The Role of Financial Services in Agribusiness Development: A Primer

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The international development community benefits from field testing tools such as this Financial Services Primer. Please feel free to contact Land O’Lakes or WOCCU if you have suggestions for improvements of this volume, recommendations for additional volumes, or general feedback.

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# Table of Contents

Key Definitions .............................................................................................................................. iv  

1. Introduction ............................................................................................................................. 1  
   
   1.1 What are financial services? ............................................................................................. 1  
      
      1.1.1 Cash rental services ................................................................................................... 1  
      
      1.1.2 Liquidity management services ................................................................................ 2  
      
      1.1.3 Risk management services ........................................................................................ 2  
   
   1.2 Why are financial services relevant for agribusiness/rural development? ....................... 3  
   
   1.3 What types of financial services are relevant for rural agribusinesses? ......................... 3  

2. Issues Affecting Financial Services to the Agribusiness Sector ............................................. 5  
   
   2.1 Demand for financial services .......................................................................................... 5  
      
      2.1.1 Demand versus qualified demand ............................................................................. 5  
      
      2.1.2 Quality of agribusinesses present .............................................................................. 6  
   
   2.2 Impact of the government policy environment .................................................................. 10  
   
   2.3 Financial services—clients’ key concerns ........................................................................ 12  
   
   2.4 Types of financial service providers .............................................................................. 15  
      
      2.4.1 Regulated financial services providers ................................................................... 15  
      
      2.4.2 Nonregulated formal financial institutions ............................................................. 16  
      
      2.4.3 Other financial services providers .......................................................................... 17  
   
   2.5 Financial products .......................................................................................................... 19  
      
      2.5.1 Savings products ..................................................................................................... 19  
      
      2.5.2 Client appraisal and credit products ........................................................................ 20  
      
      2.5.3 Cash management products .................................................................................... 22  
      
      2.5.4 Insurance products .................................................................................................. 23  
      
      2.5.5 Others ...................................................................................................................... 23  
      
      2.5.2 Availability of complementary financial services .................................................. 24  

3. Supply-Side Development Interventions .............................................................................. 26  
   
   3.1 Market research .............................................................................................................. 26  
   
   3.2 Support for product development ..................................................................................... 26
3.3 Informational materials .................................................................................................. 27
3.4 Training field staff ........................................................................................................ 27
3.5 Training branch staff ................................................................................................... 27
3.6 Training senior management and board members ...................................................... 28
3.7 Training clients .......................................................................................................... 28
3.8 Financial product marketing ....................................................................................... 29
3.9 Guarantees .................................................................................................................. 29
3.10 Soft loans .................................................................................................................. 30
3.11 Lines of credit .......................................................................................................... 31
3.12 Subsidy of infrastructure ......................................................................................... 31
4. Demand-Side Development Interventions .................................................................... 32
   4.1 Developing creditworthiness of individual rural clients ............................................. 32
      4.1.1 Education ........................................................................................................ 32
      4.1.2 Practical workshops on record keeping, business plans, and loan applications .... 32
      4.1.3 Clients introductions to financial institutions .................................................. 32
   4.2 Developing creditworthiness of cooperatives/networks/organizations ...................... 33
      4.2.1 Education ........................................................................................................ 33
      4.2.2 Practical workshops on record keeping, business plans, and loan applications .... 33
      4.2.3 Producer organization introductions to financial institutions .......................... 33
      4.2.4 Linkages ......................................................................................................... 33
   4.3 Development of agribusinesses’ capacity to do business better .................................. 34
5. Risks and Rewards Associated with Agricultural Financial Services .......................... 35
   5.1 Overview of risks .................................................................................................... 35
   5.2 Overview of rewards .............................................................................................. 36
6. Lessons Learned ............................................................................................................ 39
   6.1 Decisions to enter a market must be based on data ................................................. 39
   6.2 Specialized financial products and training are necessary ...................................... 39
   6.3 Financial services must be specialized .................................................................. 40
   6.4 Savings is critical and often undervalued by technical programs ............................ 40
   6.5 Structured trade arrangements are promising ....................................................... 40
6.6 Finance leasing is an easy point of entry to rural finance ........................................... 41
6.7 Existence of Qualified Demand .......................................................................................... 41
7. Recommendations ........................................................................................................... 42
7.1 Land O’Lakes staff ....................................................................................................... 42
7.2 Market research on dairy value chains .......................................................................... 42
7.3 Linkages to financial institutions .................................................................................. 43
7.4 Access regional resources around East Africa .............................................................. 43
## Key Definitions

