

# Scaling up Agricultural Credit in Africa

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Of the more than 1 billion people in the world who survive on less than \$1.25 per day (PPP 2005), 75 percent depend on agriculture for their livelihood. In regions such as sub-Saharan Africa, smallholder farmers who farm less than two acres produce 70 percent of the total food consumed.<sup>1</sup> An improvement in smallholder productivity at scale is likely to have dramatic effects on food security and poverty reduction, not to mention benefits for the rural economy.

In sub-Saharan Africa, economic growth in agriculture is up to 11 times as effective at reducing poverty as growth in other sectors.<sup>2</sup> In Rwanda, for every dollar invested in agriculture, the return to GDP is more than three dollars.<sup>3</sup> Investments in agricultural research, extension services, and access to credit show particularly high returns.<sup>4</sup>

Providing smallholder farmers with access to credit is essential to unlocking long-term, sustainable gains in farmer productivity and incomes. Without financing, smallholder farmers cannot afford the relatively high upfront costs of quality seed and fertilizer, relying instead on poor quality seed and little to no fertilizer. Without access to credit, they may be unable to purchase or rent tools that increase efficiency and reduce labor costs. Additionally, they may not be able to afford the training services needed to maximize seed and fertilizer application and general farm management. Finally, without access to credit, a farmer might be compelled to sell any crop surplus immediately after harvest, when prices are typically at a seasonal low.

To fully understand the challenges of agricultural financing for smallholder farmers, this brief provides an overview of how to increase financing for farmers and help them carve their own paths out of poverty, with a focus on those farmers with the smallest plots of land and limited amounts of existing capital. They are the single-largest group of smallholders that need financing.<sup>5</sup> First, we provide a snapshot of the current lending landscape and the inadequate level of available finance. Second, we discuss current successful models and the organizations leading them. Third, we highlight the common principles these models use. Fourth, we cover the challenges to scaling these models, and, finally, we make concrete recommendations for how to overcome some of these challenges.

## **Current Lending Landscape**

In most developed countries, commercial banking branches are able to provide lending for personal and business loans. However, in a number of developing countries, much of the demand for personal and business loans stems from the agriculture sector. Given the nature of agricultural risk to exogenous factors—weather, pests, diseases, and commodity price fluctuations—and its long-term seasonal nature, many banks perceive lending to farmers as too risky. Though local bank lending should be the main point of access, the financial sector meets less than 3 percent of total smallholder demand for financing, estimated at \$450 billion.<sup>6</sup> In sub-Saharan Africa, only 95 of 900 banks surveyed provide financing to smallholder farmers. While the number of adults living in rural areas who have access to bank accounts has increased in recent years due to mobile money expansion, the share in sub-Saharan Africa still hovers at a mere 34 percent.<sup>7</sup>

Instead, many farmers simply do not borrow, or they resort to informal lending from family, friends, moneylenders, or other value chain actors such as input suppliers, buyers, and traders.<sup>8</sup> However, these other sources charge much higher interest rates than commercial lenders—sometimes as high as 10 times—and access is uneven across the population. FinScope estimates that 30 to 60 percent of the rural population in sub-Saharan Africa has no access to credit at all. Therefore, innovative and creative approaches are needed to successfully provide access to credit for smallholder farmers.

### **Early Successful Models**

Despite the lack of adequate supply of smallholder financing, several organizations are using innovative tools to reach rural farmers, and three of them are profiled here. The models these organizations pursue are tailored to meet the unique financial challenges smallholder farmers face. All three organizations operate in areas of high population density (making distribution easier and cheaper), high rainfall (lower risk), and low adoption of fertilizer (opportunity to improve impact).

Juhudi Kilimo: This microfinance company in Kenya provides asset-based loans to more than 20,000 smallholder farmers in Kenya. Its loans are designed to enable farmers to purchase assets, such as a dairy cow or irrigation equipment, that will provide immediate and continuous cash flow. These capital assets are insured, and their value is used as collateral in case of default, which protects both farmers and the company. In fact, Juhudi Kilimo's livestock loan program ensures that livestock purchased by clients is high quality and that clients are using best practices for vaccination, feeding, and other livestock care. Loans are co-guaranteed by groups of farmers (typically five), and Juhudi Kilimo employs loan officers to provide technical assistance and business support. In 2013, its loan portfolio totaled \$5.8 million, with \$1.7 million in revenue.<sup>9</sup>

BRAC: BRAC, based in Bangladesh, provides credit and savings to more than 4 million people in more than 280,000 groups across the country.<sup>10</sup> Through its Tenant Farmers project, BRAC works with over 360,000 smallholder farmers in Bangladesh and provides seasonal, yearlong loans through a group liability scheme. Separate entities, such as BRAC Seed and Aarong Dairy, are social enterprises that provide smallholders with high-quality inputs and access to markets, respectively. With these other entities, BRAC is developing an “enabling environment” to help smallholder farmers strengthen their connections to other links in the value chain.

