THE INITIATIVE FOR SMALLHOLDER FINANCE

BRIEFING 01

LOCAL BANK FINANCING FOR SMALLHOLDER FARMERS: A $9 BILLION DROP IN THE OCEAN

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Access to finance for smallholder farmers can serve as a critical catalyst for economic growth and poverty alleviation. Yet local bank lending – which should be a main avenue for smallholder financial access – meets only 3% of overall demand. Currently, global development donors have tried to incentivize bank lending to smallholders by focusing on guarantees, but those have not been sufficient to stimulate lending.

Banks need investment funds and technical assistance to build their smallholder banking capabilities. 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.

ABOUT THIS BRIEFING

This briefing is the first 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.

This first briefing presents an overview of the market size and scope of local bank lending to smallholder farmers. Subsequent briefings will break down the local lending market and explore the technical assistance landscape for smallholder farmers. Over the next year, the Initiative for Smallholder Finance will release additional research and share investment opportunities for the smallholder finance industry.

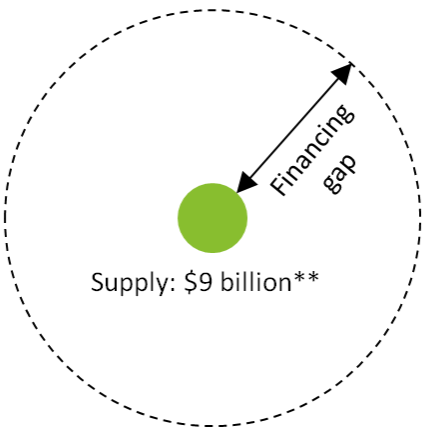
The Initiative is implementing findings and recommendations documented in the 2012 report Catalyzing Smallholder Agricultural Finance*. The authors recommend that report as background reading for this briefing.*

The total amount of debt financing for smallholders is approximately $9 billion.

Until now, there has been a lack of data on the size and scope of debt financing that is available to smallholder farmers. New research by the Initiative for Smallholder Finance[1] aims to fill the data gap, assess the types of financing products offered to smallholder farmers, and understand barriers to provision.

The total amount of debt financing supplied by local banks to smallholder farmers in the developing world is approximately $9 billion. This is a small figure and meets less than 3% of the estimated total smallholder financing demand, which is $300 billion excluding China and $450 billion globally (see Figure 1). Furthermore, this amount is dwarfed by the $230 billion in total bank lending to the agricultural sector.

Figure 1: Supply Versus Demand for Smallholder Finance



Note: Figures include South and Southeast Asia, Latin America, and Sub-Saharan Africa; China is not included.

* Dalberg, "Catalyzing Smallholder Agriculture Finance," 2012 [figures adjusted to account for geographic focus]

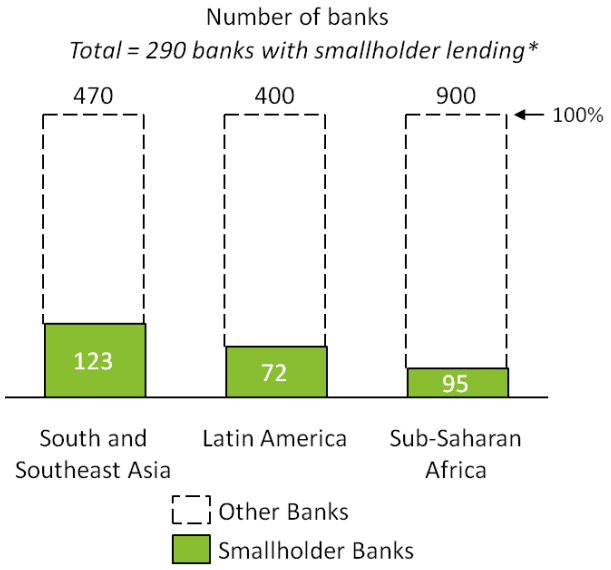
** Dalberg smallholder financing bank database

As a result of this shortage in formal financing sources, farmers are forced to rely on expensive credit from

informal sources. Informal sources often consist of loans from family, friends, local moneylenders, or others in the agricultural value chain, such as input suppliers, buyers, and traders. However, these sources often charge interest rates 2x-10x higher than commercial rates. In either case, access is uneven as well, especially for farmers not connected to structured value chains. Estimates by FinScope suggest that 15% to 30% of the rural population in Sub-Saharan Africa has access to informal finance only and 30% to 60% has no access to financial services, whether formal or informal.[2]

Formal financing is in short supply in part because of the scarcity of local lending sources. Currently, smallholder banking is offered by only a small share of the possible lenders and is concentrated within a subset of those lenders**.** Of 1,800 banks in the surveyed regions, approximately 290 (or 16%) provide smallholder farmer financing; the largest 20% percent of these banks conduct 75% of smallholder lending. An estimated 1,500 banks in developing countries do not engage in any known activity with smallholders (see Figure 2).

