

RURAL FINANCIAL INSTITUTIONS AND FINANCING RURAL ECONOMIES

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Keywords

- Rural economies - Rural financial institutions - Savings and Loan Associations -

1. INTRODUCTION

Rural producer's capacities to receive additional financial resources during transition are confronted with many restrictions of negative effects on output, farm restructuring, and investments to be made. These limitations are a result of mixed factors deriving from the expensive and deficient information on rural financial markets and a result of a number of specific problems incurred during transition. An effective rural financial market plays an important role in the development and growth of rural productivity. This implies building a financial market to meet the typical functions of market economy. Mobilizing and allocating resources without governmental interference and building an institutional framework to provide funds in compliance with the demand is also important.

Among both capital resources, domestic and foreign, the domestic ones are the most important element. In the majority of low-income countries, domestic funds represent a considerable part of investment resources. One of the main monetary resources to cover a considerable part of rural financing are also the savings of this sector.

2. AN OVERVIEW ON RURAL FINANCIAL MARKETS AND OPERATING INSTITUTIONS

Transition countries are mostly confronted with two challenges: first, is that the financial sector needs to be radically reconstructed by a governmental instrument which would collect savings and distribute funds through enterprises in a totally independent financial system capable of performing its functions within a market economy. And second, its regular functioning is a precondition for reorganizing and modernizing farmer economies and their efficiency. Information asymmetry is a characteristic of rural financial markets. This means that while performing a credit transaction, the borrower is well aware of his willingness and ability to repay the loan on time.

The credit institution, on the other side, does not know the real intentions of the borrower or whether he may change opinion after receiving the loan. In these circumstances, the risk exposure is high. The low profitability of farms is another problem of rural financing that restricts their ability to repay the debt. On the other hand, collateral commitments play an important role in the farmers' potentiality to ensure additional financing resources. In transition economies, collateral requirements from financial institutions to receive rural lending have been frequently high due to transitory factors such as: deficiencies in ownership entitlements, the lack of land markets, high inflation and insecurity, etc.

In addition, banks frequently refuse rural land as committed collateral even when ownership entitlement is complete and this is because of the lack of a rural market. This has enforced the establishment of appropriate institutional models to better manage the above risk and be better adopted in rural financing. Many governments use specialized rural banks as their core instrument to credit this sector. In most cases, the clients consider these institutions as pseudo-governmental and loans received by them as government subventions, not as business contracts. In these cases, rural banks continue to be government instruments that subsidize farms and the results are not so satisfactory¹.

2.1. BANKS AND FINANCING RURAL ECONOMIES

The reformation and the development of the Albanian banking system aims at providing support through bank products and services to various sectors of the economy. Credit applications by private farmers for financing inputs (chemical fertilizers, seeds, pesticides, etc) and mechanical appliances have been and continue to be ever large and growing. Rural credit and the supply of financial services have been largely suppressed by the bank incapacity to respond to the growing credit demand from the new private sector.

In spite of the fact that for rural financing there was a specialized institution as the Rural Commercial Bank (RCB), we may say that this institution did not work properly to support agriculture.

The incapacity of the Rural Commercial Bank to extend credit is shown in two aspects:

The first lies with the bank incapacity to meet credit demands of small farmers. This was because the RCB operated on commercial principles and as already known, the cost of managing credit to this large number of small clients was high. In addition, credit rates made credit cost be high as well.

The second lies with the limited extension of rural credit from the RCB. If we refer to structural data on the structure of credit by entity, we see that other sectors, such as trade, construction, etc) share a considerable part.

As of end 1996, RCB's outstanding credit structure indicates that credit activity and construction share 64 percent. Extended credits either by the RCB own funds or by other project funds financed by donors and channeled through the bank in most cases do not apply to economic activities of farmer economies. The deficiency of extending credits to the rural sector is reflected in the very high level of non-performing loans. As of end 1996, non-performing loans of three state-owned banks shared about

33% of total loans extended. The 1997 crisis deepened further this negative indicator.

After the '90s, in their effort to be provided with commercial loans, private farmers have used funds borrowed from moneylenders, friends or other relatives as additional financial resources.

