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# AGRA Strategy for Inclusive Agricultural Finance System

## Towards an Inclusive Agricultural Finance System

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# AGRA Strategy for Inclusive Agricultural Finance System: Towards an Inclusive Agricultural Finance System

## Background

### Agricultural finance is key, yet underdeveloped

AGRA's 2017-2021 strategy seeks to catalyze an inclusive agricultural transformation in Africa by increasing income and improving food security for 30 million farming households in 11 focus countries. An inclusive financial system that enhances access to financial services for agricultural small and medium sized enterprises (SMEs), farmer based organizations (FBOs) and farming households is a critical factor in changing farming from a solitary struggle to survive into a business that thrives.

Timely access to a wide range of affordable financial services like payments, savings, insurance and loan products is crucial for SMEs, farmer based organizations (FBOs) and farming households, in order to;

1. Invest in improved technologies such as seeds and fertilizers and in agricultural machinery
2. Manage irregular cash flows that are inherent to the agricultural sector
3. Become more resilient to external shocks such as drought and market volatility
4. Grow their reach and scale, create jobs and contribute to economic growth

In Africa, more than 50% of the population is involved in agricultural activities while less than 1% of banking credit goes to this sector (AGRA/AASR, 2017). According to the International Finance Corporation (IFC), African SMEs generate about 58% of total employment and 33% of GDP on the continent, but they receive on average less than 5% of bank financing. Traditionally, Financial Services Providers (FSPs) have avoided the agricultural sector, even when ample liquidity exists in their balance sheets. Despite the presence of abundant business opportunities in agriculture, FSPs lean towards lending to other sectors, non-agriculture household needs and/or invest in government securities. Agricultural SMEs, farmer based organizations and smallholder farmers are considered among the most difficult clientele to serve in a financially sustainable manner due to various risks and costs involved, including:

I. Occasional natural disasters such as drought, flood, and epidemics of crop diseases;

II. High transaction costs due to a lack of (financial and market) information and the dispersed nature of agricultural SMEs, farmer based organizations and farming households;

III. Seasonal and lumpy financial requirements, yet limited physical assets for collateral; and

IV. A long history of political interventions (both in the agricultural and financial markets) leading to a prohibitive environment for financial services delivery.

Even if financial services are available to the agricultural sector, they are often concentrated in well-structured value chains such as export-oriented cash crops and wealthier farmers. The costs of the services are generally high whilst the variety, volume and quality of financial products on offer are often times limited.

In brief: Despite the importance of the agricultural sector to African economies, access to finance remains a key challenge restricting the growth of the sector that is crucial for job creation and economic growth on the continent.

# AGRA Approach: Building an inclusive agricultural finance system based on partnerships and opportunities

An agricultural finance system is composed of three critical integrated components that can make the system grow and develop in an inclusive manner:

- ***Regulators:*** national governments and their funders responsible for creating the enabling environment that shapes the incentive structures of all the actors in the agricultural finance system.
- ***Supply side***: these are suppliers of financial services ranging from-
  - traditional banks and insurance companies;
  - non-bank financial institutions such as leasing, credit guarantee and factoring (accounts receivable financing) companies;
  - mobile network operators;
  - blended investment funds and microfinance institutions including savings and credit cooperatives and village based savings and loans associations who together have the ability to invest in the agricultural sector if risks and costs are well managed.
- ***Demand side***: demand for financial services ranging from seed and fertilizer companies, mechanization providers, produce aggregators, agro processors and farming households as primary producers who can become finance-able with the right products and accompanying measures.

To build an inclusive agricultural finance system all three groups of actors need to rethink how the cost and risks of agricultural finance can be reduced and managed, so that more financial resources can flow into the agricultural sector.

AGRA's Inclusive Finance Unit makes grants and provides technical expertise to support actors in the three components above to grow the availability and uptake of appropriate and affordable financial services in the food crop sectors. The grants and technical expertise provided by AGRA, supports partners in reducing the costs and risks of financial services provision as shown in figure 1.

AGRA's Inclusive Finance unit invests in three types of partners who grow an inclusive agricultural finance system: National Governments, Financial Services Providers and Agricultural entrepreneurs (SMEs, farmer organization and farming households). Each of these actors have unique challenges and opportunities to partner and contribute to an enhanced agricultural finance system. AGRA invests in these opportunities.