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Agribusiness</strong></td>
<td>Privately managed for-profit activities relating to all aspects of the supply chain: input supply, production, transport, processing, marketing, etc.</td>
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<td><strong>Arrears</strong></td>
<td>Late repayment of a credit obligation</td>
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<td><strong>Cash Flow</strong></td>
<td>The value and the timing of cash coming in or out of a business</td>
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<td><strong>Cost</strong></td>
<td>An expense incurred to operate a business</td>
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<td><strong>Creditor</strong></td>
<td>Anybody who extends finance to a business</td>
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<td><strong>Default</strong></td>
<td>Failure or refusal to repay a credit obligation</td>
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<tr>
<td><strong>Financial Product</strong></td>
<td>A well-documented system in which cash is both the commodity being traded and the medium for payment of fees</td>
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<td><strong>Guarantee</strong></td>
<td>A pledge by a third party to meet some or all of a borrower's credit obligation should the borrower default</td>
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<td><strong>Insurance</strong></td>
<td>A financial product where the risk of a negative event is managed by a third party who will compensate the insured with cash if the event takes place</td>
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<tr>
<td><strong>Interest</strong></td>
<td>A rent or a user’s fee paid by a borrower to a lender or by a financial institution to a depositor for the use of cash</td>
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<tr>
<td><strong>Lease</strong></td>
<td>Loan of an asset where the lender transfers ownership of the asset to the borrower once the borrower pays the full value of the asset to the lender, plus any fees</td>
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<td><strong>Liquidity</strong></td>
<td>Cash used in a business</td>
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<tr>
<td><strong>Loan</strong></td>
<td>Provision of cash to a borrower in return for a periodic repayment with interest paid for the use of the cash</td>
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<tr>
<td><strong>Market</strong></td>
<td>Any real or virtual place where buyers and sellers meet to transact business</td>
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<tr>
<td><strong>Principal</strong></td>
<td>The amount borrowed, in the case of a loan</td>
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<td><strong>Productivity</strong></td>
<td>The measure of the amount of revenue earned for the amount of cost spent</td>
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<td><strong>Profit</strong></td>
<td>Total revenue minus total cost</td>
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<td><strong>Revenue</strong></td>
<td>Cash received by a business for selling its product or service</td>
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<tr>
<td><strong>Savings</strong></td>
<td>Cash held in a financial institution for security or for investment</td>
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<tr>
<td><strong>Side Selling</strong></td>
<td>Signing a contract with a buyer in return for receiving credit from that buyer and then selling to another buyer to avoid repaying credit</td>
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1. Introduction

This primer is meant to serve as a thorough introduction to rural financial services for Land O’Lakes International Development staff, especially those who aren't finance practitioners. We developed it to help Land O’Lakes staffers become more familiar with the importance of financial services serving as a catalyst for rural and agribusiness development; financial concepts especially as applied to rural finance; individual financial products and financing strategies that incorporate multiple products; factors that enable or impede proper development of financial services; and the role that development organizations, including Land O’Lakes, can play to speed agribusiness development using financial services as a catalyst.

This introduction provides a brief overview of financial services; discusses the relevance of financial services for agribusiness and rural development; and covers the types of financial services relevant for rural areas.

1.1 What are financial services?

Financial services refer collectively to all professionally managed services for transactions whereby cash is exchanged for cash.¹ There are many examples of financial services but most fit into the following three categories described below.

1.1.1 Cash rental services

Rental transactions are transactions where cash is rented. That is, one party with excess cash provides cash to a second party with too little cash for an agreed-upon rental fee. When the second party repays, they repay both the cash and the fee. Following are two common examples.

- Saving—Transactions in which a client places cash with a licensed institution that agrees to hold the cash safely and return the cash to the client either on demand or at an agreed-on future date either with or without interest. This can be done for free or for a small cost to the client.
- Lending—Transactions in which a licensed institution lends cash to a client that agrees to use the cash productively and repay the cash to the institution with interest on one or multiple agreed-on dates.

¹ There are also nonprofessionally managed financial services that are formally offered by unregulated moneylenders, by nonfinancial institutions or by individuals.
1.1.2 Liquidity management services

Liquidity management transactions are transactions where for a fee, one party helps other parties to manage the timing or distribution of their cash income more effectively. Here are three common examples:

- **Overdraft**—Transactions in which (for a fee and following a review of a client’s normal cash flows) a licensed institution allows that client to make payments from its account even though the cash in that account is exhausted based on the fact that the client will receive payments to the account that will repay the amount overdrawn and the fees. Overdrafts allow clients to meet financial obligations even when they are temporarily short of cash.

- **Factoring**—Transactions in which a licensed institution pays a client a slightly discounted value in cash for that client’s invoice to a reputable buyer of that client’s goods or services. Normally, invoices for goods and services are not paid for 30 to 60 days. This can be a long wait for a business that has other obligations. With factoring, the clients get slightly less cash for their invoices from the institution than they would receive from the buyer, but they get the cash immediately and thus can meet immediate obligations. The institution receives the full value of the invoice once it is paid.

- **Transfers**—Transactions in which a licensed institution receives a cash payment from a client in one of its locations and makes a cash payment to a beneficiary stipulated by the client in another of its locations, for a fee. Transfers allow clients to move money without taking the physical risk of carrying it and without having to spend time making a delivery in person.

1.1.3 Risk management services

Risk management transactions are transactions in which, for a fee, one party helps another to guarantee that adequate cash will be available to overcome some unforeseen future problem. Here are two common examples:

- **Insurance**—Transactions in which a client pays a licensed institution a predetermined premium that is worth a fraction of the client’s anticipated financial loss should an unforeseen problem occur. If the problem occurs, the institution pays the client the agreed-on amount. But whether the problem occurs or not, the institution keeps the client’s premium.