According to the survey conducted over years 1993-1994, in 25 out of 36 cities, only 2 percent of 648 farmers resulted to have used bank loans. Amongst the difficulties pointed out by them for receiving bank loans are: high credit rates, the bureaucracy in procedures, the short-term maturity, etc. A considerable number of farmers have used loans granted from relatives or businessmen.

Besides the expansion of commercial banks (private ones), year 2000 was characterized by a strong growth of credit to the economy. Macroeconomic stability, the increased domestic safety, and the improved investment climate made banks raise rates of credit to the economy. Almost all banks, based on their policies, were interested in lending to medium and large-size businesses. Even those banks that have lending to small businesses in the core of their policy (such as the FEFAD Bank), focused their attention on the urban area clientele, denying credit extension to farmer economies. The very few credits extended in this sector covered agro-foodstuffs and the establishment of greenhouses.

A bank that has recently started to extend loans to agriculture is the "American Bank of Albania". However rural area clients of this bank are at a very restricted number and mainly operate in low western areas (where the most specialized farmers are situated in).

Amongst the main factors of banks' non-lending to farmer economies are:

- The commercial banks' lack of institutional capacity, as a result of the high cost of small credits. Banks consider the

activity of farmer economies as small business and lending to them as costly, consequently.

- The farms' small capacity and their insufficient income impede the absorption of formal investments in rural sector and other sectors related to it.
- The relatively high interest rates (due to the very high credit risk premium) are another factor. Small farmers can not repay commercial term credits provided by the banks. This results from the current practice and from the conclusions drawn from the survey on the budget of the farm.
- Banks do not engage in rural credits for they consider farms as not so stable and consistent activities. This is an aftermath of farmer families' moving tendency toward urban areas.
- Small farmers frequently lack collateral to meet commercial bank claims. The non-functioning of land market is a relatively large bar to crediting, as land is not yet preferred to serve as collateral by banks.
- The lack of bank infrastructure in the rural sector of economy is reflected in the non-extension of banking business in this sector of economy. The only bank to have a wide spread on the entire territory is the Savings Bank. This bank has stopped credit to economy as it is under the stage of restructuring and preparing for privatization. All other banks mainly operate in Tirana and it is only in the last two years that they have started to expand their credit activity to some other principal cities of the country.

2.2. ESTABLISHING MICRO-FINANCE INSTITUTIONS, AS VILLAGE-BASED ALTERNATIVE TO SUPPORT FARMER ECONOMIES

Banks' disinterest in financing farmer economies and the structural transformations of the rural sector as a result of the economic reforms made the establishment of rural financial institutions a necessity. One of the most effective institutional models represented by credit co-operative is nominated the

Savings and Loan Association (SLA) in our country. Their experience has been mostly successful. In Romania for example, the co-operative banks have been successful in providing credits to small private farmers. In Bulgaria a mutual fund program for agriculture developed with the help of EU Phare program. In Albania, the Albanian Development Fund and its rural component today, the Rural Financing Fund (RFF), have been successful.

The experience of transition countries is different. In Russia for example, the efforts to establish credit co-operatives did not bring the expected effect.

The establishment and running of these new financial institutions in the rural sector also reflect the various models of farm structure. The latter in many transition economies vary in size from very big to very small ones (table 1). This may require different institutions. Large farm applications for credit can be covered by commercial banks. On the other hand, small farms' credit demands, having higher transaction and financial intermediation costs can be better served by the credit co-operatives. In Hungary, Poland or Romania similar institutions are already functioning and have the tendency to expand.

Table 1 Rural Individual Indicator (RII) in some countries, year 1995².

Country	RII	Country	RII
Albania	94,2	Czech Republic	22,1
Armenia	81,8	Hungary	17,3
Latvia	80,2	Belarus	15,2
Romania	55,2	Ukraine	14,1
Bulgaria	45,4	Russia	12,1
Estonia	37,5	Slovakia	3,1

Source: Mathijs, E. and Swinnen, J. (1998) "Economic Development and Cultural Change".

It is noted that individual farms dominate the Albanian agriculture, a direct outcome of the economic reform in this sector. Rural land distribution to farmers has been a relatively rapid process in Albania. This resulted in the establishment of an extensively large number of small farms, around 380,000, with an average land area from 0.5 to 1.8 hectares per farmer family, divided into parcels. This indicator makes most clear the necessity for SLAs to operate in the Albanian economy, as an

adequate financial institution for this structure. These micro-finance institutions may mobilize the savings of this sector, using them for its development.

