THE INITIATIVE FOR SMALLHOLDER FINANCE

BRIEFING 02

# A ROADMAP FOR GROWTH: POSITIONING LOCAL BANKS FOR SUCCESS IN SMALLHOLDER FINANCE

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**Local bank lending fails to meet 97% of smallholder demand for financing. To support growth for smallholder farmers, banks must lend at affordable rates, design financial products more appropriately for farmers, and improve accessibility of financial institutions to smallholders.**

**Banks serving smallholder farmers could evolve in a more competitive direction marked by greater product and service innovation. In order to make strides towards closing this gap in financing, public and commercial investors should allocate capital to the banks and financial institutions that have the capabilities to grow and innovate.**

## ABOUT THIS BRIEFING

*This briefing is the second in a series by the Initiative for Smallholder Finance, a multi-donor effort designed to demonstrate how specific products and services can expand the reach of financing for smallholder farmers. Initiative activities include targeted market research, product development and testing, and investment facilitation in the smallholder finance market.*

*The first briefing in our series presented an overview of the size and scope of local bank lending to smallholder farmers.*

*This second briefing outlines what is required for a healthy, competitive smallholder banking sector, and identifies investment opportunities for public and commercial funders seeking to support smallholders. Our analysis begins with an overview of the characteristics and capabilities of banks that are well positioned to serve smallholder farmers. Next, the briefing breaks banks into four archetypes, including an assessment of how effectively each archetype serves smallholders. This document also assesses each archetype on its attractiveness to public or commercial investors.*

## Capabilities of banks positioned to serve smallholders effectively

**As described in the Initiative for Smallholder Finance's previous briefing document, approximately 290 banks in the developing world provide a total of $9 billion in local debt financing for smallholders, which meets just 3% of smallholder demand for financing.**[1] If local banks increased their capacity to serve smallholders, they would support over two billion of the world's poorest people who depend on agriculture for their livelihood.

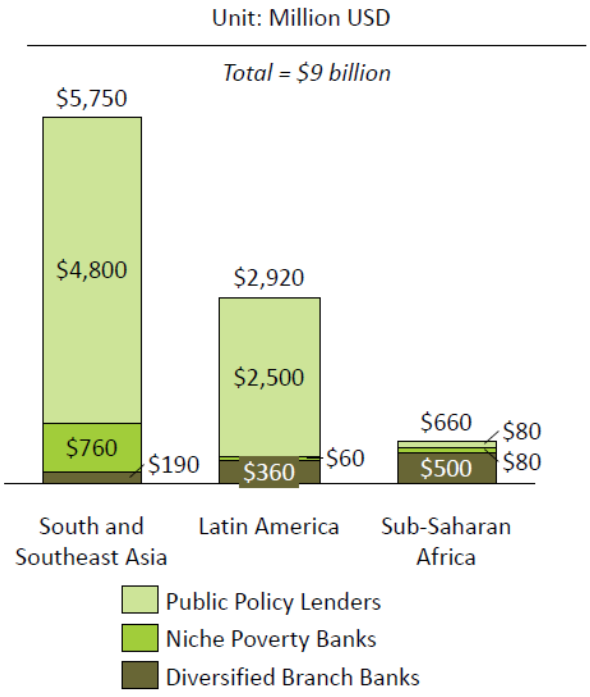
**In order to make strides towards closing this gap in financing, public and commercial investors should allocate capital to the banks and financial institutions that have the capabilities to grow and innovate.** Based on interviews, roundtables, and analysis of leading agricultural finance players, we have distilled five capabilities of banks positioned for success in the smallholder finance market. These capabilities are:

- **Flexible Products.** It is difficult for farmers to make monthly payments when most of their cash flow occurs during the harvest season, so financial products serving smallholder farmers need to have payment schedules in sync with crop cycles.
- **Innovative Distribution.** Effective banks keep the cost of serving each farmer low by distributing funds through a combination of producer groups, value chain relationships, and mobile technology.
- **Alternative Collateral.** The use of group lending, warehouse receipts,[2] or equipment leasing allows banks to offer financing to farmers who might not have traditional hard assets to offer as collateral.
- **Risk Mitigation.** Knowledge of value chains and assessments of buyer relationships help bankers evaluate future cash flows and improve credit assessments of smallholders. Meanwhile, banks can mitigate the portfolio risk of smallholder lending by spreading their risk exposure across multiple crops, regions, or non-agricultural sectors.
- **Partnerships.** When farmers use loans productively, they become better clients for banks. The most effective banks partner with institutions that provide external support for smallholders. This strategy might include partnerships with government extension

programs, NGOs, producer organizations, or technical assistance providers that conduct agriculture training.

