



Microfinance

OCCASIONAL PAPER

Financing Agroenterprises

Smallholder farmers generally lack adequate capital to invest in their production and marketing activities. Volatile crop prices, unpredictable rainfall and pests and diseases make agricultural lending too risky for formal financial institutions. The distances that need to be covered to evaluate and deliver loans to smallholder farmers add to costs and make lending unattractive to most conventional lenders. Additionally, most smallholders lack collateral or a credit history to guarantee a loan. They are seen as having too high a risk of default, so do not qualify for loans to support their farming.

But if agriculture is to increase their food security and incomes, farmers need financial services to buy inputs, hire workers, rent storage and pay for marketing. Although some can borrow from local lenders and traders, such loans are typically expensive and not aligned with crop calendars or the needs of value chain development.

Standard 30- or 90-day loans, repayable on a weekly basis, are designed for urban trading or industrial production. But they do not suit farming, which produces returns only at the end of the season but which needs finance spread over several months to cover the costs of planting, production, harvesting, storage and marketing. Farmers need financial products that meet their specific production and marketing systems. Those in remote areas need even more flexible products as their business cycles are less synchronized with national marketing systems.

For these reasons, formal lending and microfinance institutions have been unable to provide loan products for farmers. So most rural communities are forced to rely on high-cost loans from local moneylenders, loans from traders (which may compromise their price negotiations) or community-based savings-led initiatives

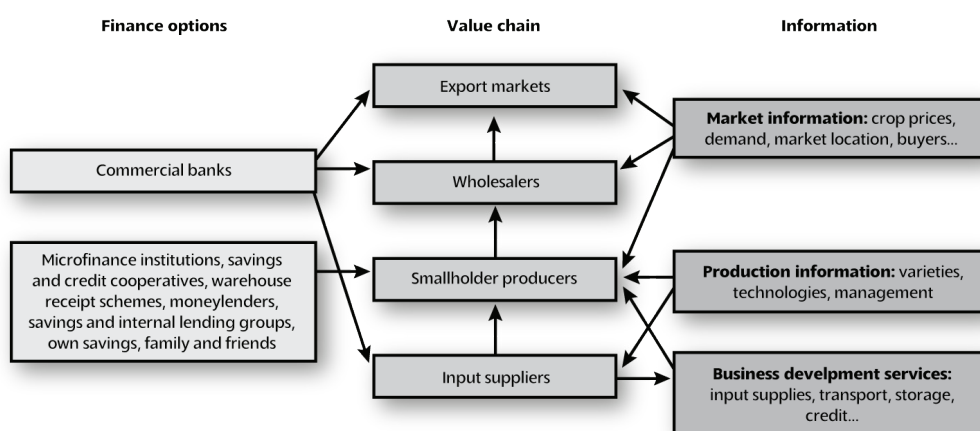
Financial Options within the Value Chain

At each stage in the value chain, financial services can come from a variety of sources: commercial banks, savings and credit cooperatives, microfinance institutions, input suppliers, warehouse receipt programs, self-help group activities, savings and internal lending mechanisms, and family and friends ((adapted from Downing (2005) Figure 28).

That's an extensive list. But of all the actors in the value chain, smallholder farmers are the most disadvantaged. They are often unable to access any of these services. Most cannot get a loan from a commercial bank, and a few might be able to borrow from a microfinance institution. Most, however, rely upon local moneylenders and traders. Most microfinance institutions still find it difficult to design agricultural loan products for smallholder producers with no collateral or a verifiable credit history.

Information and Finance

Information is vital to both producers and the providers of financial services. They need four main types of information (the last column of boxes in Figure 28): information on production, business development services and markets.



Farmers need to know not only what inputs they need, but where to get them and how much they will cost.

- **Production information.** They need to know how farmers can produce the products that the market demands. For farmers, this is obvious: they must have a sound understanding of recommended production packages: what is the best seed variety, the best time for planting, the fertilizer needs, and so on. They need the right information and access to the right inputs at the right times. That may mean the farmer has to borrow more, but it should pay off in terms of higher profit and greater ability to repay at the end of the season. Nevertheless, agriculture is a risky venture: bad weather or pest attacks may cut yields unexpectedly. Farmers understand this well, so are reluctant to risk too much by borrowing a lot of money to invest. Financial institutions do not have to be experts in agricultural production, but they also need a good understanding of farmers' needs and opportunities, and of the constraints and risks they face.
- **Information on business development services.** Farmers need to know not only what inputs they need, but where to get them and how much they will cost. They need to know where to get other types of business development services, such as transport, storage facilities and credit. Finance providers also need to consider the most important services that farmers will have to pay for so they know what amounts will be needed and when in the production-to-sales cycle.