3. THE ROLE OF RURAL FINANCING FUNDS. THE ESTABLISHMENT OF THE SLAs

The rural sector in our country during these years has provided additional financing from some resources. Here are included loans extended by the former-Rural Commercial Bank, from the international institutions (various credit funds from donors and development projects), as well as individual lenders (informal sector). The Rural Credit Project previously implemented by the Albanian Development Fund and currently by the Rural Financing Fund is the eldest project with the broadest spread in rural areas of the country. This program started to operate in the framework of the Poverty Reduction and Growth Facility, which aimed to relieve the transition period for the poor farmers. Later it turned into a micro-finance program. The program offered a new credit system based on the collaboration between two chains: the credit board of the village (CBV) and the credit officer. This program extended small loans to farmers who could not be supported with bank loans. Besides that, farmers and the CBVs were trained.

Credit extension is based on clear and well-understood criteria, on the borrower's capacities to repay the loan, investment potentialities, customer capacities and confidence, etc. This project adopted credit schemes based on the farmers' applications for small credits corresponding to the appropriate level of the farm. Credit ceiling, from some hundreds of US dollars extended at the early process is currently at \$ 2 000, and credits are granted for a period of up to 3 years. In specific cases may be extended credits up to US\$ 5,000.

The areas of intervention during these years have been the districts of Elbasan, Tirana, Vlora, Kruja, Gramsh, Peshkopi, Kukës, Pukë, Has and Tropojë.

For a long time, the main activity for using credits has been live animals. This fact related to the areas where the Rural Financing Fund extended its activity, to the credit amount and the emergency needs of rural families. It is ever-increasingly being evidenced a changing ratio in credit financed activities. To this period, 53.38 percent of the credit amount is used for live animals, while the cumulative average is 61.69 percent. Thus, it noted a falling tendency of credit use for live animals in the favour of other activities, such as green houses, trade, mechanical appliances, handicraft, etc, which are more profitable activities that significantly influence the development of farmer economies.

The extension of new villages around the cities and the growing interest to perform investments changed the credit demand, in terms of amount, term duration and the type of financial activities. Credit extension above ordinary ceiling was experimented to meet the demand and the project targets. Only in 1999 were extended 27 credits, from Lek 300000 to 500000.

Besides the average credits extended during this term (Lek 94462), the average credits increased by 20 percent compared to the average extended in 1998 (Lek 78940). This tendency went on, prudentially, since the credit guaranty is only moral, practically.

Based on what was mentioned above, the World Bank in agreement with the Albanian Government approved in early 2000 the financing of a new project, whose strategic target was the achievement of financial stability and the transformation of the existing rural micro-credit program into a stable institution that would progressively become self-financing.

The main objective of the new RFF project is to establish a SLA network and support the progressive development of their union in consistency with the current law on SLAs and based on the current system of RCF (rural credit funds, an NGO), as well as to expand the area of rural credit intervention, by expanding

the network in low land and coast areas as well as by expanding the range of financial services provided to farmers.

The project will support the transformation of the RCF into a stable system based on SLAs. The SLAs are organizations that will aim at extending loans to and collecting savings of members affiliated in. SLAs will have a larger democracy, autonomy and responsibility than RCFs. Being member-owned and capitalized organizations, SLAs will have a strong initiative to maintain the financial stability and to minimize the risk of non-performing loans. Many duties, actually performed by the Rural Financing Fund will be progressively shifted to SLAs, after they have obtained the required training and a greater autonomy and maturity. After a maximum period of 3-years, SLAs will be sustained to establish their union.

The establishment of a SLA network will be realized in two ways:

First: establishing SLAs through RCF's transformation into SLAs. The RFF, acknowledging and managing this experience, will play a very important role in putting this transformation into place. The acquired experience of co-operation and the capitalization capacities are good premises for achieving the establishment and functioning of these institutions. In addition to the technical assistance, the RFF extends credits of 11 percent rate to SLAs, which the latter extend to their members at 15 percent (the resulting spread covers their operational expenditures). Upon SLAs consolidation and capitalization and the establishment of their union, these institutions intend to become autonomous from the RFF. At the end of 2000, through this transforming mechanism, were established the first 18 SLAs which are still at the phase of consolidation. At the end of 2000, farmer economies have received RFF loans to US\$ 1.8 million, out of which 300,000 are SLA loans and the rest are loans to cover current operational areas of the RCF. What is important is that through SLAs the farmers have the possibility to receive a larger credit amount (the current amount is up to US\$ 5,000), being ever-increasingly oriented toward financing for investment

purposes. Some indicators of the RFF activity are provided in the following table:

Table 2 RFF operation indicators, in USD (US\$ 1 = Lek 140,0).