**The 290 banks we identified in our survey can be grouped into 3 archetypes with differing degrees of attractiveness to investors.** We classify them as: i) public policy lenders, ii) niche poverty banks, and iii) diversified branch banks. We will explore each type in more detail below. Not included among the 290 local banks are community lenders, which we will discuss after the three archetypes.

Figure 1: Estimated supply of smallholder lending




Note: China is not included in South and Southeast Asia
Source: Dalberg smallholder financing bank database

## Public Policy Lenders

**Public policy lenders are state and agricultural development banks that local governments originally established but later fully or partially privatized.** These banks, many of which opened in the 1960s and 70s, have a policy mandate to develop the agricultural sector, including (in many cases) smallholder financing. All told, approximately $7.5 billion – or 80% of smallholder financing – comes from public policy lenders, although they are relatively few in number. Thirty-five of these banks operate in the regions we studied, compared with 90 niche poverty banks and 160 diversified branch banks. Public policy lenders are particularly prevalent in Asia and Latin America—examples include the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand and Agrobanco in Peru.

**Public policy lenders are the current foundation of smallholder lending, but are unlikely to drive future growth in supply.** These banks often boast effective agricultural finance products, a large branch footprint, and experience managing collateral and risk in the agriculture sector. Public policy lenders are often dependent on government funding, however, which can make them bureaucratic and slow to innovate.[3] As an investment, public policy lenders are a risky proposition because they are often heavily intertwined with government policy and can be subject to fluctuating political priorities. In many cases, government regulations won't permit public policy lenders to absorb the external investments that might otherwise encourage growth.

**In certain instances, investors may be able to support public policy lenders as they convert to commercially-driven banks, or support development of a specific product or customer niche within these banks.** For example, Thailand has concentrated most of its formerly nationalized smallholder financing into BAAC, which is generally regarded as a customer-friendly and effective smallholder agricultural lender. In Peru, Agrobanco offers products to smallholders such as longer-term crop rehabilitation loans, which most other banks are unwilling to finance due to their risk profiles. Such instances depend on stable, functional relationships between public policy lenders and the local governments, and are more likely to be the exception than the rule.

## Niche Poverty Banks

**Niche poverty banks include microfinance (MFI) banks and banks focused on lending to the poor that have moved into customer segments adjacent to their urban lending base (typically including poor farmers).** Niche poverty banks often use group lending mechanisms, which allow them to reach poor borrowers that have limited assets to use as collateral. In the regions we studied, we identified 90 niche poverty banks, providing a total of approximately $900 million in smallholder lending. Examples of these institutions include

Thaneakea Phum Cambodia (TPC) and Opportunity Bank in multiple African countries. Niche poverty banks are particularly prevalent in Asia, where microfinance institutions that converted into registered banks have been expanding their customer base to include farmers.

**The niche poverty banks are well-positioned for growth because they are comfortable practicing group lending and partnering with NGOs, but they generally have limited distribution and, often, restrictive product terms.** Niche poverty banks come from microfinance, so they are accustomed to using group lending mechanisms that do not require hard forms of collateral. They have experience working with NGOs and other partners who share their mission of helping poor clients. Although the terms for their standard financial products may be overly restrictive for smallholders given that crop cycles prevent year-round cash flows, some niche poverty banks have been experimenting with new products.

The client-lender fit seems natural; serving smallholders is a lateral move from niche poverty banks' current clients, and aligns with their mission. The major barrier to niche poverty banks' growth in serving smallholders is their limited footprint and the high cost of distribution in rural areas. To overcome these challenges, some players have started investing in the use of mobile technology and building partnerships with producer organizations, which reduces transaction costs.

**Niche poverty banks – particularly those that have already built agricultural expertise and are located in smallholder-dense regions – represent a promising investment opportunity.** Some of the largest niche poverty banks can offer a return on investment sufficient to attract commercial investors. The smaller ones, however, may not have sufficient scale to absorb the amount of money that a commercial investor could efficiently disperse. These smaller banks may be attractive to impact investors, who offer slightly cheaper or more patient capital that would help mid-sized banks reach scale.

