ▭ Knowledge gap to be filled by ESW either through primary research or analysis of secondary source data
- ⑤ Knowledge gap to be filled by future research

Annex 2: Rural Finance Interventions in Nigeria

Name of Intervention	Timeline	Services	Beneficiaries	M&E	Strengths	Weaknesses	Donor (D) Gov't (G)
Nigeria Agricultural Credit Bank (NACB) pre-cursor to NACRDB	1973-2000	③retail lending ③second tier lending ③subsidized interest rates ③no deposit facilities	③rural inhabitants, primarily smallholder	annual reporting to CBN	③widespread geographic coverage ③competent senior staff	③loss-making interest rates ③high admin cost ③poor portfolio quality ③poor repayment culture ③lack of deposit mobilization ③lack staff incentives	G
Rural Banking Program	1977-2000	③mandated commercial banks to open rural branches	③rural inhabitants, including SMEs and smallholders	number of rural branches reported to CBN	③expanded commercial bank outreach in rural areas	③lack of incentives for commercial banks to develop sustainable rural operations	G
Agricultural Credit Guarantee Scheme Fund	1977-present	③national guarantee scheme 75 percent of agricultural loans disbursed by participating commercial banks	③smallholder farmers and cooperative societies	Annual reporting to CBN, including quantitative and qualitative appraisals	③increased agric lending among commercial banks ③reaching small-holders	③subject to government funding capacity ③poor credit appraisal and recovery	G
Nigerian Agricultural Insurance Company	1988-present	③loan insurance (obligatory with ACGFS, NACRDB loans)	③smallholders, SMEs	annual reporting by National Agric Insurance Committee	③sustainable operations ③nationwide outreach	③poor image among farmers ③limited scope of services	G
People's Bank of Nigeria	1989-2001	③retail lending ③subsidized interest rates ("service charges") ③compulsory and voluntary deposit	③un-banked, marginalized populations in rural and urban areas	annual reporting to CBN	③geographic outreach ③deposit facilities	③low interest rates ③high admin cost ③poor repayment culture ③poor field-staff training ③poor MIS	G
Self-Help Groups (SHG) Linkage Program	1991[73]	③commercial bank loan access to SHGs ③subsidized rates ③compulsory savings	③Smallholder farmers organized into SHGs	none identified	③encouraged lending to SHGs	③lack of monitoring ③lack of political (CBN) commitment	G
Family Economic Advancement Program	1994-2001	③earmarked government funds for commercial bank lending ③subsidized rates	③cooperative societies (agriculture and non-ag cottage	none identified	③mobilized managing bodies across the country	③loss-making interest rates ③poor design ③created market pollution ③crowded out legitimate	G

[73] After the end of Government support for the program, a few SHGs continue privately to this day in their linkages with commercial banks.

Annex 2: Rural Finance Interventions in Nigeria

Name of Intervention	Timeline	Services	Beneficiaries	M&E	Strengths	Weaknesses	Donor (D) Gov't (G)
			industries)			borrowers	
Nigerian Agricultural, Cooperative and Rural Development Bank	2000-present	③retail lending ③second tier lending ③subsidized rates ③compulsory and voluntary deposit services	③smallholders, cooperative societies,	none identified	③branch network ③knowledgeable senior management desirous of change	③loss-making interest rates ③high admin costs ③poor repayment culture ③poor field-staff training ③lack of staff incentives ③poor MIS ③lack of autonomy from FMARD ③inability to work under commercial bank license	G
TFM	2001-present	③state-by-state guarantee scheme to complement ACGSF	③smallholder farmers and cooperative societies	scheme by scheme	③too little information available to assess	③too little information available to assess	G
National Poverty Eradication Programme	2001-present	③matching fund scheme (state gvts-commercial banks) ③second tier lending	③NGO-MFIs, commercial banks	system in place, but no info available	③too little information available to assess	③too little information available to assess	G
SMEEIS	2001-present	③earmarked commercial bank funds for lending and equity investment ③subsidized rates	③SMEs (90 percent real/service sector; 10 percent microfinance)	periodic reports to CBN	③prioritizes SMEs	③low outreach ③primarily urban focus	G
ACSS	2006-present	③earmarked commercial bank and NACRDB funds for agricultural lending ③subsidized rates	③smallholders	participating banks expected to report monthly to CBN (no evidence of this)	③too little information available to assess	③too little information available to assess	G
Community Banking System; MF Policy Framework	1990-present; 2005	③retail lending ③deposit services ③conversion to MFB format required by end-2007	③rural communities	annual reporting to CBN	③cost-covering interest rates ③remunerated savings	③little focus on agriculture ③little focus on lending ③poor reporting methods ③lack of staff training	G

Annex 3: RFI Indicators Defined

Outreach

Outreach is expressed as:

(i) the number of total clients;

(ii) the number of total borrowers;

(iii) the number of total savers;[74]

(iv) average loan size (borrowers/outstanding loan portfolio);

(v) average loan size as compared to GNI per capita to get a sense of the population served; and

(vi) average deposit size (savers/total savings portfolio);

Financing structure

Financing structure is expressed by:

- debt/equity (adjusted total liabilities/adjusted total equity) and
- loan portfolio/total assets (adjusted gross loan portfolio[75] /adjusted total assets)

Financial performance and profitability

Financial performance and profitability is expressed as:

- Portfolio as Risk > 30 days (PAR), as reported by the RFIs;
- Adjusted Return on Assets (AROA): adjusted operating income net of taxes/adjusted average total assets;
- Operational Expense Ratio (OER): adjusted operating expenses / adjusted average total assets;
- Operational Self-Sustainabilty (OSS): financial revenue / (financial expense + net loan loss + operational expense);

Efficiency and productivity

Efficiency and productivity were measured by looking at:

- cost per borrower (operating expenses/# of active borrowers)
- cost per saver. (operating expenses/# of active (voluntary and compulsory savers)
- 'cost per unit lent', which refers to un-adjusted operating expenses/outstanding loan portfolio.

[74] Only the community banks and NACRDB branches offer voluntary savings products. However, they do not disaggregate compulsory and voluntary savings in reporting. Therefore, savings refers to all savings deposits. The MIX data expresses voluntary savings only.

[75] All outstanding principal for all outstanding client loans, including current, delinquent and restructured loans, but not loans that have been written off. It does not include interest receivable. It does not include employee loans

Annex 4: ESW Study Site Map