Catalyzing Smallholder Agricultural Finance

AgriFin (May 2013) | The following is a summary of Catalyzing Smallholder Agricultural Finance (http://dalberg.com/documents/Catalyzing_Smallholder_Ag_Finance.pdf) published by Dalberg Global Development Advisors in September 2012.

Upward global demographic trends, coupled with the growth of the middle class, have created an unprecedented demand for food. To secure supply and respond to customers' preference for sustainable sourcing, multinational companies begin to cultivate smallholder value chains. Unfortunately, smallholder farmers often face poor market linkages and many barriers to improving productivity. One of the main barriers is lack of access to formal financing. Social lending, an "impact driven smallholder agricultural lending that is primarily driven by social and environmental intent to support smallholder farmers, likely with lower than risk-adjusted net market returns," has emerged as one of the methods to address this financing gap. However, social lending by itself is inadequate in meeting the demand for greater financing.

The total demand for smallholder financing, including short and long-term needs, is estimated at $450 billion. This huge demand cannot be met with a one size fits all strategy due to variations in features such as crop characteristics, aggregation points, and value chain dynamics. The report suggests five strategies for multinational buyers, commercial banks, social lenders, and donors to address this demand: replicate and scale up social lending; innovate new financial products beyond short-term financing; finance out-grower schemes of multinational buyers in captive value chains; finance alternate points of aggregation; and provide finance directly to farmers.

Replicate and scale up social lending

The first strategy involves replicating and scaling up social lending methodology. Social lenders have developed an effective model to provide short-term export trade financing to producer organizations and small businesses that engage smallholder farmers. Despite its success, this model has two important limitations. First, the social lending methodology requires farmers to be aggregated into producer organizations. Currently, only about 10 percent of smallholders belong to these organizations. Second, 90 percent of this financing is meant to address short-term needs. Regardless of these limitations, there is still ample room to scale up and replicate this model. The first pathway is by expanding the social lending model into new countries using an existing crop. The second pathway involves expanding into new crops within existing countries. This strategy requires social lenders to take on the primary role, however, other actors still have important roles to play. Donors, for example, can facilitate this process by providing technical assistance to form and train smallholder producer organizations. Commercial lenders can potentially finance producer organizations with good track records with social lenders and scale up the financing.

Design new financial products

The second strategy involves developing and innovating new financing products that go beyond short-term export trade finance. The main obstacle to implementing this strategy is the cost of managing risk. Long-term lending exposes the lender to volatility, and mitigating this risk can be very expensive. Social lenders can experiment with this strategy by using producer organizations as vehicles to provide long-term investments in equipment, rehabilitation, and infrastructure. This strategy, however, requires capital support from donors. Commercial lenders can develop foreign-exchange and price-hedging products to help manage long-term risk, while local governments can increase market transparency and access to information.

Finance out-grower schemes of multinational buyers

Multinational buyers are well positioned to finance smallholders and many of them already engage with farmers through out-grower schemes. Out-grower schemes are arrangements in which a company ensures its supply of agricultural products through formal or informal contracts with farmers or producer organizations. Some emerging models of out-grower scheme include warehousing for credit, direct financing to smallholders, and serving as the front office for financial institutions. In warehousing for credit, smallholders deposits their produce in buyer warehouses in return for credit. At the end of the term, the smallholders will have a choice whether to pay back their loan, withdraw the crop, or sell the crop either to another buyer or to the warehouse. Another approach will be to extend financing directly to smallholders on the basis of trust and personal contact through regular site visits. In the third model, in which buyers serve as the front office of financial institutions, the risk is shared between buyer and lender. Buyers originate, manage, and collect loans from farmers while financial institutions provide the capital for loans and other lending products. Commercial/social lenders can mitigate risks and reduce transaction costs by leveraging on the existing relationships between buyers and smallholders.

Finance alternate points of aggregation

The fourth strategy involves financing smallholders through alternate aggregation points. Since only 10 percent of smallholders belong to producer organizations, the social lending methodology has a limited outreach capacity. In order to reach the rest of the smallholders, the key is to find alternate points of aggregation in the value chain and to use these as vehicles for on-lending to farmers. These alternate points can include warehouses, input suppliers, or traders. Financing through alternate aggregation points requires significant amounts of grants from donors due to the amount of testing and piloting required to establish these finance models. Once the model is proven to be viable, social/commercial lenders can then mobilize their capital to finance these aggregation points.

Provide finance directly to farmers

Lastly, the pathway to meet the demand for smallholder financing includes lending directly to farmers. Direct-to-farmer financing can be done by applying microfinance models to rural areas with high penetration of mobile technology. For non-aggregated farmers, mobile technology holds the keys to the future by connecting lenders and borrowers at significantly reduced costs. The use of a mobile banking platform can increase access to finance for smallholders. The success of this model will heavily depend on the willingness of donors to support microfinance institutions in developing, testing, and scaling their models in rural areas. Each of these five

strategies requires different degrees of collaboration between multinational buyers, commercial lenders, social lenders, and donors. However, each strategy is discrete and therefore can be pursued independently of the others.