

## TECHNICAL SUMMARY



### Creating Access to Agricultural Finance: Based on a horizontal study of Cambodia, Mali, Senegal, Tanzania, Thailand and Tunisia

By Reuben Jessop, Boubacar Diallo, Marjan Duursma, Abdallah Mallek, Job Harms, and Bert van Manen, Agence Française de Développement, A Savoir 14, Paris: AFD 2012.

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## Introduction

The following is a summary of Jessop, R., Diallo, B., Duursma, M., Mallek, A., Harms, J., and Manen B., (2012) *Creating Access to Agricultural Finance: Based on a horizontal study of Cambodia, Mali, Senegal, Tanzania, Thailand and Tunisia* (Agence Française de Développement, A Savoir 14). Paris: AFD.

This study analyses the reasons for gaps between supply and demand for agricultural finance, provides an overview of innovations of agricultural finance, and develops proposals for

support by governments, Agence Française de Développement (AFD), and other development partners that are responsive to the agricultural sector's needs.

## Supply and Demand of Agricultural Finance

In the six country studies, it was found that in Mali, Senegal, Tanzania and Tunisia no more than 20% of the demand for seasonal agricultural credit is satisfied, half of which consists of value chain finance. The results of this study confirm the literature that commercial banks, and to a lesser extent MFIs, avoid agriculture. Farmers for their part hesitate to take on credit as they fear banks and debt, and do not want to offer their land as collateral.

## Innovations in Agricultural Finance

Many initiatives to improve the provision of agricultural finance over the past ten years have shown great promise. Most “innovations” are not new, and some date back decades, centuries or even millennia. But, they tend to combine several financing concepts, and are nearly always embedded in value chain development. The major financial innovations are discussed below.

### Member-owned Localized Finance

In the past two decades the emphasis has been on the creation of rural and village banks, credit cooperatives/unions, self-help groups, and NGO-type microfinance institutions to localize finance in rural communities. Localized finance, however, is hampered by its small size and educational limitations of the members' management. Some focus too much on credit and not enough on savings, and end up attracting the wrong type of clients. In many developing countries, the supervisory framework for microfinance is weak because no public institution wants to supervise so many small financial operators. There is often little graduation from micro to small enterprises, resulting in a very high cost for micro lending. Finally, lack of term capital makes it hard for most localized finance providers to offer investment credit. Overall, the financial performance of microfinance has been mixed.

### Agricultural leasing

In leasing, legal ownership of the leased item only passes to the user upon the final payment (financial lease), or is indefinitely retained by the leasing company (operational lease). In most lease contracts, no collateral is needed apart from the leased item. The six country studies revealed some pilot projects in agricultural leasing, e.g. milling equipment, water pumps, small

tractors and tools, mainly by MFIs. For farmers, access to equipment on reasonable terms, and with no or little collateral, is an attractive proposition. It is also attractive for the equipment manufacturers, as leasing helps them develop new markets, and reduces the need to provide (risky) supplier credit to farmers.

### **Value chain finance**

Value chain finance is suppliers' credit (input suppliers) or prepayments by buyers, and is the most important source of agricultural finance. Financial institutions can become involved when they finance one end of the value chain, which then channels funds to the other links (internal value chain finance), or they can finance value chain partners directly (external value chain finance).

Value chain finance is attractive to banks and MFIs because of quasi certainty that farmers have a market and distribution channel, and reduced loan transaction costs. The key value chain partners tend to be well-established and well-known to the bank, and vouch for "their" farmers. However, one of the risks is side-selling outside of the agreed contract with value chain partners and intentional loan default by farmers. This risk is mitigated in narrow value chains with relatively few buyers. Farmers may not always get a "fair" deal due to the lack of buyer competition and market information. This is reflected in relatively high input prices (sold on credit) or low prices for the crop to be delivered, hence a high implicit financing rate.

### **Outgrower schemes**

Outgrower schemes evolve around a lead farm, the nucleus, which expands its production by asking smallholders in the vicinity to grow the same crop as the nucleus farm does. In some cases, the nucleus is not a farm but an agro-processing company or exporter. The nucleus firm provides the outgrowers with inputs, technology, credit, and a market. The outgrowers bring their labor and land, but bear the harvest risks. Credit may come through the nucleus, or directly from

a bank/MFI. While this increases income for outgrowers, they may be caught in a quasi-monopolistic and exploitative relationship if they are relatively resource poor and risk averse.

