PRICING AND RETURNS

FROM FIXED TO VARIABLE COSTS, SHARED WITH A VALUE CHAIN PARTNER

The value chain approach to agriculture financing allows banks to reach a large numbers of borrowers at a lower cost than it would incur by establishing its own branch or agent network, allowing for attractive pricing.

Quick jump for topics

INTRODUCTION

This step examines the impact of VCF on cost, pricing and returns for the bank and considers ways that delivery costs and risks can be reduced. First-loss guarantees, a popular instrument used in VCF, is introduced and an example

from a commercial bank comparing the operating costs of standalone credit to VCF is provided.

COMPARATIVE COSTING

Banks have found that aggregators can act effectively as commission agents for their products and services to other members of the value chain, provided they have the experience, expertise, and capacity to take on such a role. For the financial institution, the commission it pays should be less than the

commission it pays should be less than the costs it would incur if it undertook loan promotion, processing, supervision, and collection itself. At the same time, the commission system has the advantage of turning a fixed cost into a variable cost, which strengthens the financial institution's balance sheet.

FIRST LOSS GUARANTEE

The first-loss guarantee is an option that allows for risk sharing between the financial institution and the aggregator, and, in some cases, the input supplier. This works best when the aggregator understands the potential business advantages in agreeing to assume part of the risks and/or the aggregator is already financing growers. In the second case, having the financial institution provide credit to producers frees up aggregator resources for other uses.

Ultimately, the scope of the risk is smaller than the aggregator would bear or might already have assumed as the sole credit provider to smallholder farmers. Based on experience, banks ask for between 10-30% coverage for the first-loss guarantee. The size varies according to both the appreciation of the risks involved in the credit operation and of the the creditworthiness of the aggregator.

PRICING TO REFLECT RISK

Partnering with aggregators or leading firms in value chain financing creates opportunities to establish risk-sharing and cost-sharing mechanisms through which banks and their partners can negotiate mutually beneficial terms that would not be available in conventional lending. Negotiable items include:

- Extent (in percentage terms) and coverage of the first-loss guarantee
- Terms of the bank’s financing of the aggregator’s individual operations
- Size of commission to the aggregator for identifying borrowers, disbursing credit, and loan recovery
- Terms of funding to producers and other upstream participants (e.g., input suppliers)
- Use of the payments platform for cross-selling bank products

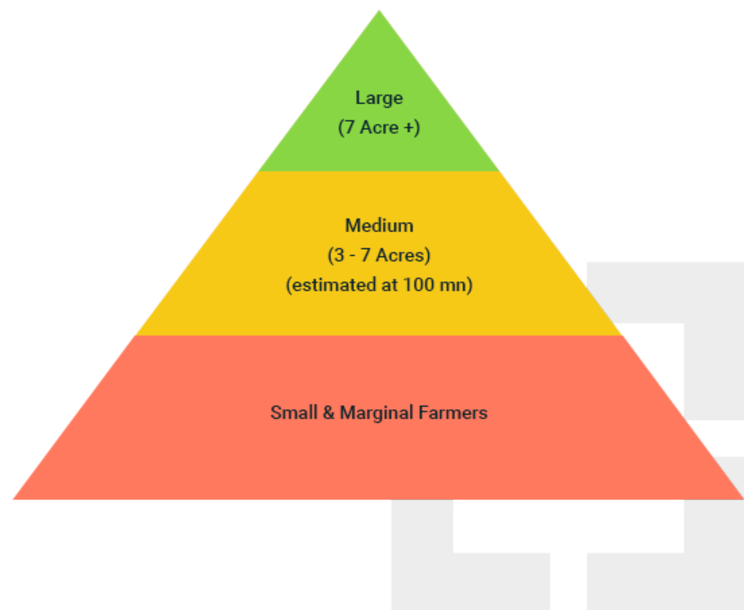
OPERATING COST

STANDALONE CREDIT TO FARMERS

	Average Ticket	Income over 5 years
Large	$ 10,000	$ 1,200
Medium	$ 5,000	$ (38)
Small & Marginal	$ 2,000	$ (1,060)

Medium Farmer - 3 acre

	Standalone Credit	Value Chain Finance
Net Income	6%	6%
COA (One time)	14%	12%
Annual servicing cost	3%	Nil
Break even	Year 4	Year 2

