Agricultural finance for smallholder farmers: Rethinking traditional microfinance risk and cost management approaches

With evidence from Uganda, Kenya, Benin and Cameroon

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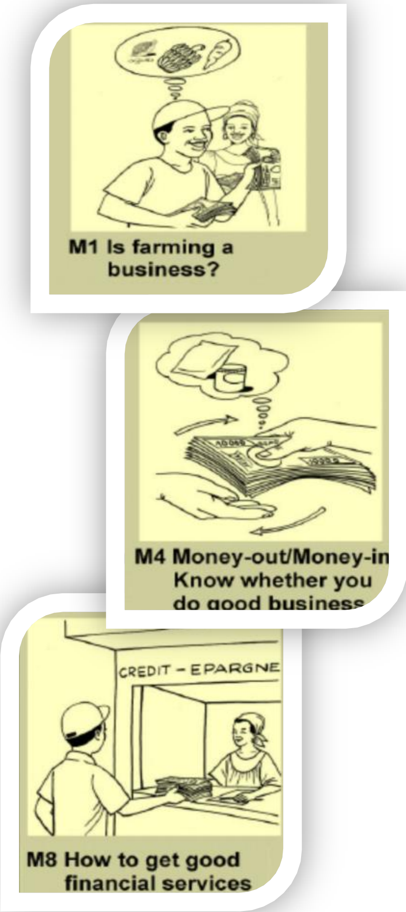
Outline

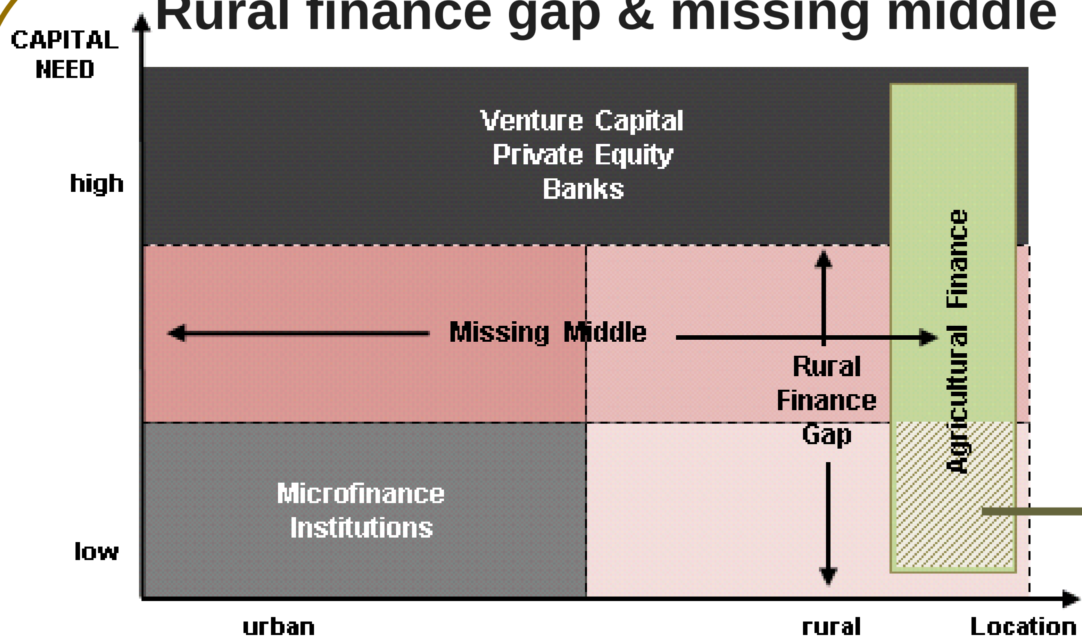


Background & Research Design

Findings

Lack of agricultural finance for smallholder farmers

Rural finance gap & missing middle



Source: modified from Doran et al 2009: 9

No finance for smallholder farmers

High risk & cost perception

Doran et al (2009). The missing middle in agricultural finance. Relieving the capital constraint on smallholder groups and other agricultural SMEs. Oxfam

Risks & costs of agricultural finance

High risk & cost perception

- **Additional risks and costs of rural areas and agriculture:**
  - ***external production and yield risks:*** natural disaster, plant/ animal diseases
  - ***market and price risks:*** weak input and output markets, volatile prices
  - ***constraints in rural areas***: high incidences of poverty, low productivity, low (financial) literacy
  - ***high costs*** due to dispersed clients and poor infrastructure
  - **…..**
- **Incompatibility of some traditional microfinance risk & cost reducing mechanisms with agricultural investments**