- **Options**—Transactions in which a client pays a licensed institution a negotiated premium to have the option (meaning the right but not the obligation) to access cash at some time in the future. Examples of this apply to commodity trades and foreign exchange transactions. The institution may sell the client an option to buy foreign currency at some future date based on the exchange rate today. Thus, if the cost of the foreign currency...
goes up, the client will exercise the option; if the cost of the foreign currency stays the same or goes down, the client will not exercise the option. In either case, the institution keeps the premium.

1.2 Why are financial services relevant for agribusiness/rural development?

Financial services are relevant for all communities and all businesses, including rural communities and agribusinesses. They enable both development activities and the optimal use of excess liquidity within a community. Financial services achieve this through what are termed *capital formation* and *intermediation*.

- Capital formation is the process of accumulating money in a community. Financial institutions with branches or headquarters in a rural community provide a safe location where excess cash can be accumulated. In agricultural communities, capital formation typically occurs at harvest time. When the harvest comes in, urban traders arrive to sell their goods; once the harvest is finished and the cash in the community exhausted, the traders leave. When a financial institution is based in a community, cash accumulates as savings, which encourages trade with the community on a permanent, versus seasonal, basis. This increases quality of life, as goods and services are more reliably accessible.

- Intermediation means mobilizing excess liquidity as savings deposits from those who have it and providing it as loans to qualified borrowers who need it. Well-managed financial institutions have systems to ensure that loans are made to low-risk borrowers; loans are used to finance business opportunities that show the greatest potential for profit (thus helping business in the community to develop); and adequate liquid cash is always available to repay savers when they demand their money (thus providing financial stability to rural households and the ability to save upfront for important investments).

1.3 What types of financial services are relevant for rural agribusinesses?

Rural areas typically suffer from shallow financial services. With respect to credit, if any financial institutions are present, they tend to be banks with a strong focus on providing liquidity management services to large clients and government and microfinance institutions that concentrate on small, short-term loans to small borrowers for trade. Moneylenders, who lend larger sums for longer periods, may also be present, but they usually lend their money at extremely high rates of interest. This compensates them for their risk and their lack of systems to manage effectively, but it also reflects the fact that little competition is forcing them to lower their charges. Agribusinesses usually require loans that are large enough to cover their seasonal investment—that is for cash-flow or liquidity purposes—or large enough to cover the investment in an expensive and critical piece of equipment, or both. Further, agribusinesses require loans
that match the seasonality of their businesses. They normally can't repay loans on a weekly or monthly basis as is often demanded by microfinance institutions.

Beyond the limited options for accessing credit, rural people are rarely able to save their excess cash in a secure and convenient institution. Banks, for example, see little benefit in developing the staff and systems to mobilize what they view as small, short-term deposits. Microfinance institutions are frequently disallowed from mobilizing savings because government regulators view them as unsophisticated or too small to manage depositors’ cash safely.

The highest priorities for rural agribusinesses are:

- **Access to savings services:**
  - Enables them to accumulate money at season’s end for the next season’s investment;
  - Enables them to save for larger, longer-term investment goals; and
  - Enables them to save for emergencies that might affect their business or household.
- **Access to seasonal working capital loans:**
  - Enables them to increase the scale of production in a given season and thus earn more income.
- **Access to multi-year finance:**
  - Enables them to invest in capital equipment to increase the level of productivity while saving labor costs; and
  - Make smaller payments over a period of years, which lowers the negative impact of financing on the business’s cash flow.
- **Access to health insurance:**
  - Enables them to avoid losing their working capital or selling off existing assets when their owners or employees become ill.
- **Access to specialized insurance such as livestock health and life insurance, asset insurance, price insurance and weather insurance:**
  - Enables them to survive shocks to their businesses by having a program that will compensate them in cash or repay their creditors.

We will cover all these issues in more depth in the following pages.
2. Issues Affecting Financial Services to the Agribusiness Sector

2.1 Demand for financial services

In economic theory, a market is any place, real or virtual, where buyers and sellers meet to transact business. As with any other markets, financial service markets are governed by supply, or availability, of financial products and the demand for the financial products that are offered. If there is limited or no demand, there is no market for the products and/or services.

2.1.1 Demand versus qualified demand

It is important to distinguish between demand and qualified demand. As in any other sector, effective and sustainable demand must underpin agricultural financial services. Demand refers only to what clients want. Qualified demand refers to what they want and are willing to pay for. For example, surveys done in the dairy sector in many African countries have indicated a high demand for financial products to increase and improve the dairy herd, buy transport equipment, improve water supply, access cooling equipment, and buy feed and veterinary drugs. But deeper analyses reveal that many of the actors are unwilling or unable to pay for financial services and products for a variety of reasons. So the qualified demand for financial services must be determined, and not just the simple demand for them.

A qualified demand for a financial product must be backed up by a viable business that generates adequate revenue to meet that financial product’s obligations. The business must cover all costs, earn an attractive return for the business owner and ensure the lender’s repayment. If a business is earning little or no profit—making low realizable margins—the risk of nonrepayment is very high. As the business becomes more profitable, the risk of nonrepayment goes down. For an agricultural subsector to be underpinned by qualified demand, it is important that the various actors realize profit margins higher than lenders’ interest rates and thus have capacity to repay.