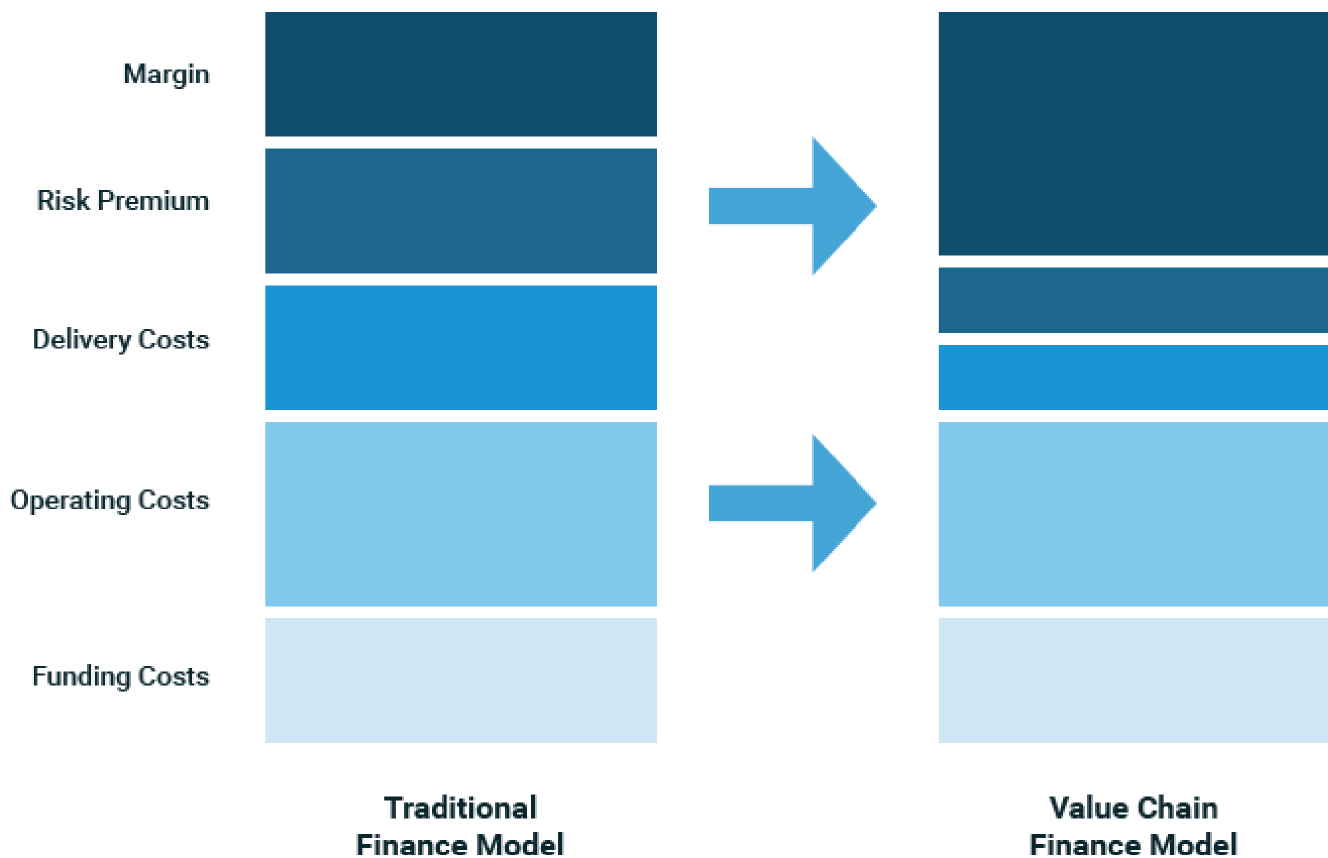


COSTS, PRICING AND RETURNS

Put simply, pricing of financial products is the result of the sum of cost of funds, operating costs, delivery costs, a risk premium, and a margin or (net) return. The value chain finance model has the potential for reducing delivery costs, and for mitigating many of the risks associated with financing agriculture, and therefore impacting the size of the risk premium that financial institutions build into their cost models.

When the aggregator performs a number of the credit process functions (including but not limited to, identification of farmers for credit, document

processing, supervision, and payment retention), financial institutions will pay a commission to the aggregator. The commission is typically a percentage of the credit extended. Often the entire commission is not paid in full at the time of disbursement, with the final payment subject to adjustment based on loan repayment rates. As such, this is a variable rather than a fixed cost. Back office costs remain the same, although the total cost is lower, including the charge for the risk premium.



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