EUROPEAN
MICROFINANCE WEEK 2013
THE FUTURE OF MICROFINANCE:

Traditional microfinance features increase agricultural lending risk

Typical MF features/ requierements	Requirements for borrowers/ investments		Petty trade	Milking cow	Crop loan	Agric. equipment
Small loan amount	**Investment amount**	Small	Small	Medium	Small/ Medium	Large
Quick repayments	**Delay between investment & return**	Short	Short	Medium to Short	Long	Very Long
Cost covering interest rates	**% Return on investment**	High	High	Medium	Medium to Low	Low
Frequent repayments	**Lump size of return**	Low	Low	Low	High	High
Diversified hh income	**Centrality of investment to hh income**	Low	Low	Medium	Medium to High	Medium to High
Staggered loan dis-bursement within group	**Time sensitivity of investment**	Low	Low	Low	High	High
High volumes per loan officers	**Distance between clients**	Short	Short	depends	Long (mostly)	Long (mostly)
	Infrastructure	Good	Good	depends	Bad (mostly)	Bad (mostly)

Research Question

How can MFIs adapt their traditional **loan features** and **lending procedures** to mitigate **credit risk** and manage **transaction costs** when providing agricultural finance for smallholder farmers?

- How to adapt traditional microfinance features and mechanism without increasing risks?
- How to manage additional risks and costs of agricultural lending?

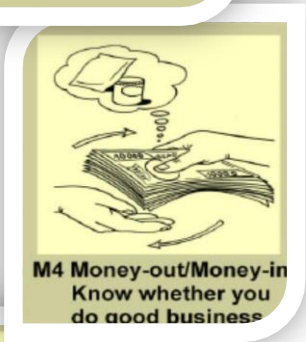
Interviewed MFIs

4 countries: Kenya, Uganda, Benin,

	MFI/ country		Age (years)	GLP (MM USD)	Deposit (MM USD)	Clients (thousands)	Bran-ches	Agric. loan portfolio (MM USD)	As % of GLP
CB	Equity Bank	KE	20 - 29	1,301	1,501	7,151	186	39.5	3%
CB	CRDB	UG	20 - 30	215	284	1,134	39	26.5	12%
MFC	Faulu	KE	22	40	7	226	96	0.6	2%
MFC	RUCREF	UG	13 - 20	1	0	6	7	n/a	n/a
MFC	Juhudi Kilimo	KE	4 - 9	2	0	7	8	2.1	100%
MBFI	Agaru SACCO	UG	11	1	1	9	4	0.4	42%
MBFI	FECECAM	BJ	37	56	85	641	108	n/a	24%
MBFI	MC²s	CM	21	28	62	132	90	4.5	16%

+ several experts and consultants in the field of agricultural finance

Outline



Background & Research Design

Findings

Loan features

“Know your client *and* know your crop”

- **Loan features that fit smallholder farmers and agricultural product**
  - Repayment schedules fitting the seasonal cashflow of smallholder household (hh); grace periods
  - No staggered disbursements within joint liability groups
  - Frequent interest repayments
  - Partial disbursements
  - Linkage of loan with insurance product (life/ animal/ weather)
  - Cooperation with value chain actors (e.g. vouchers instead of cash)
  - Warehouse receipt system to reduce market price risk

Interest rates

- Different strategies: 3 MFIs lower, 3 higher than commercial interest rates
- Quoted interest rates: 10 - 46 % p.a.
- Effective interest rates: 18 - 68 % p.a.; PTI between 50 - 80%

Effect of interest rates on income:

Example of a cotton smallholder farmer

- 1 percentage point **change of interest rate** → 0.79 US $ income change
- 0.01 US $ **farm gate price change** → 5 US $ income change

Loan assessment

Choosing the "right" farmers is key for success

- ✓ Commercial smallholders
- ✓ Adequate agricultural experience

"Good farmers can even harvest reasonable yields in unfavorable weather conditions & have high enough yields to make some profits even in case of market price drops"

Assessment of

- ✓ 6 C's: 5 C's of traditional microfinance *plus* Crop
- ✓ Cash flow of the whole hh/ all hh activities

Sound agricultural knowledge of specific crops & value chains is crucial

- Individual assessment by loan officer
- Use of joint liability groups for information gathering (internal credit committees & group discussion in absence of loan applicant)

