Briefing Note I

Plenary session I and related innovative practice clusters
Leveraging finance for inclusive rural transformation

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Investing in inclusive rural transformation
Innovative approaches to financing

Plenary session I and related innovative practice clusters

Leveraging finance for inclusive rural transformation

There are about 3.4 billion people living in rural areas in the world today. Two thirds of these people depend on roughly 500 million small and family farms for their livelihood and up to 600 million people on these farms may be undernourished. Despite the attention given to the urbanization trend over recent years, ending extreme poverty and hunger in the world will not be possible without inclusive and sustainable rural transformation of smallholders into dynamic small enterprises.

Small-scale food producers account for a large proportion of global agriculture and food production. Farmers operating two hectares of land or less manage only 12 per cent of total agricultural land, but they produce more than 80 per cent of the world's food in terms of value. Past development efforts in agriculture have led to major improvements in productivity, however, progress has not been the same everywhere and has often been accompanied by social and environmental costs that reduce impact and threaten sustainability. Agricultural development is, by definition, unsustainable if it fails to benefit those whose livelihoods depend on it by increasing their access to resources and assets, their participation in markets and their integration into the value chain.

Transformation of productivity requires a holistic approach to value-chain development, bringing all actors together through equitable and profitable value-chain relationships. A competitive agro-industry can serve as a platform for inclusive and sustainable development that creates jobs, fosters inclusive and broad-based growth and diversifies the product consumption base. It will allow the pursuit of social and economic empowerment for vulnerable groups, improving their access to food and their resilience, and thereby enabling them to produce more food for their needs and for others as an additional source of income, and supporting a transformation of rural areas in developing countries.[1]

Increasing investment and access to finance is critical to achieve rural transformation, in particular for smallholder farmers and rural small and medium agrifood enterprises (SME). And yet, in Africa for example, only a very small percentage of commercial lending is destined for the agricultural sector. This is largely due to the inherent high risks prevalent in the agricultural sector, which are exacerbated in rural areas. These risks deprive the sector of much-needed finance to boost production, processing and marketing of small producers and agro-food SMEs along the value chain.

1. United Nations (2016), Report of the Secretary-General, *Agriculture, Food Security and Nutrition*, A/71/283.

A closer look at these risks include:

- **Transaction costs** that are higher in rural areas than in urban areas due to a more dispersed population with weaker infrastructure.
- Inherent **risk factors** in agriculture often inhibit financial institutions from lending. These include production risks linked to natural hazards (such as droughts, floods and pests), smallholder farmers' often inability to provide collateral for loan guarantees due to lack of proof of land ownership, and price volatility.
- **Underdeveloped financial sector** in low-income countries may mean the availability and innovation of sector-specific financial instruments and services is low. Further, although financial services may be available, they may not be suitable for all types of agricultural activities, particularly smallholder farmers, which have diverse needs with respect to timing of disbursements, amounts and risk mitigation capacity, among others.
- A **lack of data** on farming (and on smallholder farmers and SMEs in particular) in low-income countries makes assessment of credit suitability challenging for financial providers. This changes the conditions required to access financial products and undermines opportunities for profitable investment.

At the same time, public finance plays an important role in supporting rural transformation and investment in rural agriculture. In response, there is growing momentum to leverage public funding to mitigate these risks and thus attract more private investment in rural agriculture. Models and vehicles include guarantee and first-loss funds, dedicated technical assistance delivered alongside private debt or equity investments, and risk-mitigation products such as micro-insurance and use of ICT for improved market access. New collaboration models are defining ways in which blended finance can be deployed to unlock more private investment.

Further detailed examples of public efforts directed towards managing risks in the sector include:

- **Support to farmers** in the form of payment of indemnities, reductions in social security contributions and exemption of taxes during periods of crisis in the sector, or subsidizing private insurance schemes. For example, in Brazil, Garantía Safra was created as a disaster assistance programme that compensates small-scale farmers for production losses following weather-related and other events.
- **Creating credit guarantee funds or supporting credit guarantee schemes** offered by private institutions through counter guarantees. The Mexican Fideicomisos Instituidos en Relación con la Agricultura (FIRA), the Indian Credit Guarantee Fund Trust for Micro and Small Entreprises (CGTMSE) and the Nigerian Agricultural Credit Guarantee Scheme Fund are among the longest-standing agricultural guarantee funds in the world and offer good models for potential replication in other countries.
- In the case where risk management is left to the farmer, governments can still support by **providing information** to the sector on potential risks, ideally through the use of ICT tools and rapid-deployment applications.
- A government can **act as a facilitator** without disbursing public funds itself. This role is especially significant in value-chain finance, where the government can develop a business model to link the different actors that would benefit from financing one another.

For governments to deliver on their critical role of unlocking private finance requires national policies to improve and attract agricultural finance, cutting across the ministries of agriculture, finance and economy. However, at the same time, the number of government actors influencing agricultural finance – in particular that which is directed to smallholder farmers and SMEs – makes its development more complex.

Financial regulation is critical for the delivery of productive financial services and products, particularly to ensure optimal allocation of financial resources, minimize the transaction costs in financial intermediation and adapt financial institutions to changing environments.

The regulatory framework governing the financial sector is twofold: (i) the government must provide enough openness and flexibility for the financial sector to offer the financial instruments needed for the rural sector and especially to smallholder farmers and SMEs, and (ii) regulation should control abuses by financial institutions, such as offering unduly high rates and fees/charges or taking excessive risks with people´s savings or investors´ funds. Laws also have to be coupled with efficient supervision of the financial sector. However overregulation can also present problems for flexibility and innovation in finance.

If the country aims to attract foreign or domestic financial institutions to invest in agriculture and rural areas more generally, it must offer an overall stable and efficient institutional environment that increases the confidence of financial institutions to invest. Weak land tenure systems and poor enforcement of laws and regulations affect the extent to which financial institutions will finance agriculture and the rural areas.

A few governments have chosen more interventionist measures, such as requiring the private sector to finance agriculture. The Indian government, for example, has imposed a mandatory target on domestic and foreign banks to provide 40 per cent of their lending to priority sectors. Among the priority sectors, a specific portion of lending must be granted to farmers and small organizations of farmers (Reserve Bank of India, 2013). It also encourages banks to open branches in smaller cities to push the inclusive finance agenda.

Governments can also promote and help organize the creation of institutions and partnerships between financial actors and can provide certifications, technical assistance and financial literacy to smallholder farmers, small entrepreneurs and rural SMEs. For example, in the United Republic of Tanzania, the Rural Financial Services Programme catalysed the creation of local community savings schemes and credit cooperatives.

During the morning session, we will hear from experts across the sectors on these issues more broadly, including:

What role can financial services and instruments – public and private – play in closing the investment gap for smallholder farmers and rural agrifood SMEs? What are some current obstacles or challenges to identifying the gaps and leveraging finance to fill them?

How can we create the enabling environment for creating multistakeholder partnerships to better leverage the expertise of various actors such as national governments, private sector, farmers' organizations and civil society actors, in the light of the 2030 Agenda and its SDG targets?

How inclusive has rural transformation been for smallholder women farmers? Are there specific challenges in addressing their financial needs and in closing the investment gap? Should the multistakeholder partnerships referred to above be extended to cover service providers of smallholder women's business capacity development?

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