## 1. National Governments

Governments are instrumental in creating an enabling environment for agricultural finance; however, most countries lack a focal point for agricultural finance hence initiatives are dispersed among Ministries of Agriculture, Finance, Economic Planning and the Central Bank. An enabling environment means that Government policies are predictable and that Government is a trustworthy partner. Sudden interest rate caps, export bans, input subsidies and late payment of invoices are examples of events that undermine the willingness of private sector actors to invest in the agricultural sector. On the positive side, Governments are unique in their capacity to formulate enabling policies and regulations including warehouse receipt regulation, mobile money and agency banking regulation, leasing policies, etc. Governments can make big contributions to the agricultural finance sector. Intra-governmental coordination is key, and AGRA's work in policy and advocacy and state capability division aims to get improvements in this space.

Figure 1. Inclusive Finance Systsem

Governments also have the unique capacity to borrow cheaply from international financiers and other governments. This allows Governments to attract private investors by setting up blended finance mechanisms that reduce the risk of agricultural finance. Blended finance means mixing soft capital (government and donor) to sustain risk of losing funds with private, more commercial capital. Blended finance comes in the form of first loss facilities, guarantee schemes, credit lines and insurance premium subsidies in combination with technical assistance for providers and users of financial services. AGRA provides technical assistance to Governments to improve the design and deployment of blended finance vehicles and, in some instances AGRA supports government institutions by managing such funds on their behalf.

## 2. Financial Services providers (FSPs)

Financial services providers perceive agriculture as risky and costly. In aggregate, financiers have a range of different challenges in terms of growing their agricultural portfolio, overall leading to an inability to expand their agricultural portfolios:

a. Market challenges including agriculture-specific risks such as price volatility and climate shocks; adverse government policies such as sudden export bans; and low borrower capacity, which makes building a bankable pipeline very expensive, especially for small loans. These risks drive some financiers to limit agri-exposure.

b. Strategic limitations including limited physical presence in rural areas drives up operating costs and pressure to limit exposure in the form of tight risk caps and limited buy-in for agricultural finance at executive level.

c. Capacity gaps including a lack of specialized teams and products with agri-specific terms and low ability to assess creditworthiness in the sector. Specialised agricultural financiers tend to focus on a narrow set of value chains and markets they know well like coffee, cotton and cocoa.

However, provided the risks and costs can be reduced and shared, the financial services providers have the unique opportunity to tap into a huge market of underserved agricultural SMEs and farming households that represent a US$200 billion market worldwide.

Innovative approaches emerge around *non-traditional partnerships* between FSPs and other stakeholders in the agricultural sector who can share the risks and costs of agricultural finance.

Such partnerships include the following:

a. **Off takers and input suppliers:** Credit is a critical input to enable contracts between value chain actors and farmers/ farmer organizations. By collaborating with value chain actors, FSPs can reduce their risks and costs. The amount of credit provided by FSPs is about 25% of that derived from value chain actors. Short-term agricultural credit in Africa is mainly provided through business transactions, especially in closely managed value chains.

b. **Governments:** By channelling subsidies and tax or school fee payments through the financial system, financial inclusion of rural populations can be enhanced. Blended finance vehicles like guarantee funds backed by public resources, can share the risk with financiers and make agricultural finance feasible.

c. **Alternative suppliers such as leasing companies and investment funds:** These FSPs have specialized knowledge to generate good deal flow that can be co-financed by FSPs that lack that technical capacity. Refinancing or securitisation of the portfolios is another opportunity

d. **Savings and credit cooperatives and informal groups such as Village Savings and Loan Associations (VSLAs):** These FSPs are trusted and close to rural populations. Other financiers can leverage this opportunity through refinancing arrangements or agency banking strategies.

Another huge opportunity arises from recent development and diffusion of information and communication technology (ICT) which has been quickly changing the agricultural finance landscape in Africa. Africa is by far the leading mobile finance market, especially among those countries with a high penetration of mobile phones and well-developed payment services. For example, traditional cash payments for agricultural products have partially been replaced by mobile payments that reduce the transaction costs and enhance the security compared to cash transactions. In addition, mobile network operators generate alternative data that can be used to offer mobile-based savings and lending services. Notably, the users of these services are increasing rapidly.