### **Value chain intermediation**

This is a special type of value chain finance where an intermediary, which is not itself a value chain partner, facilitates the process for all parties. One such intermediary is DrumNet in Kenya which has developed a technology platform allowing it to act as an intermediary between finance providers, farmers, input suppliers, and buyers. It negotiates contracts with buyers on behalf of farmer groups. Once the contract is established, farmers are able to obtain financing from a bank. Money is disbursed directly to an input supplier who then provides the input to farmers. At harvest, the product is certified and sent to the buyer, which triggers a payment in favor of DrumNet. DrumNet then pays off the bank and gives the remainder (minus its fees) to the farmers. Transaction costs are reduced via DrumNet, which aggregates financing, technical advice, input supply, and marketing.

### **Agricultural factoring and trade receivables finance**

Factoring is the sale of receivables to a "factor", an entity that ensures subsequent debt recovery and also bears the credit risk. Invoice discounting, such as trade receivables finance, is a type of borrowing in which the receivable is used as collateral (the credit risk is not sold).

Experience with factoring in Kenya showed that it took a long time for smallholder tea farmers to be paid for their tea. The factoring company advanced farmers 70% of the value of tea delivered to the Mombasa tea auction, and charged 2.5% interest per month for its service. The tea auction repaid the factoring company directly.

### **Warehouse receipts**

Warehouse receipt finance is applicable to agricultural commodities that can be stored.

The farmer delivers the grains to the certified and secured elevator for storage, in exchange for a warehouse receipt. The farmer hands the warehouse receipt to the bank as collateral for credit—often 70%–80% of the value in storage.

Warehouse receipt finance lets farmers decide the best time to sell the crop, benefiting from in-year price changes. This increases the farms' income and helps with cash flow planning. The fact that the product is tested, graded and certified nearly also increases its value. Warehouse receipt finance requires an enabling legal environment, notably secure ownership rights of the products in storage, bankruptcy law, transferability of title documents, and efficient dispute settlement among parties.

### **Credit guarantees**

Credit guarantees can be provided to banks and MFIs to encourage them to finance agriculture. This works when farmers use adequate technology, have good markets, and have projects that will generate cash flow, but lack the collateral to satisfy the risk-management requirements of the bank/MFI. A critical issue is the amount guaranteed: when set too low, banks will not find it practical, and when set too high, banks will not be motivated to collect the debt. High guarantees may also lead to “moral hazard” as borrowers decline to repay, knowing that their loan is guaranteed regardless.

### **Agricultural Insurance (index insurance)**

The country studies showed that, apart from some local pilot projects, agricultural insurance is not well-developed. Index insurance is a “derivative” instrument in that the pay-out to farmers is triggered when the threshold value for an underlying risk indicator (the “index”) is breached. The main problem in using index insurance to guarantee credits is that a payment is triggered when most of the farmers have either no losses or substantial losses. The cost of index insurance is also very high.

### **Price smoothing**

Price smoothing aims to reduce the impact of annual fluctuations in prices. At the beginning of the season, the scheme sets a target for producer prices based on a five-year moving average of world market prices. If the actual world market price after harvest exceeds this target price, the balance is deposited into a smoothing fund. If the actual world market price after harvest falls short of the target price, the shortfall is recovered from the fund.

### **Mobile Banking**

Through the linkage of mobile operators with banks and MFIs, clients can withdraw, deposit, and repay loans through the mobile phone, saving them the inconvenience and cost of traveling to the nearest bank or MFI office. This brings down the cost of providing financial services to farmers, and is vastly contributing to the monetization of the rural areas. Another innovation is mobile service points by banks and MFIs whereby a van visits villages once or twice a week to offer financial services.

## **Role of Government and Development Partners in Agricultural Finance**

The six country studies reveal that nearly all innovations in agricultural finance have been introduced and implemented by the private sector. However, governments play a key role by creating a legal framework for conducting financial operations, and policies for conflict settlement, law enforcement, land rights, infrastructure and social services. Financial institutions hesitate to conduct leasing, warehouse receipt finance or to finance farm contracts simply because they are not sure they are legally covered in terms of collateral.

The authors of this study believe that government should do away with price and interest rate distortions, which misdirect agricultural resources. Governments should intervene directly in agriculture but should focus on piloting innovations through seed money and

providing support for institutional development, rather than on introducing large-scale credit programs through public institutions. They should strengthen physical and social infrastructure, which continues to be a large impediment to agricultural development.

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