The information and financial needs of farmers change over time. As they begin to scale up their operations and engage in more sophisticated or remote markets, they will need different types of information, and different types of finance.

- **Market information.** Market information, i.e., the regular provision of basic product prices, is also vital to farmers and financial service providers. Farmers need it to develop business plans, forecast their expected incomes, and negotiate prices with buyers. They need it to make informed decisions on profitable crop types and varieties, the best time of planting, harvesting times, storage options and where to sell a product. Loan providers also need it to evaluate the risk associated with a specific type of loan.

To design new types of finance products for poor farmers, financial service providers need to have certain types of information about the value chain so they can anticipate how much money farmers will need to borrow, when they will need it, and when they can expect to repay. This information will be specific to each commodity: a farmer growing beans—a short-season crop—will need a different type of loan from one growing sugarcane, fruit trees or sheep, which have longer production cycles and different financing needs.

The information and financial needs of farmers change over time. As they begin to scale up their operations and engage in more sophisticated or remote markets, they will need different types of information, and different types of finance. Selling produce in bulk, for example, is more profitable than selling it by the bag: it is necessary to pay for storage, grading, sorting, packaging, hiring a truck, and so on. Members of a co-op may want to be paid immediately when they deliver their produce to a collection station, rather than waiting a couple of months for payment. So the co-op will need finance up front.

Role of Formal Financial Services

Most formal financial service providers, especially commercial banks, are reluctant to invest in smallholder agriculture because they think it is risky and smallholders are not creditworthy. Microfinance institutions and savings and credit co-ops generally work in the same communities as smallholder farmers and finance non-farm activities, so rate the risks lower and are more open to providing loans to smallholders. But they have not created loan products for agriculture or for specific crops or livestock. Generally, they offer the same generic loans for agriculture as for small-scale trading.

The value chain approach offers financial institutions insight to the types of loan products that are required and how finance can fit the needs of smallholder farmers. Here are four examples of ways that financial institutions can, through creative means, engage in the value chain:

- In **Mali**, the Banque Malienne de Solidarité has been financing three levels of the potato value chain. This bank provides a letter of credit to a seed-potato importer, loans to more than 1,000 potato growers through local microfinance institutions, and loans to grower cooperatives to export potatoes to Côte d'Ivoire, Ghana and Burkina Faso.
- In **Uganda**, Stanbic Bank is using a warehouse receipt system to provide loans to the 2,100-member Kapchorwa Commercial Farmers Association. Association members deliver their maize harvest to a designated secure warehouse, where it

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is weighed and kept under proper conditions until the farmer is ready to sell it. The farmer gets a certified receipt that can be taken to a branch office of Stanbic Bank and converted into a loan, with the warehoused crop serving as collateral. The loan is paid back when the grain is sold.

- In **Kenya** in 2007, Safaricom, the country's largest mobile phone operator, began offering a payment service for the unbanked, known as M-PESA (M stands for mobile, and pesa is Swahili for "money"). A farmer can use a mobile phone to transfer money quickly and securely to another mobile phone user. The farmer can turn cash into e-money at any Safaricom office. He or she then follows the instructions provided to send the money to someone else, who goes to their local Safaricom office to collect the cash.
- In **Ethiopia** in 2006, CRS in partnership with Metemamen, a local microfinance institution, started offering loans for navy bean farmers in Ethiopia (chapter 8). The initial idea was to lend to farmers only so they could buy improved seeds. But the team quickly recognized that the farmers also needed money for fertilizer and other inputs so they would get a good yield from the improved seed. So Metemamen decided to increase the loan fund to cover these additional purposes.

Another area where more flexibility was needed was the timing of the loans. The loans were supposed to coincide with the rainy season, but some farmers wanted to borrow funds after the rainy season to finance planting other crops. Smallscale irrigation let them continue production throughout the year while they did other work, such as grain trading. In response, Metemamen introduced two loan periods. The first, from mid-June to mid-September, coincides with the rainy season. The second, from mid-December to the end of June, is timed to finance dry-season, irrigation-dependent farming.

