Briefing Note II

Plenary Session II
New financing approaches and instruments for smallholder agriculture and agrifood SMEs

Innovative Practice Cluster B1
Assessing and managing risks

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Investing in inclusive rural transformation
Innovative approaches to financing

Plenary Session II

New financing approaches and instruments for smallholder agriculture and agrifood SMEs

The major challenges facing lenders that want to engage in the agricultural sector may be broken down into two key areas: the unique problems of agriculture due to high transaction costs and sub-optimal policy and regulatory environments. Beyond these two, there are other issues affecting agricultural lending, e.g. credit risk (i.e. borrowers may not be willing or able to repay the loan); agricultural risks (i.e. production and market/price risks); and political risks (e.g. debt forgiveness, interest rate caps). There are also other specific risks: lack of adequate collateral; poor financial literacy; limited access to markets, which in turn reduces the bankability of smallholders; and lack of adequate infrastructure etc.

Agricultural finance usually also involves high transaction costs due to low population densities, low infrastructure quality, and distant locations. Inefficient agricultural markets can limit the viability of rural financial services. Distortion in the production and financial markets can also affect the profitability.

One cannot overemphasize the high degree of heterogeneity of smallholder farmers and rural (M)SMEs that makes it difficult to think of a single model and approach that can make a difference. **Understanding and better classifying farmers while dealing with their specific challenges is the first step in thinking about potential solutions and innovative approaches.** IFAD, for example, usually segments farmers into non-commercial subsistent smallholder farmers, commercial smallholder farmers in loose value chains, commercial smallholder farmers in tight value chains, medium and large commercial farmers.

Innovative approaches and "models" are being assessed and developed for agricultural finance to smallholders and SMEs, and they vary according to specifics of the scenarios and country environments. For example, a lender, funder or investor[1] in Malawi faces fundamentally different challenges from a funder and investor in Mexico, and therefore different approaches and models might be more useful for her. At the same time, a funder and investor in Ghana has quite different challenges in financing cocoa rather than maize. Such models can help the banker finance agriculture by: (i) replacing traditional collateral with new types of security (known as **"financing" models**); (ii) mitigating risks more effectively (**"risk mitigation" models**); or (iii) lowering transaction costs (**"distribution" models**).

1. This generic term shall indicate that there is – besides banking services – a steadily evolving market of social lenders and impact investors and local state sources that play an important catalytic role in driving financing into untapped markets.

In **“financing” models** targeting the farmer or groups of farmers, collateral generally involves cash flow analysis by lenders in order to underwrite anticipated earnings, overall savings, and/or group guarantees. Financing models using movable assets as collateral often include leased equipment or harvested commodities in warehouses. Financing models that rely on buyers as the repayment source are based upon an overall value chain analysis in which strong business relationships persist between farmers and buyers, and formal or informal contracts provide security to lenders.

Although financing models are designed to minimize the risk of default, various **risk mitigation models** may be a useful complement to transfer key risks to markets. Insurance products, such as credit life products, have been mainstreamed in the market. There are, however, emerging health, production and weather insurance products that can significantly improve the security package and ultimately reduce the default risk to lenders. Personal insurance products may be formally tied to financing opportunities through health credit products, or informally tied as microinsurance coverage expands. Crop and weather insurance products under certain preconditions and circumstances could provide solutions to dealing with crop losses. There are also risk management instruments that can deal with commodity price risks, but their use in most low-income emerging markets is still very limited.
Risk mitigation models need to, however, go beyond financial risk transfer and insurance and actually require a comprehensive management of risks (adaptation and mitigation).

Distribution models – including digital financial services, agent banking networks and mobile payment systems – help support the financing models and reduce transaction costs. As banks are tending to provide cash flow-based loans to the rural agricultural sector, they connect with their clientele through a transaction history, learn about their needs, and develop relationships – all of which are essential to build and maintain a profitable loan portfolio. Distribution models may also reduce banks’ transaction costs through efficient loan disbursement and repayment systems. Overall, distribution models provide access to a clientele that previously was out of reach.

It must be emphasized that information and communications technologies (ICT) application in the financial sector has a potential for the most transformative innovation in financial services since the emergence of microfinance. Lenders are finding ways to use ICT to lower the transaction costs of expanding rural outreach, but telecoms are also directly competing with lenders to provide financial services.