The number of actors with profitable undertakings is equally important in determining the level of qualified demand. If only a few actors in a location are profitable, it is unrealistic to assume the existence of qualified demand. Thus there is a need to collect a representative sample of potential clients in order to estimate the qualified demand. This requires carefully reviewing agribusiness activities within the financial institution’s target market area before offering a financial product.

Finally, to estimate qualified demand, a lender must not only understand the capacity but also the willingness of businesses within a location to repay. Capacity is characterized by adequate returns and cash flows on the part of the borrower’s activity. Willingness relates to the borrower’s ethical personality, trustworthiness, and attitude toward paying debts. Lenders will find that some locations are spoiled because government, donors, and charities, have offered credit on subsidized terms, or have made no attempt to recover loans in the past, leading local
businesses to the conclusion that credit is a gift and not an obligation. Willingness of borrowers to repay can be assessed by reviewing the history of the performance of credit programs in the area. Also useful are open-ended focus group discussions, where the targeted community is encouraged to discuss credit and a neutral evaluator takes note of their attitudes.

In summary, the user of this manual should be able to raise the following questions when ascertaining the qualified demand for agricultural financial services.

- What is the average margin earned by potential borrowers?
- How do these margins compare with the average interest rate charged by the financial institutions present?
- How does the timing of the potential borrowers’ cash flows compare with the timing required for repayment by the financial institutions present?
- Is there a critical mass of profitable actors within the given value chain?²
- Is there a strong history of repayment and a positive attitude toward honoring repayment obligations within the community?

2.1.2 Quality of agribusinesses present

As mentioned in the preceding section, qualified demand for agricultural financial services is underpinned by the profitability of the undertakings of the different enterprises within the targeted community. Two key concepts of profitability are important to understand: gross margin and annual return.

**Gross margin**—This is all of the agribusiness’s revenues minus all costs of production. It is called gross margin because it normally does not consider costs of finance or taxes (once considered, this results in the net margin). Gross margin informs the producer and anyone considering lending to the producer how much cash will normally be on hand at the end of the season or the end of the year. Gross margin is thus a measure of profit in cash terms. To determine the value chain actors’ gross margins, you must first collect data on costs and revenues from a representative sample of those actors over the most recent business cycle. Then you compare these costs and revenue to determine the degree to which the agribusiness realized more revenue than cost (profit) or less revenue than cost (loss).

**Annual return**—This is the agribusiness’s annual gross margin divided by its annual costs of production expressed as a percentage. Annual return provides a percentage measurement of annual profitability. This is very handy to both producers and lenders because the annual return can easily be compared to the lender’s annual interest rate. If an annual return is less than the lender’s interest rate, the producer can’t borrow and repay from the current business. An annual

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² Determining the critical mass requires an expert to design and implement a research instrument to survey enough appropriate actors to then, based on statistical modeling, generalize to the broader population.
return slightly higher than the lender’s interest rate may be equally discouraging, as it indicates that the producer will have to pay the majority of the profits earned to the lender and may be likely to attempt to default instead of repaying. An annual return well above the lender’s interest rate (at least double that rate) indicates a highly profitable business that is capable of using commercial finance properly.

Any enterprise’s profitability is also a function of the experience, management skills, and attitude of the entrepreneurs involved. The reliability of the market into which that enterprise sells its products or services is also important because it affects the price realized and directly affects the margins reaped by the enterprises. These points are elaborated below.

**Managing costs of activities**—The gross margin of any agricultural undertaking is a function of costs incurred to accomplish the activity, the yield in terms of output achieved and the price for that output (goods or services) realized in the market. Producers can maintain reasonable control over their cost of production by carefully sourcing inputs and exercising good management practices for better yield. It is imperative that good management and quality inputs be applied at the same time.

In dairy, for example, milk yield depends on quality of breed, cost and quality of feed, and cost and quality of veterinary care. Dairy farmers who use inputs in the right combinations and control costs usually realize higher gross margins and stronger annual earnings, which can then support commercial financing. Dairy farmers who don't manage their farms efficiently normally earn lower gross margins that can't sustain commercial financing. Similarly, in crop production, improved inputs and timely accomplishment of activities lead to optimal yield levels and the lowest possible cost of production per unit of output. Failure to use improved technology and poor agronomical practices can both negatively affect the producer’s yield and the producer’s gross margin.

Of course managing the cost of production is sometimes affected by factors beyond the control of the given value chain actor. Input prices may rise, or the yield may be affected by bad weather, pests, and diseases. In such cases, the resulting cost of production may exceed the revenue earned and result in a loss to the agribusiness. Management of price and production risk are covered in greater detail in Section 5.

An important challenge facing financiers who are trying to establish an effective demand for financial services is that many producers don't know their cost of production with reasonable accuracy. That means they can't estimate their annual return, which would demonstrate if their business is capable of supporting commercial finance.

This is particularly true of smallholder producers. The situation at the smallholder level is worsened further by the practice of using unpaid family labor. Because producers don’t know their costs and thus can’t estimate their profitability, financial institutions also can't estimate the
producers' capacity to repay a loan. Financial institution staff members are rarely skilled at quickly identifying optimal production systems versus subsistence production systems.