## 3. Agricultural SMEs, farmer based organisations and farming households

Not all agri-SMEs, farmer based organisations and farming households are risky and expensive clients for financial services providers. Providing mobile payment and savings services to millions of farmers presents a huge business opportunity and solves many of the cash flow management challenges of farming households that have irregular income streams. In analysing the addressable demand for financial services, segmentation of the different agricultural entrepreneurs and their needs are key.

1. Agricultural SMEs and farmer organizations exist by virtue of the existence of primary producers, i.e. small, medium and large-scale farmers. Investing in farmers' access to services is key to building their own businesses. Improved services delivery models show that instead of being a cost, these services can present an additional income stream for those SMEs and farmer organizations. (IDH, 2017)
2. Responsible agricultural financing means that farmers can convert financing into income increases (cash or in-kind) that justify the cost of such financing. Successful cases of improving farmer income found that interventions built on productivity-enhancing technologies (quality fertilizers, better seeds, improved livestock, and micro-irrigation) yielded 80-140% income gains whereas those focusing on value chain inefficiencies registered in the 20-60% range. These productivity-enhancing technologies typically require finance and are precisely the target of many agricultural financing solutions for smallholders (Hystra, 2016)
3. Often, it is the lack of data and remoteness of SMEs and farmers that make appropriate risk assessments difficult. Agricultural entrepreneurs can provide transparency on their performance allowing for credit scoring by automating their transactions and accounting, by enrolling on digital platforms and by virtually aggregating their demand for services and finance.
4. Illiteracy and lack of infrastructure remain the largest bottlenecks in improving uptake of (financial) services by farmers. Leveraging the presence and capacity of those actors who are close to the farmers like lead farmers, farmers' organizations and agricultural SMEs can ensure cost effective last mile delivery to and capacity building of farmers.

# AGRA's Value Proposition

## Technical and financial go-to partner to innovate and build an Inclusive agricultural finance system

The above opportunities in growing the agricultural finance sector, shape AGRA's interventions in the 11 focus countries. AGRA gives grants and technical assistance and forges partnerships with Governments, Financial services providers and Agricultural entrepreneurs, to enable them to develop and deploy the following financial services:

I. Blended finance: A financial product whereby risks of agricultural lending are divided according to the risk appetite of each funder. Governments and donors often take higher risks.

II. Value chain finance: A financial product whereby risks and costs of delivery are shared among stakeholders that share their interest in growing a specific crop (input dealers, off takers, primary producers, financiers)

III. Digital finance: A financial product whereby the digital highways reduce costs of delivery of financial services and enable the use of alternative data for credit scoring.

The AGRA grants, technical advisory and partnership building aims to accelerate innovations and buy down the risk of failures that those early adopters encounter when new opportunities are in their experimentation phase. AGRA proposes itself as a learning partner and catalyst; we can use our convening power to disseminate lessons learned and best practices derived from our grants and advisory work.

## AGRA's work is in the following three work streams:

A. **AGRA provides technical support and grants to Governments to:**

- Improve the enabling environment, policies and regulation for agricultural finance
- Make optimal use of public funds by blending funds for agricultural finance and by developing and deploying tailor-made risk sharing facilities based on the country context, value chains, financial sector development and policies and regulations.

### Case study | Box 1: Government engagement in de-risking agricultural finance in Burkina Faso, Mali and Kenya

#### Input subsidy advisory work in Burkina and Mali

As part of its country support program in Burkina and Mali, the agricultural ministries in both countries requested AGRA support, to review the existing input delivery system including the input subsidy program. Based on the gaps with the existing subsidy programs, the following actions are recommended to increase banks' and private sector participation in the subsidy program and prepare an exit strategy of the subsidy.

| Gaps with the existing subsidy programs | Recommendations presented to Council of Cabinet |
|---|---|
| Administration of subsidy schemes is often bureaucratic and inefficient. | - Through E-voucher system, adopt mechanisms that allow instant reconciliation of transactions and timely payment of redeemed vouchers to suppliers/dealers<br>- Explore possibilities of involving commercial banks and their branches in the subsidy payment process |
| There are no reliable tools and database to ease program targeting. | - Expand farmers registration process (including biometric features) building on previous initiatives in both countries<br>- Enable possibility of bank account creation for farmers during the registration process to increase their financial inclusion |
| Lack of clear graduation framework for all beneficiary categories and limited availability of financial products suited to farmer's needs (with exception of cotton and some irrigated rice farmers). | - Option 1:<br>Design and implement an embedded credit program in the subsidies programs, to faster the graduation from input subsidies. The credit program will enable the beneficiaries to gradually break away from dependence on subsidized inputs and become self-reliant in buying commercial inputs through loan. The approach is use a risk sharing facility with value chain participants to secure input loan for smallholder's farmers, after one or two cycles of receiving subsidized inputs.<br>- Option 2:<br>Reduce gradually the percentage of subsidy and replace it by an advance purchase of input by farmers during the post-harvest period. The approach is to encourage farmers to lay away money just after harvest, through saving account or a layaway platform in order to access the subsidized inputs. Each year, farmers will gradually increase their input saving while the subsidy rate will decrease. |