Yet, even among the biggest and most effective niche poverty lenders, there are few that could significantly grow their smallholder offerings with capital alone. Most of these banks need capital investment paired with training for their management and loan officers, who often need to learn how to develop products and assess agriculture value chains.

Rabo Development and Grameen Credit Agricole are prime examples of banks effectively combining capital with technical assistance to improve their financial services for smallholders.

## Diversified Branch Banks

**Diversified branch banks are commercial banks that have come "down market" to offer products to smallholders. The smallholder products usually comprise a small portion of their overall portfolios.** Typically, diversified branch banks have a large branch footprint and attract capital more easily than niche poverty banks. The 160 such institutions we identified in our study provide a total of approximately $1 billion in smallholder lending. Diversified branch banks are most common in Africa—examples include Standard Bank in multiple African countries and Union Bank in Nigeria. Although diversified branch banks are generally much bigger than niche poverty lenders on the whole, the share of their portfolios that is dedicated to smallholders remains very small.

**Though diversified branch banks' extensive branch footprints and risk management expertise position them well to serve smallholders, their off-the-shelf products rarely fit agriculture cash flows and often require hard assets as collateral, which limits their accessibility to smallholders.** Diversified branch banks typically have branches in locations close to centers of agricultural activity. They can absorb agricultural lending risk well, because they have diverse cross-sector portfolios and strong risk analytics capabilities. Diversified branch banks usually offer many products, and while many of those products are not agriculturally driven, this openness to and precedent of variety means they can more readily create a smallholder product than most niche poverty lenders. The major constraint diversified branch banks face in trying to serve smallholder farmers is that they typically require hard asset collateral – such as land titles or equipment – that small farmers simply may not possess. Working with NGOs and other agriculture extension programs might help diversified branch banks overcome the collateral issue, but they are generally unaccustomed to doing that.

**Although diversified branch banks typically prefer to pursue larger, more profitable clients in urban areas, incentives occasionally align for them to serve**

**smallholders.** These incentives may include: i) an increase in urban competition, leading to the pursuit of opportunities in rural areas; ii) the desire of downstream clients (e.g., processors and buyers) to find funding for their smallholder suppliers via bank support for value-chain financing; iii) government pressure or regulatory requirements to serve the agricultural sector; and iv) a sense of civic duty or corporate social responsibility. Some diversified branch banks have followed the lead of more nimble and innovative actors into the smallholder market, but typically only after the concept has worked for a pocket of clients in the country (see box on impact-driven smallholder lenders). Diversified branch banks generally innovate less than impact-driven lenders, but do deploy significant resources when they decide to enter the market.

**Diversified branch banks typically dedicate only a small portion of their portfolios to smallholder finance, making it difficult for investors to hone in on that particular portion.** An investor interested in smallholder finance would not want to underwrite the entire debt of the bank, so a separate investment vehicle or fund would be needed for an investment to be feasible. To overcome this obstacle, public and impact investors have tried tying guarantees to loans for smallholders so that an investor can share the cost of risk for investing in smallholders. However, as discussed in our previous briefing document, investors need to pair guarantees with technical assistance to banks that builds their capabilities in smallholder lending.

Some diversified branch banks have begun to mimic the group lending approaches of niche poverty banks, and it may not be long before we see partnerships or even mergers between the two types to combine the size and resources of diversified branch banks with the group lending experience of niche poverty lenders. Investors may be able to find opportunities to participate in such partnerships or mergers.

## Community Lenders

**Community lenders include savings and credit co-operatives (SACCOs), village savings and loan schemes, and small rural banks that mobilize deposits from local communities to offer some credit.** The total volume of lending from community lenders is unclear. We did not include them in our market sizing because they are small, dispersed, and hard to identify, but they number in the thousands – examples include the network of over 400 rural banks in the Philippines and the many rural banks in Ghana. Despite their prevalence, community lenders have limited capital because they depend on local community deposits.

**Community lenders have the advantages of a rural presence, experience with rural clients, and strong local knowledge of individual borrowers that helps them manage risk.** However, their activity is typically focused on non-farm activities, even in rural areas, so they rarely offer products for smallholder farmers.

**As an investment opportunity, community lenders are often too small to absorb third party investment, and many do not have the legal structure to do so.** They are unlikely to be a major investment opportunity in their own right, but they could be a partner for diversified branch banks or niche poverty lenders that want to extend their footprint.