The lack of documented information on the agribusiness itself, in combination with low capacity for financiers’ representatives to differentiate between commercial and subsistence agribusinesses, explains the observed low qualified demand among producers. This also explains why most producers think interest rates are high; they can't compare the interest rates with the actual margins they realize on their output. Ironically, it is not unusual for producers to be extremely profitable but, because they themselves don’t know realize that, they think financing costs are exorbitant, and financial institutions are reluctant to service them because they have no records.\(^3\)

In general, producers that are able to determine their cost of production and profit margins are normally willing to access financial services, provided their profit margins exceed the rate of interest on these financial services. They realize that external funds, or even their own savings, can allow increases in their activities and generate more income for their households.

More sophisticated agribusinesses such as transporters, bulkers, and processors often have a better grip on their costs and revenues. Further, they are often beneficiaries of financing based on their command of their business and their ability to demonstrate to financial institutions that they are creditworthy.

As a final caution, it is suicidal for any financial institution to lend to an agricultural undertaking whose gross margins are zero or negative, as it has no capacity to repay commercial credit. Once the borrower fails to repay, which is predictable, the financial institution will rate the risk of further lending to the sector very high and may even withdraw from financing that sector.

Thus, effective demand is determined to a large degree by analyzing what are the costs of production versus revenues to derive gross margins of targeted agribusinesses.

**Functioning markets and market linkages**—Access to and the stability of the market for agricultural commodities and products are both important in sustaining the qualified demand for agricultural financial services.

Products that have unpredictable or volatile markets can't sustain the demand for financial services, since the people producing these commodities will always be uncertain of their

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\(^3\) Research in Kenya showed that small commercialized dairy producers with improved breed cows and quality feed in four major milk sheds earned annual returns in excess of 100 percent, which, of course, compares favorably with costs of finance at 18 percent per annum. However, neither the producers nor the lenders had quantified the producers’ businesses, and thus no commercial lending to this highly profitable and very creditworthy sector was taking place.
expected revenues. For example, the volatility of milk prices in rural Kenya and Uganda, depending on the season of the year, has been a constant problem for agribusiness lenders. When milk yields are high, milk prices often crash and hurt dairy producers’ ability to repay loans.

Similarly, when producers and traders are restricted from accessing markets for their commodities because of disease outbreaks, inappropriate competition practices, or even government regulation, it negatively affects their ability to borrow or repay. Take the case of an outbreak of livestock disease such as foot and mouth disease. In such a case, a quarantine is usually imposed on the movement of livestock and livestock products from that area in order to restrict the spread of the disease. This scenario has frequently been encountered in Uganda. The governments of all of the countries in East Africa have frequently imposed bans either on the import or export of certain agricultural commodities and negatively affected producers’ access to profitable markets and thus reduced their gross margins. Because such events negatively affect the demand for financial services, it is important to understand the trends of market access.

In all cases where price is volatile, demand is unpredictable and market access is not assured, producers will hesitate to seek credit from financial institutions as they fear the consequences of defaulting on a loan. Likewise, institutions that finance production of such commodities will also be hesitant.

When they function well, market linkages can improve demand for financial services in that margins are predictable and recovery of credit is easier. Such linkages include processor-producer purchase contracts, input supply contracts, and technical support to the producer by the buyer. These linkages may be with individual producers or with producer groups and cooperatives. In cases where contracts exist, producers or producer groups can assign these contracts to financial institutions and enable the efficient flow of credit to their sector.

Practically, this means that the producer can access cash for production expenses for a crop to be sold on forward contract. The lender is named as the beneficiary and will receive the cash for that crop, or the portion of cash earned from the sale of the crop to service the amount of cash extended to the producer. Thus, with an established contractual market linkage, the producers can access adequate credit to optimize their businesses, and the lenders can be sure of repayment.

Donor programs can play a vital role in facilitating market linkages, by strengthening producer groups and cooperatives or by directly linking the producers or producer groups to major buyers. In Uganda, for example, a number of producer groups have been linked to major commodity buyers and processors and consequently the demand for financial services by these producer

\[4\] Uganda has restricted import of sugar; Kenya frequently restricts import of maize; Ethiopia has restricted export of cereals, etc.

*The Role of Financial Services in Agribusiness Development: A Primer*
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groups has been stepped up. Such linkages have been realized between sunflower, dairy, and palm oil producers and their respective processors. All have had a direct positive effect on the demand for financial services from the actors within these commodity groups.

When developing credit arrangements against contractual market linkages, it is important to restrict side selling by producers. Side selling occurs when producers divert the commodity to buyers other than their contractual buyers in order to evade repaying credit that has been pegged to the contracting buyer. For this reason, agricultural commodities with a single market channel, such as those that must undergo processing and where processing facilities are limited within a given geographical location, normally have higher potential for accessing financial services.

Overall, the entire supply chain of the commodity being targeted for financial services provision must be working efficiently. That is, input suppliers must have positive annual returns for input supply to be predictable for producers; producers must have positive annual returns for raw material supply to be predictable to transporters; transporters must have positive annual returns for raw material supply to be predictable to processors; processors must have positive annual returns for processed agricultural goods supply to be predictable to wholesalers. These efficiencies in the supply chain should not be assumed, but rather understood and verified. It is dangerous to focus on one level of the supply chain, such as production, while ignoring the other levels.