Reducing Risks

While such services are highly desirable, most financial service providers perceive agriculture to be too risky:

- **"Covariant risks."** Loans for agricultural production are susceptible to many borrowers defaulting at the same time—for example, if a drought causes widespread crop failures. Lenders normally like to spread their risk by lending to a diverse portfolio of borrowers. With different sources of income, it is not likely that all these borrowers will be unable to repay their loans at the same time.
- **"Asymmetric information."** Lenders do not feel they know enough about the borrowers, their crop and livestock production, and future market prices.
- **Cost of serving rural areas.** It is more expensive to provide a service to remote or sparsely populated rural areas than in the cities. The cost of rural outreach cuts already low profit margins below what the lender finds acceptable.

Some financial institutions have overcome these problems and have been creative in developing financial products for the agricultural sectors, but their number is still insufficient.

Borrowers tend to be good at pointing out the shortcomings of financial institutions, but less good at recognizing their own weaknesses and responsibilities when applying for and using a loan.

Doing their Homework

One way to mitigate risk is to ensure that the different actors, especially the lenders, have an in-depth knowledge of the value chain and the relationships between the actors at the different levels. That will help the lenders design appropriate financial products. If a lender knows that the value chain actors have also done their “homework,” he or she will be more confident that a loan will be used for the intended purpose, and that the borrower is unlikely to default.

This “homework” includes:

- Conducting market studies to identify opportunities
- Linking to suppliers to ensure that the right inputs will be available on time
- Negotiating forward contracts to lock in a minimum price
- Securing the necessary technical support (e.g., from extension services)
- Obtaining the technology needed to ensure success

Multi-Phase Loans

Most farmers lucky enough to get a crop loan tend to receive it as a lump sum at the time the loan is approved. They are tempted to use part of the money for other, non-productive purposes, with the intention of replacing it in time. But when the time comes, they cannot find enough cash to pay for part of the production cycle. The yield suffers; the borrower makes less money, and may even default on the loan.

To reduce this danger, lenders can agree to lend a lump sum, but disburse it in several stages: part at the start of the season to pay for land preparation and inputs, part in the middle of the season to pay for weeding and pest management, and the remainder at the end to cover harvesting and post-harvest activities. An agricultural expert is usually needed to decide on the timing of such payments. This person must be credible; few local extension officers are sufficiently qualified to provide this type of advice. It is important that each party is clear on how the process works. An intermediary can help explain and manage such multi-phase loans: a local NGO working with a farmer association, for example, or a savings co-op working with a farmer group.

Information Disclosure

Borrowers tend to be good at pointing out the shortcomings of financial institutions, but less good at recognizing their own weaknesses and responsibilities when applying for and using a loan. Basic financial principles require borrowers to fully disclose their financial positions and provide reasonable estimates of yield and expected prices, based on historical production information. That allows the lenders to make a fair assessment of the real risk. But borrowers either do not have this information or do not want to disclose it, so lenders tend to overestimate the risk and remain unwilling to lend for agriculture.

Market intelligence is a key component of the business planning process. As financial service providers become more engaged with agricultural lending, they will look to market intelligence information generated within the value chain to guide them when they select clients and decide on credit terms.

Self-Financing Investment

Self-financing is one option for farmers who find it hard to borrow money. Farmers do this anyway: they do not rely solely on loans to pay for production costs. But their savings are small and easily spent on other things, so they generally cannot invest enough to pay for an optimal level of inputs. Instead, they buy small amounts of inputs, resulting in suboptimal yields and low returns.

Why do farmers find it difficult to save? Many have nowhere safe to save their money, so cannot accumulate much capital. Providing secure ways to save is one way to help them do this. One promising approach being tested by CRS is “savings and internal lending communities” (see the case from Tanzania in chapter 7). In this approach, groups of farmers pay a small sum each week into a common pool. Members can borrow from the pool if they wish to cover short-term expenses; they repay their loans with interest. By the end of the season, the pool will have accumulated a significant amount of money, which members can borrow as a lump sum to buy inputs for the next season. Defaults are rare because the members know each other well and can decide whether to make a particular loan, and because social pressure induces borrowers to repay.