Loan monitoring & repayment

Loan monitoring

- ✓ Regular visits by loan officer according to crop cycle / animal lifecycle → partial disbursements based on successful completion of previous step
- ✓ Sometimes technical support/ agricultural advices

Loan repayment

- ✓ Group repayments
- ✓ Monthly interest payments
- ✓ Tough recovery processes in first year(s) to break distorted credit culture

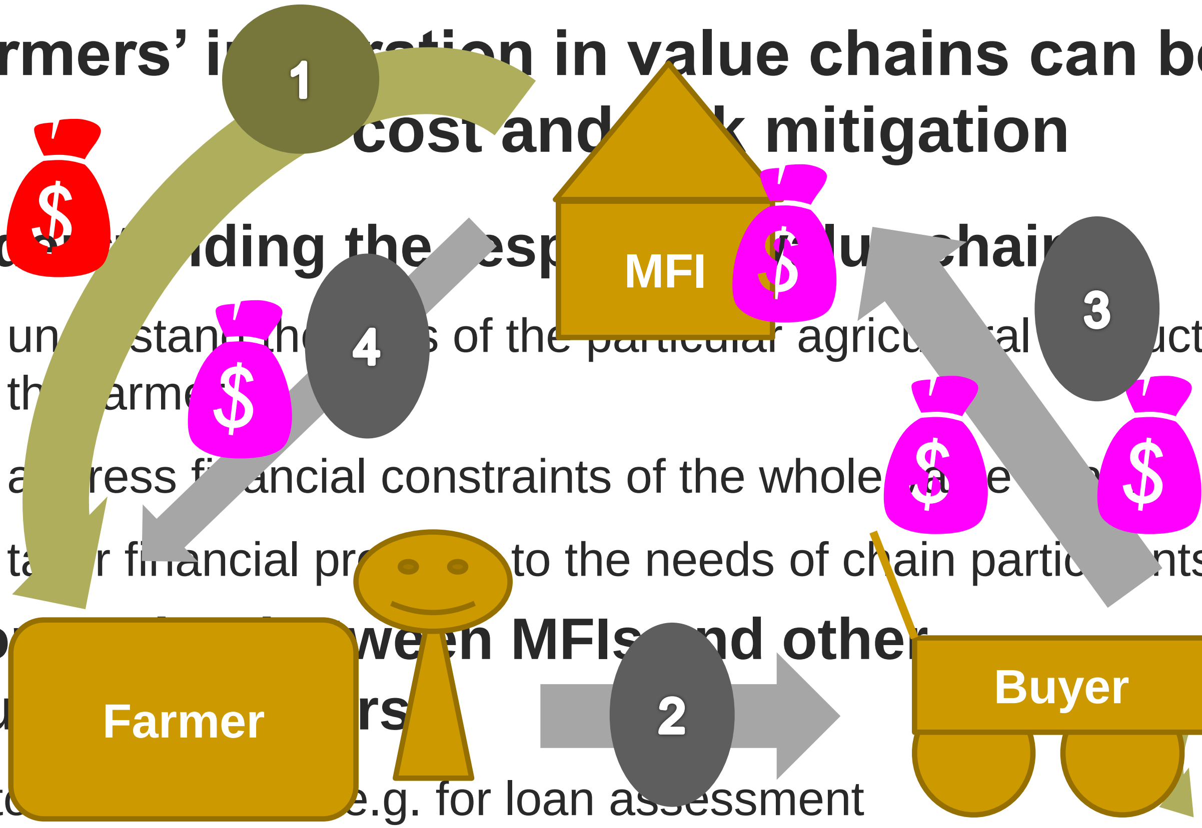
Qualified staff with agricultural background

- ✓ **Qualified staff with background in agriculture/ agricultural economics**
  - ***at headquarter***: crucial for loan development & strategic decisions
  - ***as loan officer***: crucial for loan assessment and monitoring
    - able to properly analyze agricultural projects and validity of farmers' information
    - be up to date with agriculturally relevant data of specific area
    - right attitude & motivation to work in the field
    - able to technically advise smallholders