One Acre Fund: One Acre Fund offers more than 280,000 farmers in Burundi, Kenya, Rwanda, and Tanzania a comprehensive service bundle of seed and fertilizer, financing, training, and market facilitation. Asset-based loans allow farmers to receive high-quality inputs delivered within walking distance of their homes. Loans are offered through a group liability scheme with a flexible repayment schedule, which accommodates the seasonal fluctuation of farmer income. The model allows farmers to increase their income by an average of 50 percent on every planted acre, with loan repayment rates averaging 99 percent.<sup>11</sup>

Of these three organizations, two (BRAC and Juhudi Kilimo) operate without a subsidy. One Acre Fund operated at 74 percent financial sustainability in 2014 and subsidized

the operational shortfall with donations. From the 1960s to the 1980s, smallholder farmers often received subsidized cheap credit from state-run rural financial institutions. More recently, a trend toward “smart subsidies” contributes to the creation of stable financial institutions with the capacity to disburse market-rate agriculture credit over the long term.<sup>12</sup>

### **Common Principles for Successful Lending**

These organizations share some common principles that mitigate risk for lenders and increase impact for clients. Of course, local contexts vary, and not all principles apply to all markets. Lenders need to carefully evaluate the agriculture sector in their geographic area before developing an agriculture loan product.

Asset financing: Offering asset-based loans, as opposed to cash, ensures that loan capital is targeted to products and services that improve agricultural productivity and farm profitability (for example, quality seed, fertilizer, livestock, and irrigation equipment). In markets where it is difficult to source seed and fertilizer in rural areas, clients benefit from guaranteed access to farm inputs. In many cases, providing access to a “package of services” that includes agriculture financing in addition to farm inputs maximizes the social and financial return of the loan.

Focus on productivity: Farmers are more likely to repay their loans if their productivity is markedly increased. To mitigate production and price risks, organizations should provide agriculture trainings and price support to help farmers maximize yields and profits. Many farmers use outmoded agriculture practices that prevent them from realizing higher yields.<sup>13</sup> One Acre Fund conducts weekly trainings with farmers on various agronomic practices, including seed spacing, composting, and fertilizer micro dosing, and it teaches farmers how to safely store their crops until prices are high. Opportunity International links its clients with government extension workers who provide agriculture trainings.<sup>14</sup>

Appropriate loan terms: Farmer income is based on seasonal crop cycles, which means cash flow is irregular. Loan periods need to cover the entire agricultural season: They should begin when farmers purchase inputs a few weeks before planting and end shortly after harvest. In some cases, the loan period should extend well beyond the harvest so that farmers can delay selling until market conditions are favorable.<sup>15</sup> Repayment should also be flexible and convenient for farmers, and interest rates should be transparent and reasonable.

### **Challenges to Scale and How to Overcome Them**

As discussed above, there is an enormous gap between the demand for agriculture financing and the supply provided by public banks, microfinance institutions, nongovernmental organizations, and other financial institutions. Much of this gap is attributable to the perceived risk of lending to farmers. Farmers’ lumpy and irregular income streams, poor productivity, outmoded agricultural practices, and seasonal crop cycles all pose unique challenges to financial service providers.<sup>16</sup>

However, in our experience, the largest barrier to scale is *perceived* risk. Microfinance institutions and banks overestimate the risk of smallholder farmer financing. In fact, minor adjustments to lending criteria—as outlined in the principles in the previous section—can significantly improve repayment rates and reduce farmer risk.<sup>17</sup>

Success stories can help microfinance institutions and banks more accurately assess the risk of lending to smallholder farmers. Unfortunately, the information available about what works in agriculture financing, particularly lending to smallholder farmers, is still limited. The Initiative for Smallholder Finance<sup>18</sup> has done excellent work over the past three years to publish new research on the smallholder agriculture finance market, and CGAP (the Consultative Group to Assist the Poor)<sup>19</sup> currently has a multiyear focus area aimed at better understanding the financial needs of smallholder farmers. These are just the beginning steps in what should be a robust, better-funded learning effort. More needs to be done to understand the successful agriculture financing practitioners. These practitioners—wherever they are working—need to be identified, as well as the principles they follow, in order to determine how to replicate and scale their agriculture loan products.

A second major barrier to scale is the lack of concessional working capital for agriculture credit specifically. Donors have significantly ramped up their aid dollars for agriculture development over the past 10 years, but much of that money has gone toward three- or five-year projects that are unsustainable beyond their funding period. There seems to be a disconnect between the agriculture development donor community’s rhetoric, which laments the lack of financing available for agriculture, and its lack of effort to engage the microfinance sector. On the microfinance side of things, industry leaders are typically not experts on the agriculture sector, and as available grant capital for microfinance has declined, they perceive a “windfall” of funding for agriculture.<sup>20</sup> They are largely unaware that there is a dearth of financing available to smallholder farmers, and the tremendous market opportunity that presents.

In the early days of the microfinance industry, microfinance institutions had access to plenty of submarket working capital. But as the industry has matured and the institutions have grown, financing has largely shifted to microfinance investment vehicles, which offer debt and equity at market (or close to market) rates. An opportunity is available to revisit some of the grants and concessional working capital structures that incubated the microfinance sector as potential tools to narrow the gap between the limited supply of agriculture credit and the \$450 billion demand.<sup>21</sup>

Agriculture and farming provide the livelihood for a majority of the world’s rural poor, so growth in this sector has tremendous potential for reducing poverty and boosting prosperity. Juhudi Kilimo, BRAC, One Acre Fund, and other organizations are tapping into a huge, unmet need, and are poised to grow their operations. To fully unlock the poverty-reducing power of agriculture, donor governments, multilateral organizations, private actors, and nongovernmental organizations must work in partnership to provide finance that is suited to the needs of smallholder farmers and rural communities. With

proper nurturing, the smallholder farmers of today will become the prosperous entrepreneurs of tomorrow.

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