As an example, efforts targeted at providing credit for improving productivity of producers that don't first consider whether suppliers of improved inputs are present and profitable may simply result in default. The limited inputs available are quickly bought up, prices for those inputs skyrocket, and many producers fail to purchase at a reasonable cost what they need to increase their yields. Therefore, the transactions in the entire supply chain need to be efficient and underpinned by adequate levels of competition in order for the demand for financial services to be strong and the provision of those services to be effective.

2.2 Impact of the government policy environment

Conventionally, finance is hailed as an engine of growth by development theorists. As such, providing financial services is normally of strategic importance to national governments, as it underpins national policies and priorities, including poverty reduction, food security, and economic growth. In addition, in many developing countries agriculture is the major contributor to GDP, employment, and foreign exchange earnings, and is the major source of household livelihoods. As such, governments pursue policies that aim at increasing access to financial services for agriculture, increasing agricultural production, or safeguarding food security. Implementation of these policies, to a degree, influences the provision and usage of financial services for agriculture.
Underpinning demand with policy and regulation—Pro-demand government regulations and policies include those designed to improve productivity by reducing the cost of financial services. These include provision of government extension and advisory services, facilitating access to improved inputs and breeds, facilitating market linkages, and providing production infrastructure such as for water and power. Such policies, if well implemented, should have a positive effect on demand for financial services for agriculture, as they increase the opportunities for the actors on the demand side to increase their investments. Where such policies are nonexistent, demand for financial services can be highly constrained. A major strategy to influence pro-demand government policies and regulation is through lobbying and advocacy by the interested agricultural sectors, with or without the support of donor programs.

Supporting supply with policy and regulation—Governments usually want to increase access for financial services along with demand for them, so they put in place policies and regulations aimed at stimulating access. Such policies and regulations focus on minimizing default risk and can include specific laws for regulating borrowers’ and lenders’ rights. Governments may also work to improve the profitability of financial service providers through fiscal incentives, increasing outreach through direct incentives on rural branching, increasing liquidity through direct injection of funds or addressing borrowers’ inadequacies through provision of credit guarantees. These interventions aim to provide an incentive to financial service providers to increase their financial services to a given targeted sector, in this case agriculture.

Supporting supply and demand with infrastructure and security—In a number of cases, infrastructure for agricultural production and marketing may be beyond the capacity of individual entrepreneurs. Such infrastructure can include water for production, power for processing, storage facilities, market infrastructure, and even roads to access commodity supply points. Similarly, financial services providers may also require infrastructure that may be beyond their capacity to fund from their own resources, including power, telecommunication services, and roads. Security is of paramount importance for groups, and providing security is primarily the responsibility of governments. Stability and security promote profitable agricultural enterprises and better delivery of financial services. Therefore, the extent to which governments are prepared to provide the necessary infrastructure and security directly affects the level of demand and supply of financial services for the agricultural sector.

Protecting markets and setting standards—In some cases, governments protect the markets for their own agricultural commodities, by imposing high tariffs on imports of similar commodities or imposing outright bans on importation of these commodities. Such policies ultimately prevent competition and therefore distort market efficiency. Governments may also

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5 For example, governments may provide clear policies for such things as leasing, warehouse receipts, etc., that give clear assurances to lenders and borrowers of their rights and obligations.

The Role of Financial Services in Agribusiness Development: A Primer
regulate the quality of products—including local products—coming onto the market, by setting specific and compulsory standards for commodities. Though standards for unprocessed agricultural products are often hard to meet, especially by smallholders, they are nonetheless important. Such policies encourage better production and processing practices, facilitate access to profitable markets and should, therefore, stimulate the flow of financial services.

**Distorting markets**—Some policies and regulations, such as bans on exports of agricultural products and the imposition of price controls, can distort markets. These affect the efficiency of the supply chain and distort the competitiveness of the value chain and markets. Government-mandated standards for agricultural commodities may be so restrictive that they actually discourage the production and marketing of the affected commodities. Producers may feel it will be too difficult or too expensive to achieve the required standards. Further, there are instances in which governments react to temporary shocks in domestic agricultural production by encouraging the subsidized sale of cheaper imported agricultural products. This discourages local producers, as they are uncertain whether the government will repeat such acts. Beyond demotivating producers, such actions can hurt the inputs supply businesses, as they will be uncertain if the producers will actually demand the inputs and at what level they will purchase them. In promoting access to financial services for any given agricultural value chain or commodity, one needs to understand if that value chain or commodity is prone to government intervention.

### 2.3 Financial services—clients’ key concerns

Although financial service providers have concerns relating to effective recovery and maximizing return on the financial products they offer, users of financial services also have their own concerns. They want to realize maximum profit on the activities for which they seek financial services. Therefore, financial services that will be perceived by the potential users as unlikely to contribute to the growth of their businesses will not be attractive. In many instances, financial services providers fail to place their loans in the market because their lending terms are unattractive. Similarly, potential users may avoid saving with financial institutions if they perceive that such savings will not generate a return to them in the form of profit or if they doubt the security of their cash. The key considerations of the users of agricultural financial services are cost, convenience, dignity, timing and appropriateness. Consumers of financial services will consider all of these issues simultaneously.