Innovative Practice Cluster B1

Assessing and managing risks

Agricultural lending **risks are diverse** and need to be mitigated in a variety of ways. Current **risk mitigation practices** include (1) intensive, field-based client monitoring; (2) limitations on the number of loans per credit officer; (3) portfolio diversification (by clientele, geographical location, sector and/or crop); (4) leveraging of credit bureaus and credit scoring; (5) use of “real” collateral (i.e. secured with legal title on fixed assets and certain movable assets); and (6) use of insurance products. A number of financial institutions also use external portfolio guarantees to reduce their credit risk.

Insurance products and services offered to households help them manage risks with spillover benefits also expected for lenders. At the same time, insurance markets in many parts of the world are at an initial stage of development, characterized by an absence and/or weakness of agricultural insurance institutions, premium prices unaffordable for micro and small rural producers, markets dominated by agro-industrial export companies, lack of pertinent information, undeveloped insurance culture, and inappropriate and insufficient distribution channels.

Value-chain analysis is also a way for lenders to better assess the entire chain to determine the risk profile and repayment capacity of the borrower. Lenders more and more are leveraging relationships within well-functioning value chains to reduce risks and costs. They might also identify adequate entry points to provide credit, for example financing traders or processors who in turn can lend to small producers. This reduces transaction costs, while mitigating lending risk.

Warehouse receipts systems are a common method to catalyse agricultural lending by collateralizing stored commodities. In addition to managing risks, the benefits may include secure places for storage, leading to reduced price variations across seasons, and permit farmers to avoid selling immediately at harvest.

Limitations on exposure to specific crops. Limiting exposure to individual crops can also be used to mitigate the systemic risks associated with agricultural lending.

Portfolio diversification and exposure limits. Portfolio diversification, an important risk mitigation strategy for any financial institution, is particularly important for institutions engaged in agricultural lending, and is a hallmark of many of the financial institutions with successful agricultural lending programmes. They can diversify based on a variety of factors, such as clientele (large, small), geographic regions and sectors (agricultural, commercial).

Leveraging of credit bureaus and internal credit ratings and credit scoring. Many financial institutions consult credit bureaus to control for risk at the client level. Furthermore, some also use internal credit rating systems and do some pricing for risk as clients with higher scores may be eligible for interest rate reductions. Credit scoring is another form of risk assessment based on a statistical analysis of factors expected to affect creditworthiness. Mobile phones create new scoring possibilities.

Conservative approach to establishing loan amounts. Another beneficial and common practice for mitigating risk is conservative estimation of cash flow as the basis to set the qualifying loan amount.

Use of real collateral. Not surprisingly, use of portfolio diversification techniques, credit bureau reports and internal credit ratings does not eliminate the need for real collateral for "large" loans. Financial institutions will often require real collateral for loans of any significance (and an individual, solidarity guarantee for small amounts). Agricultural insurance as mechanism of climate risk transfer requires a framework of integrated risk management and adaptation to climate change. What is required as part of a comprehensive management strategy is institutional development; analysis and review of legal and regulatory frameworks, agricultural insurance infrastructure and data information systems; support to product research and development; education, training and capacity-building for farmers, distributors and insurers at country level; and promoting innovations.

Innovative Practice Cluster B2

Delivering finance to smallholders and rural SMEs

Direct lending is the predominant approach for delivering financial services to smallholders. There is limited use of agent networks and there is minimal – albeit growing – use of ICT to reduce the costs and risks of agricultural lending.

Private and social investments are also increasing worldwide and particularly in sub-Saharan Africa, and considerable attention is given to its role in expanding and modernizing the agricultural sector. Several investment strategies have the potential to complement and partner with banks. Some invest in start-up agribusinesses with the potential to grow and eventually obtain funding from banks/intermediaries. Those can also directly partner with government and development agencies, DFI/IFIs and private investors that increase borrower creditworthiness by reducing barriers in supplying inputs and technical services and improving market access. Many of these activities indirectly support finance through improved livelihoods for farm and non-farm households so that they become better financial customers. Most private investment is believed to be channelled into larger-scale projects, while some investment vehicles and development projects focus on value chains involving smallholders and smaller agribusinesses. The Dalberg Group, including the Initiative for Smallholder Finance and the Rural and Agricultural Finance Learning Lab for the MasterCard Foundation, in 2016 argued for massive investments to support smallholders. The gap between the financial needs and the supply of financial services at present is at an estimated US$150 billion in the regions of sub-Saharan Africa, Latin America and South and Southeast Asia. In addition, agricultural insurance reaches just 10 per cent of smallholders. Projected growth of 7 per cent per year from formal institutions and value-chain actors will not make a meaningful dent over the next five years.[2]