All the recommendations have been presented to the council of cabinet of each ministry for endorsement. The next steps are the validation through a national workshop in each country and the resources mobilisation for their implementation

**PROFIT: a blended finance vehicle to de-risk agricultural finance in Kenya**

The Government of Kenya has used an IFAD loan to set up a blended finance facility for agricultural SMEs, SACCOS and farmers. The guarantee facility of USD 6.9M for two banks has unlocked a loan portfolio of USD 32M (leverage 4.6) benefitting over 150,000 farmers. The loan portfolio could be built thanks to a technical assistance facility managed by AGRA that funded product development and staff capacity building for the participating banks as well as business development services for the potential borrowers. In total, close to 300 SMEs, 45 SACCOS and 6 microfinance institutions were supported under this program.

B. **AGRA provides technical support and grants to Financial services providers to:**

- Train and support FSP staff to design and deploy value chain and digital finance product that are cost effective and present a business case.
- Facilitate the linkages with blended finance facilities and with finance-able agricultural entrepreneurs

## Case study | Box 2: Value chain finance through banks in Ghana and Tanzania

### Advans Ghana risk sharing value chain partnerships for agro-input financing to small-holder farmers.

AGRA supports Advans Savings and Loans to develop partnerships with Wienco, Barry Callebaut and Touton to share the risk of input financing. The off-takers, input dealers and farmers together provide between 30% to 40% guarantees in the form of cash collateral for loans advanced to farmers. In another arrangement, the off-taker provides a 100% guarantee for repayment of the input loans. Within the first year, Advans has provided agro-input loans valued at US$ 303,644 to 1,355 smallholder farmers. All off-takers pay farmers through Advans Ghana. Loan repayment instalments are deducted before the remaining amounts are paid into farmers (mobile) accounts. The benefits for each actor of this model are:

**Advans Ghana has:** Opportunity to expand the agricultural loan portfolio while reducing and sharing the input finance risk with the direct value chain players that have a business interest in serving farmers; the cash collateral mobilized can be used to reduce the costs of funding and the cost of loan default which are major components of the interest rate;

**Farmers have:** Opportunity to access loans at lower price and access a guaranteed market for their produce as the loan is based on a prior linkage with the off taker;

**Input supplier/off takers:** Opportunity to take less risk in pre financing crop production: most of the input suppliers and off takers are already used to pre-finance farmers in order to guarantee the supply of produce. With this partnership, they are sharing the risk and funding requirements with the other actors.

Based on these benefits and the results achieved so far with Advans Ghana, AGRA is supporting others Financial Services Providers in Burkina Faso (Coris Bank, RCPB) and Mali (Kafo jiginew and BNDA) with the implementation of this type of risk sharing value chain partners

### Tanzania Agricultural Development Bank: Blended finance to de-risk capital investments by SMEs

This blended finance product developed by AGRA involves Equity (a down payment by the SME), a Loan (from the Bank) and a Grant (from AGRA) to enable SMEs to invest in equipment for which the business case has not yet been proven. This risk sharing arrangement has attracted new investments in capital goods such as metal silos and threshing equipment. A 1:8 grant/loan ratio has been achieved in the few months of rolling-out the product. Attaching the disbursements of the grants to the loan repayments by the SME, instead of giving direct subsidies to the beneficiaries creates an incentive for repayment and builds a trusted relationship between TADB and the SMEs, which can inform future financing relationships between the bank and the SME.