**Cost**—Users measure the cost of financial services in terms of the interest and other charges levied by the financial services providers on their products. When the interest and charges on credit are high, users will demand and use less credit, and vice versa. Similarly, if the charges on savings accounts are high or the interest offered on deposits is low, potential savers will not be interested in saving. Evaluation of cost is on an individual user basis and is largely determined by the expected gross margin the user expects to realize on the activity that she or he wants to
finance. For example, if a producer expects to realize a gross margin of 100 percent, based on the expected cost of production and expected revenue, the producer will not consider interest on credit of, say, 30 percent to be high. Even though the producer would prefer a lower interest, he or she would not forego borrowing because of the perceived high interest being charged. But another producer who expects to realize a profit of 30 percent would complain that the interest was high and would not borrow at 30 percent unless she or he was desperate to finance the activity at any cost.

The major challenge for the agribusiness actor is to understand the gross margin on the activity to be able to rationally compare with the cost of borrowing. As mentioned earlier, many agribusiness actors, especially smallholder producers, don't know their costs or realized returns, so they can't reasonably judge whether borrowing costs are high or low relative to their capacity to repay the debt.

Nonetheless, lower-cost financial services facilitate the demand for finance among agribusinesses. The cost of financial services is affected by many factors, including the level of competition in the financial services sector, level of inflation in the economy and the systems, and the efficiency of the financial services provider itself. These factors all affect the operating costs of that provider and these costs are ultimately passed on to the borrowers.

Finally, many financial service providers have a habit of hiding the costs of the financial services that they provide. They tend to emphasize the costs of the interest only when speaking to their clients while imposing fees for processing, commitment, credit monitoring, collateral registration, or insurance. Even lenders that charge interest only may choose to charge flat-rate interest versus declining-balance interest. Flat-rate interest is based on the amount of money the borrower receives at the beginning of the loan. Declining-rate interest is calculated on the balance remaining each month. Flat-rate interest is easy to calculate and offers farmers immediate cash, but it is generally at least twice the declining-interest rate, so borrowers wind up paying much higher costs. Although common in developing countries and often used by moneylenders and microfinance institutions, flat-rate interest has been outlawed in most developed countries.

It is important for users to understand all the costs charged when making a decision to use financial resources. Unfortunately, the majority of smallholder producers and primary traders lack the ability to digest the cost implications of borrowing. Therefore, agricultural borrowers need guidance from farmer and industry organizations and advocacy groups in demanding that financial service institutions explain clearly the full cost of accessing financial services.

Convenience and client dignity—Beyond cost, accessing financial services involves overcoming real and perceived hurdles including long distances to market, poor infrastructure, and limited access to transport services. These realities impede users’ ability to easily use credit
and saving accounts. Smallholder producers, in particular, are deeply affected by inconvenient access to financial services. For example, some financial institutions expect clients to go to them to apply for funds, take the officers for field appraisal, come back to discuss the appraisal, wait for the application to be approved, make several trips to the institution to make repayment installments, take guarantors to the institution, obtain community leaders’ and spouse’s consents, and so on. Users may simply decide it isn't worth their while to seek financial services at all. Time is money, and time shouldn’t be wasted on an endless process that is inconvenient and may feel humiliating. Even well-qualified borrowers must comply with all demands from the lender, no matter how pointless they may seem to the borrower. A financial service provider that is able to go out to potential users and quickly complete the requirements on site will always have an advantage. The level of competition among financial service providers will determine the degree to which access to the services can be made convenient.

**Timing**—Agricultural activities, especially those relating to production, are time sensitive. As farmers sometimes say, an activity that must be done today is better done yesterday. Any delay in production will lead to reduced yields and lower gross margins. Producers, for example, need to buy inputs ahead of planting season, or ahead of feeding time, in the case of livestock. They also need to hire equipment and contract for labor before the time when these inputs are needed. Therefore, users of agricultural finance should access the required financial services at the time when they are needed, and not later. Clients are often unaware that financial services providers require lead time to provide credit. Further, many financial institutions are slow to approve and disburse credit. In agricultural finance, precise timing becomes a huge problem and an impediment to demand. The other critical element of timing for both borrowers and lenders is related to repayment. If the repayment timing does not match with the cash flows from the activity to be financed, neither borrowers nor lenders will be comfortable, unless the borrowers have other reliable alternative sources of money to make the repayments.

**Appropriateness of financing provided**—Financial institutions very often want to minimize their lending risk by reducing the amount of approved credit. It is not uncommon for lenders, because they have not properly appraised the borrower, to arbitrarily slash the amount of credit extended versus the amount requested, with no clear consideration of the consequences of such an action. This *underfunding* has the direct effect of compromising the activity for which financing was sought, and results in an increased risk of borrower default.