2. Dalberg Global Development Advisors. Inflection Point: unlocking growth in the era of farmer finance. 2016

Direct to the client: direct lending versus indirect lending (through producer groups, buyers, etc.). Direct lending is the most commonly documented lending methodology or delivery approach for reaching semi-commercial smallholders. This is accomplished through mobile loan officers who travel from traditional bank branches to rural clients, typically following an established routine and itinerary. Financing smallholders through input suppliers and buyers is also common ("through lending" or "third-party financing"). This modality, much like value-chain finance, is, however, not used that much. Even where financial institutions are leveraging value-chain relationships, they are often disbursing loans directly to smallholders.

Reliance on branches with mobile loan officers. This approach to service delivery is common. While this contributes to the close monitoring of clients, it also contributes to the high cost of agricultural lending. Assigning mobile officers to clear, distinct operational zones can create efficiencies and other positive externalities in this labour-intensive approach. Typically, credit officers spend roughly 90 per cent of their time in the field and are required to visit their agricultural clients at a minimum monthly (they usually visit more often). Since they travel daily in their assigned zone of operation, officers may actually greet the farmer informally in the street almost on a daily basis, which serves as a reminder to the farmer of his or her commitments and contributes to the farmer feeling supported as well as affording the loan officer opportunity to casually note anything unusual about clients. But this delivery approach is costly as it is hugely labour-intensive and probably is unlikely to be scalable. In contrast, one needs delivery approaches that have a higher operational efficiency and lower transaction costs per loan.

Limited but increasing use of ICT to reduce the costs and risks of agricultural lending. ICT can be used in a variety of ways to reduce the costs and risks of agricultural lending, including for data capture and analysis and product delivery. In environments where mobile-phone banking and point-of-service (card-based) transactions are becoming widespread, electronic delivery of services should be an attainable target. However, as a digitized delivery system, the impact of ICT on making interest rates on micro loans affordable is an issue that needs more research and analysis.

The **lack of appropriate delivery channels** is one of the main constraints to smallholder lending. Use of branchless banking appears to be an underutilized channel for reaching rural and agricultural clients. Some financial institutions do have agent networks, but many of those networks are located in urban and peri-urban areas. **As agent networks in rural areas become more common and expand, mobile banking may become more common.**

Topics to explore

What are the typical market segments and their characteristics?

What are the main constraints faced by smallholders and rural (M)SMEs in accessing investment and working capital to expand their businesses?

Where are the main smallholder producer and rural (M)SME investment opportunities? – perceived ability to produce, to sell in markets and ability to generate return; competing investment options (generate return, preserve assets, re-investing to grow the business further and adopt innovations.

Where are the major gaps in the current landscape of finance and investment funds? – institutional – support infrastructure – policy and regulatory level.

Which are the main challenges and performance of existing investment funds? How effective they are as a means for reaching smallholders and rural (M)SMEs?

What are the new types of financing and investment offerings – comprehensive risk mitigation models and distribution and delivery models?

How can lending risks and costs be sustainably mitigated?

Who are the key drivers to sustainably increase financial inclusion and reduction of the gap of smallholder farmers and rural (M)SMEs?

Which are the most effective and efficient innovative solutions to deliver to and access financial services and support by smallholder producers and rural SMEs?

Which are the growth pathways for inclusive growth through financing?

What is the respective role of the public and private sectors to enhance the access of smallholders and rural (M)SMEs to investment capital?

Should key drivers of financing and investment offerings get into collaboration with providers of non-financial services to rural (M)SMEs (and smallholder producers)?

This background note was jointly prepared by IFAD and the University of Warwick.