Figure 2: Smallholder Bank Coverage Ratio



* The Dalberg smallholder financing bank database includes 250 institutions. The total number of banks has been calculated using a "mark and recapture" statistical methodology to estimate the number of un-identified banks

Source: Interviews with bankers, Dalberg smallholder financing bank database

The existing supply primarily comes from public policy banks, but commercial and microfinance banks have started entering the space. Public policy banks – i.e., state and agricultural development banks that were originally established by local governments and later fully or partially privatized – provide 80% of smallholder financing. The remainder comes from commercial branch banks that have come down-market to offer products to smallholders or from microfinance banks that have moved into lateral customer segments (i.e., poor farmers).

Most of the commercial banks and microfinance banks began serving smallholders recently – within the last five years. Moreover, all of the institutions in these two categories that we spoke with reported plans to grow. Subsequent research from the Initiative for Smallholder Finance will detail the approaches used by various bank archetypes to serve smallholders effectively.

Demand side barriers play a role in preventing growth in the smallholder finance market. Demand side constraints among smallholder farmers are well known in the donor community and include:

- Lack of producer organizations and structured value chains for smallholders,
- Low financial literacy and financial management skills among farmers, and
- Low productivity, margins, and cash flow for servicing loans.

Although supply side constraints from the perspective of banks are less often discussed, there is a high barrier to entry for banks interested in serving smallholders. While banks surveyed in this study report that they can offer smallholder products profitably, doing so requires large upfront investments in staff skills, technology, and back-office processes that cannot be recouped without reaching scale.

Banks need specific agricultural expertise to assess smallholder loans and design appropriate financial products, but many lack or have difficulty acquiring this expertise. Furthermore, while banks report that the average risk for smallholder lending is similar to the rest of their lending portfolios, the risk distribution is skewed toward occasional negative spikes (e.g., during droughts or floods) that can undermine profits in down years. The

lack of reliable insurance or reinsurance products for smallholders contributes to banks' discomfort with lending. Finally, an absence of land titles (for collateralization) and credit bureaus (for customer assessment) is common in many of the regions studied. Given these challenges, (and the fact that margins on smallholder banking are no more attractive than those of other investment opportunities) many banks prefer to lend elsewhere.

The few banks that managed to overcome barriers have done so through a mix of product, distribution, and collateral customization that serves smallholders effectively. For example:

- To improve farmers' ability to pay on time, some banks have collaborated with local agriculture experts to design loans with flexible repayment terms that are linked to actual crop cycles.
- Regarding distribution, mobile technology has enabled roaming agents to distribute finance to rural customers where they live and work, collecting information while reducing transaction costs.
- Farmer organizations can serve as a central point for loan distribution and collection.
- The use of group lending, warehouse receipts, or equipment leasing allows banks to offer financing to farmers without traditional hard assets as collateral.

To manage risk effectively, the most innovative banks recognize the importance of having intimate knowledge of value chains and buyer relationships in order to gauge future cash flows and improve the credit assessments of smallholders.

To expand local lending, donor support must move beyond guarantee funds and demand side technical assistance.

There is an opportunity for banks to learn from one another in order to improve their smallholder practices. Only a subset of banks use the practices listed above, and few, if any, use all of them. Leading smallholder banks we spoke to suggested that even if other large banks enter the smallholder financing market, it will be years before saturation is reached, and even then, there will be opportunities to compete based on product innovation and differentiation.

CASE STUDY: OPPORTUNITY BANK IN UGANDA

Opportunity Bank in Uganda serves smallholders using a microfinance model, with products tailored to the crop cycles of farmers. The bank works with partners such as extension service providers or off-takers who have relationships with farmer groups then signs a Memorandum of Understanding with the group to offer savings and microloans guaranteed by the group members. Interest payments are made monthly, but principle is typically paid at the end of the harvest cycle, including a grace period, to match farmer cash flows.

Opportunity Bank uses mobile branches and roaming bank agents to reach farmers in rural areas and the bank is experimenting with mobile payments to reduce transaction costs. Opportunity Bank reaches about 3,600 smallholder clients through the group lending model. The biggest challenge for the bank is hiring bank staff with an agricultural background. *(Source: Interview, Opportunity Bank Uganda.)*

Donors have primarily relied on guarantee funds and technical assistance in order to stimulate financing for smallholders. Guarantees unlock development finance resources by reducing risk, cutting down on lender administrative costs, and encouraging banks to test new client groups. Technical assistance improves the bankability of farmers and increases the capability of banks to offer smallholder products. However, current applications of guarantees and technical assistance have shortcomings, as discussed below.