### CASE STUDY: IMPACT-DRIVEN SMALLHOLDER LENDERS

**Impact-driven smallholder lenders are an important and complementary part of the smallholder finance ecosystem.** These lenders are not fully commercial; they typically trade off some degree of financial return in exchange for social impact. Impact-driven lenders often finance operating funds for smallholder producer organizations participating in export commodity supply chains. To manage risk, they use purchase contracts with global buyers as a form of collateral and a risk guarantee. Most of these lenders have a global orientation, but they concentrate on select regions, such as Latin America, and specific crops, such as coffee. Examples include Root Capital, Oikocredit, and Triodos Sustainable Trade Fund. In the 2012 report on "**Catalyzing Smallholder Agricultural Finance**" Dalberg estimated the size of these lenders' disbursements to be $350 million.

**Impact-driven smallholder lenders may catalyze broader financial sector participation and fill product gaps in smallholder lending.** These lenders started their operations specifically to improve financing for smallholder farmers, and have leveraged relationships with global buyers to offer trade financing to smallholder producer organizations. In some cases, local banks have begun to follow their lead into smallholder lending (e.g., in Peru). As other local banks enter the market and competition increases, impact-driven smallholder lenders will likely play a role in showcasing innovative business models and consolidating relationships among global buyers operating across multiple countries.

## Conclusion: Investors can grow the smallholder market

**The smallholder banking market presents interesting opportunities for investors to come forward and help grow the market.** Niche poverty lenders – particularly those that have or can obtain agriculture sector expertise – present the most attractive investment opportunity among these archetypes. Meanwhile, investors might find case-by-case opportunities to support public policy lenders that are transitioning to a more commercial approach. Diversified branch banks and community lenders are important players, but do not present investment opportunities that are as profitable.

Regardless of the bank archetype, investors directing capital towards smallholder finance should couple that capital with technical assistance—either by delivering it themselves or partnering with a third party provider—to strengthen the agricultural financing capabilities of the bank.[6]

### ILLUSTRATIVE INVESTMENT SCENARIOS

The table below outlines smallholder investment scenarios based on three investment sizes ($1 million, $10 million, and $100 million). These scenarios assume the investor could use equity, debt in the form of direct lending, or debt in the form of first-loss guarantees.[4] We aimed to balance the transaction costs, partnering potential and diversification needs of investors, and the absorption capacity and transaction costs of the banks and funds on the receiving end.[5]

| | $1 million investment | $10 million investment | $100 million investment |
|---|---|---|---|
| **Challenges and Opportunities** | • The investor will likely want to diversify across 5 to 10 investments, which is small compared to the funding needs of most banks (a bank's "break-even" portfolio size is often greater than $5 million)<br>• Transaction costs may not justify such a small deal.<br>• Smaller banks often need technical assistance more than they need funding. | • The investor would likely create tranches of ~$1 million, which is a relevant order of magnitude compared to smallholder lending portfolios (a typical one might amount to $5 million).<br>• Absorption capacity is unlikely to be a problem, particularly for larger banks. | • The investor would not have placement restrictions and could invest in the largest smallholder banks.<br>• Smaller investments might be less attractive and less feasible (e.g., investments under $1 million).<br>• Absorption capacity of banks could be a problem. |
| **Investment Scenarios** | • This investment size could be appropriate as early seed capital for some of the smaller niche poverty lenders.<br>• Another option would be to join an existing fund in order to syndicate with other investors to access larger investment opportunities. | • A $1 million investment could fit some of the smaller niche poverty lenders as debt or equity growth capital.<br>• A $1 million guarantee fund covering first-loss risk could be leveraged ~10 times for a facility of $10 million, which is on the smaller side, but could be relevant to some diversified branch banks<br>• Syndication with other investors would be a good option to access larger opportunities | • $10 million directly invested as debt or equity in a niche poverty bank could support a substantial portfolio.<br>• $10 million leveraged as a guarantee facility could underwrite $100 million, which would support multiple banks or a few of the largest diversified branch banks.<br>• An investor of this scale could opportunistically participate in a public policy lender conversion. |

## Methodology

**This study breaks new ground by establishing a dataset that was not previously available and by reporting on the smallholder banking industry in a new and replicable way.** Using multiple sources, our team constructed a database of banks with smallholder lending offerings. These sources included USAID's Development Credit Authority database, Root Capital lender surveys, and existing published case studies, including the 37 case studies in the IFC's 2012 report on "Innovative Agricultural SME Finance Models." The team also scanned the websites of all 1,800 banks in Latin America, Sub-Saharan Africa, and South and Southeast Asia for indications of smallholder lending products.

