Segmentation of Smallholder Households: Meeting the Range of Financial Needs in Agricultural Families

AgriFin (July 2013) | The following is a summary of Segmentation of Smallholder Households: Meeting the Range of Financial Needs in Agricultural Families (http://www.cgap.org/sites/default/files/Focus-Note-Segmentation-of-Smallholder-Households-April-2013.pdf), published by CGAP in April 2013.

The importance of agriculture in developing economies cannot be overstated. For more than half of the 48 least developed countries, agriculture accounts for more than 20 percent of the gross domestic product (GDP). In ten of these countries, the sector contributes more than 40 percent of GDP. Despite its importance, agricultural productivity in developing countries remains quite low due to limited access to inputs, poor infrastructure, weak connectivity to markets, and lack of access to finance. As a result, smallholder farmers make up the majority of people living in absolute poverty. Currently, there are approximately 2.5 billion people living in 500 million smallholder households in developing countries. Unfortunately, their demand for financial services has not been well understood let alone met. A better understanding of their demand for financial services, including both those linked to general household purposes and those related to agricultural activities, is critical to improving access to finance for this segment of the population and to ultimately lifting millions of people out of poverty.

This paper proposes a segmentation framework for the 500 million smallholders to better characterize their financial needs, particularly those related to agricultural activities. The framework divides smallholders into three segments – noncommercial smallholders; commercial smallholders in loose value chains; and commercial smallholders in tight value chains. This segmentation differentiates smallholders by the types of crop they grow, how they engage with markets, and how these markets are organized.

Noncommercial smallholders (approximately 300 million households with 1.5 billion people) are typically considered subsistence farmers. They farm in order to survive and thus most of their production is concentrated in staple crops and sometimes includes small livestock. The use of inputs and mechanization is minimal, if any. They consume what they grow and generally are buyers of food and sellers of labor. Noncommercial smallholders are not connected to a structured value chain of any kind. The income of this population segment is low, highly irregular, and unpredictable. Meanwhile, their financial transactions tend to be too small to be of interest to formal financial service providers. The cost of developing a financial product for noncommercial smallholders is larger relative to its potential revenue. To meet their basic financial needs, they are limited to informal financial services, such as pawn-based lenders, microfinance lenders, remittance or telecommunication companies transferring money from family members or conditional cash transfer programs, and local savings and loan groups, which allow members to save on a regular basis and borrow a small sum of money without fees and collateral.

Commercial smallholders in loose value chains (approximately 165 million households with 825 million people) are slightly better off than noncommercial smallholders. Their production involves a mix of staple crops and some higher value crops (sugar, tea, coffee, oilseeds, fibers, or energy crops). They usually have access to more land than noncommercial smallholders, although they still have limited access to inputs, financial services, and often rely on traditional production methods and unimproved seeds. Commercial smallholders in loose value chains produce some surplus, which they usually sell in informal local or regional markets and typically have access to a wider range of financial services. Their characteristics, however, present some fundamental challenges to financial providers. First, their income includes a seasonal component. Furthermore, their transactions size is on the lower end of the scale of what can be profitably offered by formal financial providers. Their profiles are well suited for banks, credit unions, and microfinance institutions (MFIs) that seek to expand into rural areas and have built capacity in agriculture. Harvest savings accounts, in which profits from the harvest are deposited for a later, agreed use, and passbook savings accounts into which family members can deposit income from non-farming activities are a few examples of appropriate financial products for this segment. Input suppliers can also extend loans based on their relationships with these smallholders.

Commercial smallholders in tight value chains (approximately 35 million households with 175 million people) usually produce more higher-value crops, although they also grow some staple crops. They manage at least two hectares of land (subject to regional differences) and have access to improved seeds, inputs, finance, and secured markets. Commercial smallholders in tight value chains have the capacity to produce high-quality outputs that are sold through organized value chains on a contract basis. Their staple crops might be sold more informally through informal local and regional markets. Their demand for financial services is more complex and diversified than the other two segments. The profile of commercial smallholders in tight value chains presents different challenges to financial services providers. Although their overall household income may come from diverse sources, a significant portion of their agricultural income may depend on a single buyer. In addition, contract farming agreements may increase their exposure to risks since outputs must meet exacting standards specified in these agreements. Value chain financing has a significant role to play in meeting the financial needs of commercial smallholders in tight value chains, although many more financial tools are needed to meet their household financial needs. Overall, most agricultural households need a portfolio of general finance at all times, and specific agricultural finance only as they produce higher-value crops.

In response to the demand for smallholder financing, there are several promising products, delivery channels, and provider business models. Commitment savings accounts are modified savings products that limit the accessibility of funds and target its use. For example, restricted savings products allow farmers to use their end-of-season profits to finance the next season's planting costs, thus avoiding interest expenses and transactions costs. In terms of delivery channels, mobile phones have been proven to be an effective method of reaching vast numbers of clients at low cost. Mobile phones can be used to send information about improved farm practices, crop disease prevention, post-harvest handling, marketing, or weather information. Mobile phones have been used more frequently to conduct financial transactions in agriculture. The expansion of MFIs into rural and agricultural areas is one of the most promising business models due to common concepts underpinning this approach. First of all, the use of cash-flow based lending models has helped to expand access to finance since a potential borrower is assessed based on his overall household cash flows instead of the potential success of one specific investment. This approach also insists on the diversification of loan portfolios, thus avoiding the concentration of risk in a single market, delinking loan repayment from loan use, and enforcing repayment. The willingness of MFIs to build their internal capacity by developing expertise in agriculture could potentially play a significant role in meeting the various financial needs of smallholder households.

To improve supply of finance, a better and more refined segmentation of the financial demand of rural households is markedly important. Access to finance is a necessary -- not sufficient -- condition to improve agricultural productivity. There are other aspects that are inextricably linked to bringing about transformation in the agricultural sector. Simultaneous improvements are urgently needed in market infrastructure, farmer organizations, extension services, research services, and other sources of innovation.

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