

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

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Abstract

Nigerian financial system has witnessed significant growth over the years. The phenomenal growth and high financial depth can be attributed in part to the country's vast network of financial institutions, including rural finance.

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

Keywords: rural finance, growth, infrastructure, microfinance institutions.

1. Introduction

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

Based on the available evidence, Nigerian financial system has witnessed significant growth over the years. The phenomenal growth and high financial depth can be

attributed in part to the country's vast network of financial institutions, including rural finance. For years, Government and the Central bank of Nigeria had to intervene especially with respect to stipulation of credit guidelines in favour of agriculture and agro allied activities which constitutes 70 per cent of activities in the rural areas. Moreover, several programmes and schemes were implemented to enhance increased credit to the rural areas. Some of these policies include sectoral allocation of credit and concessionary interest to rural and micro entrepreneurs. As an illustration, in 1969, banks in Nigeria were compelled to lend at least a minimum percentage of their loanable funds to agricultural sector. The stipulated minimum percentage of loanable funds increased from 4 per cent in 1972 to 18 per cent in 1996. Also, the CBN introduced the rural banking policy in 1977 that required commercial banks not only to open stipulated numbers of rural branches but also to advance not less than 50 per cent of the total deposit mobilized in the rural areas to rural borrowers. The number of rural branches increased from 13 at the inception of rural banking scheme in 1977 to 722 in 2005. Finally, there were such programmes as Agricultural Development Programme (ADP), National Directorate of Employment (NDE), the Directorate of Food, Road and Rural Infrastructure (DFFRI), Better Life for Rural Women, and National Microfinance Policy and Regulatory Framework (NMPRF).

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

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

2. Conceptual Issues in Rural Finance Services provision

2.1 The concept of rural finance

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

Basically, the objectives of rural financial systems include, amongst others, promotion of measures to facilitate the access of all categories of rural producers (individual farmers, rural industrialists, cooperatives etc) to credit on reasonable terms; provision of safe place to save and serve as insurance against risk and promotion of the establishment; and support for the operation of banking and credit institutions, which are particularly responsive to the needs of rural producers.

2.2 Rural financial system and economic development.

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

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

3. Challenges to Access to Financial Services in Rural Areas.

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

Higher risks: Credit risk is higher in rural areas both for borrowers and rural financial institution. High and often covariant, risks in the rural economy are related to the dominance of agriculture, which accounts for a high percentage of Gross Domestic Product (GDP), and employment (HDR, 2000). The revenues of rural households,

whose incomes mostly depend on seasonal agricultural and livestock production, are volatile due to fluctuating weather conditions and pests or diseases. Besides, crop marketing systems in the rural areas are inefficient and small-scale farmers are exposed to greater uncertainty regarding the marketing of their output as a result of the liberalization of agricultural markets since the 1990s. As a result of lack of storage facilities, rural farmers often sell the bulk of their output at harvest when prices are low leading to low and variable income. In the same way, the traders that form the link between producers and the wholesalers markets tend to be under-capitalized. Faced with limited access to trade finance from formal financial institutions, have had to offer trade credit to wholesalers and processors. This usually creates a liquidity problem and limits their ability to absorb (and store) the substantial surplus available during the harvest season. The attendant glut often leads low farmgate prices with no market instruments to manage price risk.

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

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

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

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

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

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

4. Meeting the challenge of increasing access to rural finance.

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

Generally, rural finance can be promoted by supporting informal schemes such as community-based savings groups, as well as by fostering formal institutions through

technical assistance (supply-side measures) and assisting poor households and small enterprises in accessing financial services (demand-side measures). Besides, donors can provide support to the development of favourable policy and regulatory frameworks. Some specific programmes to enhance increased access of rural dwellers to finance under the broad groups mentioned above are highlighted below:

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

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

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

Provision of favourable enabling environment: An enabling and conducive environment is a prerequisite for an efficient financial system and effective rural development and poverty reduction. At the macro level, a number of factors are very important for preventing systemic risk. This entails implementation of measures (monetary, fiscal, financial etc) to achieve basic macroeconomic goals such as high growth rate, low inflation and low unemployment rate. Macroeconomic policy measures that promote growth and poverty reduction will ensure increased financial flow to the rural areas. Expansion of income that leads to increased domestic consumption and investment will

expand the range of production activities for the rural dwellers thereby providing the small entrepreneurs the opportunity to enter the market. Moreover, monetary policy interventions to contain inflationary pressures will lead to stability and growth which will impact positively on the cost of fund, thereby lowering the cost of borrowing for rural clients.

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

Additionally, financial institutions should adopt the policy of risks minimization. It is true that financial institutions in the rural areas lack collateral or the possibility to legally enforce contracts; however, they can use social links (for example through group savings and lending) to reduce their risks. The so-called linkage model combines informal systems such as self-help groups with formal banks. Groups are linked to the bank through a group contract, so that bank does not have to deal with each client separately (Inforesources, 2008). Adopting this approach will help the financial institutions to reduce their risks and transfer transaction costs to the self-help group. Also, there is the suggestion that collateral can be created in the rural areas through warehouse receipt systems (Coutler and Onumah, 2002). This is with a view to taking care of the problem of lack of collateral in the rural areas. Warehouse receipts (WR) is defined as documents issued by warehouse operators as evidence that specified commodities (of stated quantity and quality) have been deposited at particular locations by named depositors (Coutler and Onumah, 2002). The depositor may be a producer, farmer group, trader, exporter, processor or indeed any individual or corporate body. The commodity remains the property of the depositor until sold at market, while the warehouse operator can extend credit in the form of cash to people who deposit commodities in his warehouse. Several benefits of the system have been noted in the literature. These include provision of opportunity for lenders to mitigate credit risk by using the stored commodity as collateral; reduction in transaction costs thereby encouraging commercial lending to the rural sector; and provision of opportunity for farmers to market their crops and get a

better price as they can defer sale of produce until prices rise after the traditional harvest season (Coutler and Onumah, 2002). All the same, the system has its own advantages. One, it tends to exclude smallholders and small-scale traders. Two, lack of regulatory oversight of the collateral managers can lead to fraud, which may discourage inventory-backed financing by banks.

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

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

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

Conclusion

Rural finance is now recognized as an important tool in the fight to reduce poverty, increase growth and enhance donors' development effectiveness agenda. It encompasses all savings, lending, financing and risk minimizing opportunities (formal and informal) and related norms and institutions in rural areas. In addition to fostering rural development, rural finance is increasingly used as an incentive to promote sustainable use of natural resources, use of alternative energies, and environmentally sound behavior. However, despite the importance of rural finance for growth and the significant demand for financial services, financial service providers such as banks, credit unions, microfinance institutions or insurance companies are typically reluctant to serve rural

areas. Consequently, majority of the country's rural population does not have access to the formal financial system.

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

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

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