**All told, the team was able to construct a database of 250 institutions offering smallholder financing products.** Recognizing that not all banks necessarily advertise their smallholder financing activities, the team used a "mark and recapture" statistical technique to estimate the number of unknown smallholder banks. By comparing how many of the known smallholder banks (from the USAID and Root Capital datasets) were re-discovered in the website scan, the team was able to estimate how many additional banks were missed in the website scan. For more information on "mark and recapture," see: **http://en.wikipedia.org/wiki/Mark_and_recapture**

We supplemented the data with interviews with leading players in smallholder finance and a review of existing public literature in order to learn about portfolio sizes, products, common approaches, and challenges.

By taking an average portfolio size of banks for each archetype in each of the profiled regions and multiplying by it the estimated number of banks, the team was able to arrive at an estimate of the total size of smallholder lending portfolios in each region and for each bank archetype. Furthermore, the team pulled data on agricultural sector lending from all the Central Bank websites across all the profiled regions in order to construct a view of the total size of agricultural sector lending in relation to smallholder lending.

**Caution is warranted because there are limitations to a global estimate of this kind.** First, the extrapolations are based on a limited sample and vulnerable to errors around a range of confidence. Thus, they are directional estimates only. Second, much of the data was self-reported by banks, so accuracy cannot be fully verified. Third, although the team made an effort to scan the entire global banking sector, there is an inherent selection bias because the banks profiled are usually the banks most active in the space and do not necessarily represent the average.

**This survey marks a down payment on industry reporting in the smallholder banking market by establishing an initial estimate of the market size and creating a methodology that could be replicated in the future.** If this survey is repeated in future years, we would expect response rates to increase, leading to a larger sample of banks, increased accuracy, and additional nuance.

## Notes

[1] Source: The Initiative for Smallholder Finance, "Local Bank Financing for Smallholder Farmers: A $9 Billion Drop in the Ocean," October, 2013. The total demand is approximately $300 billion excluding China and $450 billion globally.

[2] Warehouse receipts are a form of financing in which a farmer or other value chain actor deposits a commodity in a warehouse or storage facility and receives a formal receipt guaranteeing the presence of that commodity in the facility. The receipt may be presented to a financial institution as collateral for a loan. Thus, the commodity serves as collateral without the financial institution having to manage the physical commodity.

[3] Public policy lenders often offer subsidized rates that crowd out market-driven actors that might otherwise arrive at sustainable lending practices for smallholders.

[4] As discussed in this briefing, equity and direct lending are usually most appropriate for niche poverty lenders. Guarantees are relevant to all archetypes.

[5] Investor's minimum investment is typically driven by whether the investment justifies the transaction costs, and if it is possible to team up with other investors or leverage existing products or mechanisms. The maximum investment is often driven by diversification needs. From the perspective of a bank receiving the investment, the minimum investment size is typically driven by whether the investment justifies the transaction costs involved. The maximum investment size is driven by absorptive capacity of the bank, which is largely a factor of its size and ability to expand its portfolio to fully leverage the additional capital. Based on our interviews, the average size of a smallholder portfolio when it breaks-even on profitability is about $5 million. Some of the largest diversified branch banks have smallholder portfolios in the $20 to $30 million range, but most are much smaller. Niche poverty banks are typically under $10 million. Only the public policy lenders exceed $50 million.

[6] More details on technical assistance for smallholders will be examined in subsequent briefings.

## RESEARCH BY

Dalberg

Dalberg Global Development Advisors is a strategy and policy advisory firm dedicated to global development. Dalberg's mission is to mobilize effective responses to the world's most pressing issues. Dalberg works with corporations, foundations, NGOs, and governments to design policies, programs, and partnerships to serve needs and capture opportunities in frontier and emerging markets.

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## ABOUT THE INITIATIVE FOR SMALLHOLDER FINANCE

The Initiative for Smallholder Finance is a multi-donor initiative hosted by the Global Development Incubator to build research and development infrastructure in the smallholder finance industry and make progress toward filling the gap in financing through targeted product development, piloting, and partnerships.

For the original report that led to the creation of the Initiative for Smallholder Finance, see "Catalyzing Smallholder Agricultural Finance" (2012).

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