C. **AGRA supports Agricultural entrepreneurs by providing technical support and grants to:**

- Innovations that reduce cost of financial services delivery to farmers, mainly by using digital finance and alternative delivery channels
- Innovations that reduce costs of assessing creditworthiness of agri-SMEs, farmer based organizations and farmers; this can be through rating, digitisation of transactions, match making platforms, cloud accounting, credit scoring
- Innovations that deliver capacity building at reduced cost for agri-SMEs, farmer based organizations and farmers; capacity building is necessary to improve finance-ability and to decrease the risk of default; this can be through e-learning, mobile accountants, village based advisors

## Case study | Box 3: Innovations that reduce cost of making SMEs and farmers finance-able

**ScopeInsight Assessment and Rating Tool**

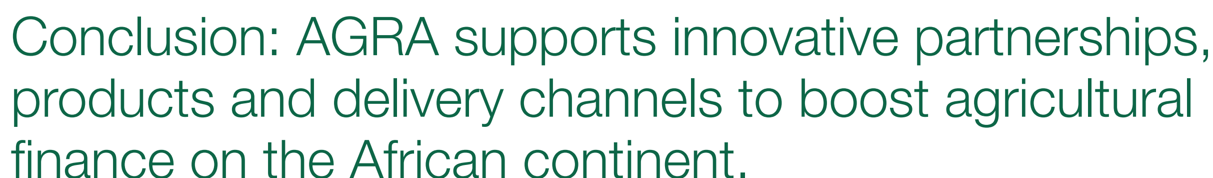
The ScopeInsight assessment and rating tool is an innovative universally applicable tool that measures and benchmarks the level of Agri-SME professionalism (Internal management, Operations, Supply, Markets, External Risks, Enablers and Financial Management). The Scope tools create a common language between stakeholders and can be used across region, sector, crop and farmer segments. The tool is accepted by relevant actors such as BDS providers and financiers and will help to:

- Get useful insight in the SMEs financial needs, strengths, weaknesses and growth opportunities;
- Get useful insights into internal and external benchmarking data
- Better target Business Development Services, training and coaching services;
- Prepare and link the SMEs to the right financial instruments;
- Collaborate with banks and investors to offer the right type of instruments and products as well as reduce the risk and transaction costs
- Build a sustainable ecosystem for agri-SME finance

AGRA supports the expansion of a private sector led ecosystem around ScopeInsight tools, by enrolling new assessors, using the tool for identification of BDS needs and finance-ability of the SMEs and by introducing the tool to financial services providers seeking to reduce their due diligence costs.

**FISFAP: an acceleration fund for use of digital solutions in smallholder finance**

AGRA, in partnership with Mastercard Foundation has provided matching grants and technical expertise to 18 partners in Ghana, Kenya and Tanzania to accelerate their innovative business models for financial services delivery to small-scale staple crop farmers. Because small scale farmers are risky and costly clients for financial services providers, AGRA supports partners to develop and deploy alternative delivery channels (agency banking, mobile wallets), digital (financial) products and aggregation (m-Commerce and e-verification) and access to mechanization services through a virtual market place (‘Uber for tractors’).



# Conclusion: AGRA supports innovative partnerships, products and delivery channels to boost agricultural finance on the African continent.

Agricultural finance presents a huge opportunity by its mere size and economic importance on the African continent. However, costs and risks of developing those opportunities in sustainable business cases are high. Innovations such as blended finance, value chain finance and digital finance require innovative partnerships between public and private partners. Funds with different risk appetites and use of alternative delivery channels are key to reduce risk and costs till a level where agricultural finance presents a business case to all stakeholders. AGRA builds and catalyzes financing of partnerships between Governments, Financial services providers and Value chain actors like SMEs, farmer based organizations and farmers to accelerate the emerging opportunities and innovations into sustainable solutions that become accessible to all.

**In an ideal world according to AGRA**:

1) Farmers can buy their required quality inputs and services nearby at an affordable price allowing them to produce crops that they can sell at a profitable price to reliable buyers. Farmers can cope with hazards because they are able to manage the various risks well.
2) Agricultural SMEs that deliver relevant services and markets to farmers can grow their companies and serve a growing number of farmers profitably, because they have access to the affordable capital and knowledge they need to grow.
3) Business development services providers and Financial services providers consider agricultural SMEs and farmers as a profitable client group which they can serve with appropriate (advisory and financial) products that have acceptable cost and risk levels.
4) Governments support the above eco-system of borrowers, lenders and facilitators through an enabling environment whereby farmers, SMEs and their services providers are de-risked, and where necessary, subsidised within government budgets.

AGRA works towards achieving this ideal world by deploying its funding and technical expertise alongside other actors to unlock the potential of the agricultural transformation in Africa.

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