Indicators	31.12.1999	30.06.2000	31.12.2000
Number of SLAs' members	0	112	505
Number of established SLAs	0	5	18
Number of SLAs in process	0	9	3
Outstanding loans	2 694 144	2 958 954	2 673 760
Number of active assets	5 754	5 415	4 423
Average loan amount	468	534	605

Source: RFF, Annual Report for 2000.

Second: Establishing new SLAs. If the first way presupposes the outside village alternative combined with that of the farmers, the second way is more original and is based only on farmers' initiative. This process is already at its first steps in our country³.

Establishing new SLAs is another way that assumes special significance, considering also the deficiencies of the first way. In addition, from the economic analysis of the farmers' budget, it results that in perspective development areas, the savings capacity and the ability to repay the credit is higher. On the other hand, these areas have a better infrastructure and may be considered as urban areas or in the vicinity of urban centres. The establishment of new SLAs in these areas gains priority even for the fact that the rural population of these areas there are less premises or willingness to displace toward big cities. Until end 2000, with the technical assistance of the RFF were established three SLAs in the rural areas. From gross or monetary income analysis, it results that farmer families of these areas have higher incomes. Such areas are believed to include those village groups that encircle urban areas with micro-towns such as Vorë, Maliq, Milot, Divjakë, Novoselë, etc. The latter will serve as residences for SLAs' headquarters. On the other hand, this will help the increase of banking services provided to farmers. SLAs may be best and quickly established in those areas where co-operation is better developed. Similar farmer organizations that co-operate in marketing trade, etc., though few in number, do already exist. It is extremely important for

the establishment of the first SLAs to be successful, since our farmer first would like to see the example and then act. The establishment of new SLAs represents the only way for financing farmer economies of these areas, considering that the banking reform is creating a gap of financial services in the village areas.

The current established network of rural SLAs, including similar institutions established with the support of other projects, has reached 30. This is the reason why the review of the relevant legal framework has turned into an emergency. The changes proposed by the Bank of Albania in relation to the supervision of these institutions are of primary importance. The draft-law on SLAs, drafted with the participation of the Bank of Albania, is now in its final stage and expected to be passed by the Parliament. The speeding up of procedures for its approval is important considering that these institutions are beginning to mobilize the savings of their members.

Conclusions:

The banking system deficiency, which led to the liquidation of the Rural Commercial Bank, has also led to a paradox situation: Although Albania is a rural country, there are no institutions specialized in rural financing.

The current situation requires the establishment and functioning of financial institutions specialized in rural areas. As the most adequate model, we propose the establishment and functioning of credit co-operatives or otherwise called savings and loan associations. Only these institutions can establish a micro-credit system for the Albanian farmer.

Establishing new SLAs in rural areas with a clear developing prospective will include villages in the vicinity of urban areas or small towns with rural orientation. The best areas for establishing new SLAs are those where farmers' associations are created. In my opinion, it should represent the first example for establishing the SLAs.

In the next 2-3 years SLAs may be extended only in local level. When consolidated, this SLAs' network will naturally require the establishment of the first SLA unions and their final shifting into the most organized form, assuming all the features of an institution or a financial intermediary which will be subject to the legal, regulatory and supervisory framework of the banking system.

NOTES

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¹ As already known, the decision for the liquidation of the Rural Commercial Bank was taken after the deterioration of its credit portfolio.

² RII indicator measures the change from state-owned and collective farms to individual farms. It is measured as $RII = (\ln 95 - \ln 89) / (100 - \ln 89)(100)$, where $\ln 95$ and $\ln 89$ represent the share that individual farms occupy in the total of rural land for years 1995 and 1989, respectively.

³ Although newly established SLAs, 5 SLAs have been established in the rural sector.

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