Such groups rarely generate enough savings to provide more than one or two loans at a time. But the loans are more flexible than a formal loan from a microfinance institution: borrowers can use it to cover their expenses while they wait for the harvest. That helps them avoid being forced to sell off their standing crops cheaply to meet an urgent expense, or worse, selling land or livestock on which their long-term livelihoods depend. Such savings groups also help improve their members’ financial literacy, management capabilities, creditworthiness and group cohesion.

In a CRS-supported project in India, self-help groups use a portion of their savings to finance their collective marketing activities (see the case study below).

Dynamics of the Savings-Led Model

Applying a savings and internal lending model to agricultural finance activities requires some strategic thinking before it can become a viable source of finance. During the first cycle, savings and internal lending groups are just beginning to save collectively, so are not ready to take on the additional risk of agricultural lending. Furthermore, it takes time for the groups to generate enough savings to lend to their members, still more time before they can save enough to support agricultural production activities. In reality it will likely take a savings group 3–5 years to reach an optimal operating level, i.e., when the pool of savings at beginning of the cycle is greater than the maximum amount at the end of the first or second cycles.

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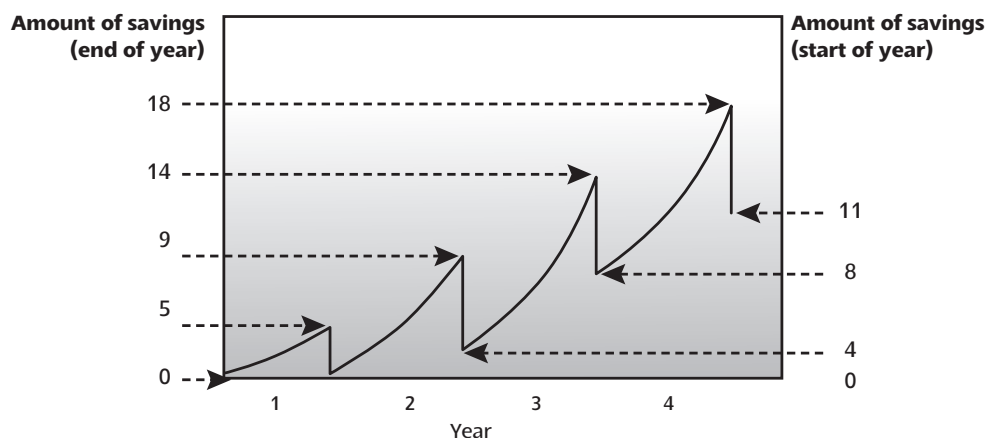
Savings and internal lending groups have a built-in control to ensure that the savings are safe. This is known as the “action audit” or share out. At their final meeting in a savings cycle, the group members pay their contributions as usual. The treasurer collects outstanding loans and fines, tallies up the savings, and announces the total for each member. The group then calculates its total income and net earnings. Each member is then given a portion of the net earnings, based on how much he or she has paid in during the cycle. Once this is done, the group decides how much, if any, of the total savings will remain to start the new cycle. This rest is distributed to the members, who often use it to buy inputs for the next season.

Figure 29 illustrates how savings and share outs work over time. At the end of year one, the members share out the entire savings, so start the second cycle at zero. Starting at zero, however, means that they cannot immediately get new loans for their businesses. So at the end of the next cycle they agree to leave between one-third and one-half of their savings in the common pool to start the third cycle.

Now that loans can start quickly in the third cycle, the members earn and therefore save more than in the previous cycles. They can save progressively more of the common pool to start each subsequent cycle. By the fourth cycle, the group starts with more savings than it had at the end of the first or second cycles. That lets it make larger loans during the cycle and higher returns at the end.

It is at this point that more organized agricultural finance becomes possible. Members also realize the true potential of savings. They start pre-financing input purchases (by pre-paying suppliers to lock in input quality and price), or set aside additional savings for future input purchases.

Such savings and internal lending schemes are probably not sufficient to address all the capital requirements of their members, but they are a significant step in that direction.



Source: Tom Shaw, CRS

Such savings and internal lending schemes are probably not sufficient to address all the capital requirements of their members, but they are a significant step in that direction. The amount of self-funding will be clear for external lenders, and their risk profile will be lower.

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