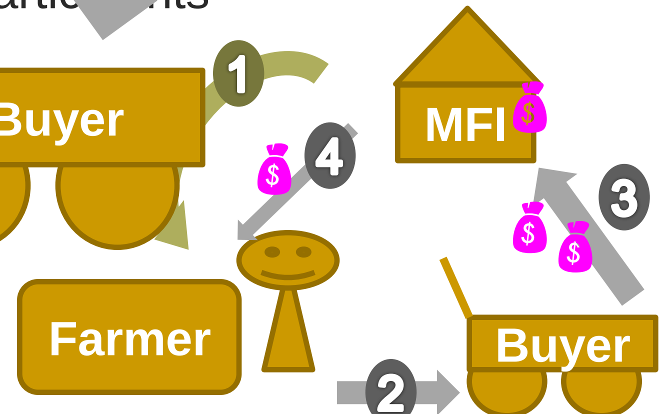
"You can't turn a banker into a farmer, but an agriculturalist into a banker"

Value chain finance

Farmers' i… …ation in value chains can be used for cost and… …k mitigation



- ✓ **Und… …ding the …esp… …lu… chain**
  - un… stan… the… …s of the particular agric… …al… …uct and thus th… farme…
  - a… ress fi…ancial constraints of the whole… …a… e…
  - ta… r financial pr… to the needs of c…ain partic… …nts
- ✓ **Coo… …we…n MFIs …nd other valu… …rs**
  - t… e.g. for loan a…essment
  - & repayment collection → reduce interest rates
  - reduce risks of non-repayment



Cooperation with external actors

- ✓ **Comprehensive cooperation** with NGOs, development agencies, governments, extension services, insurance companies etc.
  - Technical assistance (e.g. loan product development; training)
  - Guarantee funds
  - Research & development of tools to mitigate external risks, e.g. index based weather insurance/ yield insurance
  - Make smallholder farmers "bankable"

Cost effective outreach

✓ **Innovative technology can reduce outreach costs**

- mobile banking branches
- branch "outlets"
- agency banking
- mobile money (M-Pesa; M-kesho)

? **Profitability of agricultural lending**

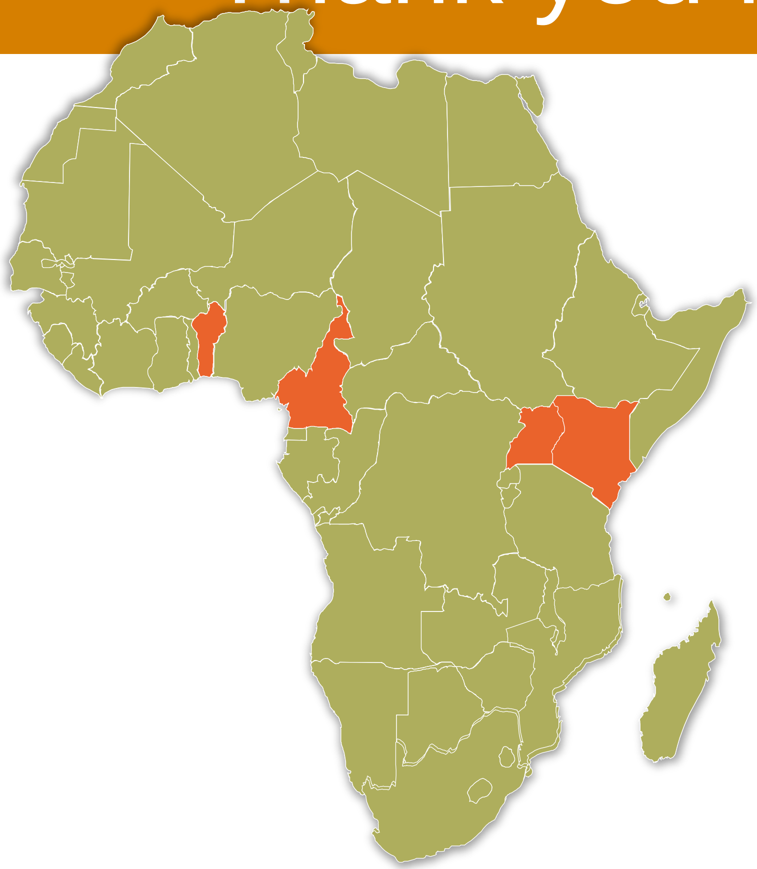
Conclusion

Agricultural microfinance for smallholder farmers is possible!

- ✓ adaption of loan features and lending procedures necessary
- ✓ agricultural knowledge is crucial
- ✓ value chain finance can help mitigate risks and costs

→ **strong commitment and well thought out business strategy!**

Thank you for your attention



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