Our findings suggest that guarantees alone will not be sufficient to motivate banks to serve the smallholder market effectively. Guarantees do not address the fundamental need for investment capital and expertise that banks require to build distribution and back-office infrastructure for serving smallholders. Guarantees increase day-to-day profitability of banks when serving particular segments, but they do not create excess cash flow that would allow one-off investments in staff skills, technology, and back-office processes for smallholder

banking. More importantly, guarantees do not address the expertise required to design appropriate products and conduct credit assessments of farmers. As one banker in Kenya attested, "Most donors don't do training for loan officer staff, so guarantees may just encourage irresponsible lending in the agricultural sector."

Technical assistance can be useful on both the demand and supply side, but the vast majority of the $1.1 billion in donor technical assistance funding goes to programs addressing demand constraints, while only 3% goes to addressing supply constraints.[3] On the demand side, farmers need donor support to reduce their riskiness as borrowers by acquiring skills in financial literacy and agricultural productivity, as well as by organizing into producer groups that will reduce distribution costs and serve as collateral. Such demand side support is useful, but it needs to be balanced with supply side support to banks on how to assess risk and customize products for smallholders. Among the largest technical assistance providers in the world, only 8-10 have credible programs focused on banks, so even banks eager to enter the market may find it difficult to acquire the necessary expertise. Among these technical assistance providers, Rabo Development and Grameen Credit Agricole have been effective at moving local banks and microfinance institutions into the smallholder banking market by making equity investments and offering training and technical support to improve banks' capabilities.

The disproportionate amount of donor funding focused on demand side constraints rather than supply side constraints indicates a pressing need to increase funding towards technical support for banks' internal capabilities in smallholder finance. Given the shortage of bankers and technical assistance providers with expertise in smallholder finance, donors should prioritize creating training programs and curricula that can develop requisite skills and capabilities within banks. Banks also need investment capital to overcome the initial hurdles of building smallholder banking capabilities.

According to our findings, in order for local bank financing of smallholder farmers to expand and become a driver of economic growth and poverty alleviation, donor support must move beyond guarantee funds and demand side technical assistance toward balanced support for investment capital and supply side technical assistance.

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 those from the IFC's 2012 report, **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 looking 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. The data was further enhanced through interviews with leading players in the smallholder finance space and a review of existing public literature to learn about portfolio sizes, products, approaches, and challenges.

Caution is warranted, however, because there are limitations to a global estimate of this kind. First, the extrapolations are based on a limited sample and thus give rise to errors around a range of confidence. Thus, they are directional estimates only. Second, banks self-reported much of the data, so accuracy cannot be fully verified. Third, while the team made an effort to scan the entire global banking sector, there is an inherent selection bias because the banks profiled are often the most active and are not necessarily representative.

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] The Initiative for Smallholder Finance is a multi-donor initiative 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. The Initiative's sponsors include the Citi Foundation, Ford Foundation, KFW Development Bank, MasterCard Foundation, Skoll Foundation, and USAID.

[2] FinScope National Surveys, 2008-2012. Note that FinScope statistics count rural loans that are typically for non-farm activities, meaning that loans for agricultural activity are even less common.

[3] Source: Research by the Initiative for Smallholder Finance. More details on technical assistance for smallholders will be examined in subsequent briefings.

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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.

See the report that led to the creation of the Initiative for Smallholder Finance, **Catalyzing Smallholder Agricultural Finance** (2012).

PERSONS INTERVIEWED

The authors are grateful to the following people for allowing us to interview them while conducting research for this briefing:

Sheikh Aliyu-Auchan - Union Bank, Nigeria
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Felkin Kayuni - Standard Bank, Malawi
Claude Lafond - Entrepreneurs Financial Centre, Tanzania
Andre Lalumiere - Opportunity Bank, Uganda
George Macharia - Equity Bank, Kenya
Ephraim Mwefyeni - Zanaco Bank, Zambia
Carlos Pacheco Caycho - Confianza, Peru
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Sierk Platt - National Microfinance Bank, Tanzania
Julius Respicio - Bank of the Philippine Islands
Victor Reynoso - Banco ADEMI, Dominican Republic
Nat Robinson - Juhudi Kilimo, Kenya
Guy Rwaburindi - Kenya Commercial Bank, Rwanda
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