Alternatively, clients often request more funds than they require, as a hedge against underfunding, and then go on to mismanage the excess cash, especially if the loan is granted in full. Thus, lenders must appraise borrowers properly, or the result will be a higher risk of borrower default. It is in the clients’ best interest to be sure that their loan requests are well appraised and appropriately funded. And lenders should try to be flexible when monitoring loans so they can extend further credit if necessary.
2.4 Types of financial service providers

There are myriad types of providers of agricultural financial services, both formal and informal. Formal financial sector service providers are restricted to legally registered and regulated financial institutions. Informal financial service providers refer to organizations that aren't regulated by laws. The effectiveness of the two financial service providers for agriculture varies. For purposes of this primer, financial service providers for agriculture are categorized as 1) regulated financial institutions, 2) nonregulated financial institutions, and 3) other providers. We will discuss their success in delivering agricultural finance in detail in the next sections.

2.4.1 Regulated financial service providers

These are financial institutions that must comply with their respective countries’ governmental rules and regulations, so they operate within the applicable laws. They are supervised by central banks, insurance commissions, and self-regulatory bodies, and their operations must meet standards set by the regulators. This section deals only with regulated financial intermediaries.

The underlying principle for central bank supervision of financial institutions is the protection of depositors’ funds. Because of this, the quality of regulated banks’ loans is constantly monitored. Credit that is nonperforming must be written off, and loans must be covered by adequate collateral provided by borrowers. Before they are licensed, regulated lenders must also meet minimum capital requirements, and minimum standards for infrastructure such as software, equipment, and buildings, among other items.

To comply with regulatory and supervisory requirements, regulated financial institutions put stringent requirements on their financial products. They are frequently inflexible when handling cases they consider to be unusual or high risk. This is because consideration of the unusual is costly beyond their already high costs of operations driven by the need to meet regulatory scrutiny. However, as regulated institutions, they are normally considered to be the most stable and are normally the service providers preferred by large enterprises, big institutions, agencies and governmental departments. As highly regulated financial institutions, they are reliable. They are also in a stronger position to mobilize low-cost savings to fund agricultural credit. Their relevance for agricultural finance provision is discussed below.

- **Commercial banks**—These form the biggest constituent of financial institutions in many countries and command the bulk of formal credit. The majority of their financial products are short-term working capital\(^6\) with loan amounts not exceeding the seasonal or annual operational requirements of the business. Typically, loan amounts for agribusinesses tend

\(^6\) Conventionally working capital financing is for a period of up to one year. This may vary however from one financial institution to another.
to be in the range of USD 5,000 to USD 25,000, depending on the size and complexity of the agribusiness. In addition, commercial banks provide term finance in the form of loans and leases. In terms of financing agriculture, the minimum loan amounts offered in many instances are above the maximum qualified demand of individual smallholder producers. The minimum loan amount for the bank might be USD 5,000 whereas the smallholder may need only USD 250. Banks are thus are mainly relevant for commercial producers, large-scale transporters, commodity bulkers and processors. However, with innovation and under competitive pressure, a number of commercial banks are trying to finance smallholder operations, either through producer groups or cooperatives. Unfortunately, commercial banks are mainly located in urban areas, and are inaccessible to many rural producers.

- **Development banks**—These focus on large financing of medium- and long-term loans. They are relevant for agribusinesses with larger financing requirements such as farm infrastructure development, processing and transportation equipment. Loan amounts generally range from USD 50,000 to USD 2,000,000 with loan terms ranging from 1 to 10 years. They are essentially located in capital cities and lack branch networks, and therefore have limited rural outreach.

- **Agricultural banks**—These tend to be government owned and operated, and they are currently active in only a few countries. Their terms are relatively flexible, although they are sometimes characterized by excessive political interference and thus may operate unsustainably. Loan amounts generally range from USD 500 to USD 500,000, with loan terms ranging from 6 months to 5 years.

- **Micro deposit-taking institutions**—These regulated microfinance institutions are engaged in mobilizing and lending savings. By the nature of their initial establishment, these financial institutions have wide geographical coverage, including rural operations, and their financial products cater to a wide spectrum of clients, including microenterprises. They are more relevant for rural agricultural producers, even smallholders, than their regulated competitors. Loan amounts generally range from USD 50 to USD 50,000 with loan terms ranging from 3 months to 2 years.

### 2.4.2 Nonregulated formal financial institutions

These are licensed financial institutions that aren't regulated or supervised by the central banks of the countries in which they operate. They are normally registered in several forms, including microfinance institutions (MFIs), building societies, and credit cooperatives. Most are member-

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7 Savings cooperatives are frequently regulated by nonfinancial regulators, such as the ministries responsible for cooperatives in Ethiopia, Tanzania, and Uganda. In Kenya, supervision is provided by a specialized division of the Central Bank.
based and member-regulated financial institutions formed to provide financial services to their members only. Because they are weakly regulated, they are in position to be flexible in their approach to providing financial services. However, you must be careful to analyze such institutions’ strengths and weaknesses on a case-by-case basis before choosing to do business with them. To perform such analysis, you need to review such crucial attributes such as liquidity, governance, quality of management, solvency, etc.\(^8\)

Though microfinance institutions often operate in rural areas, these institutions conventionally provide small loans with many periodic repayments to organized or formal groups of individuals. These may name group members with assets to guarantee a loan, and no further credit is extended until that loan is repaid. This practice only works well in trading centers or commercial business centers because in the rural areas populations are too dispersed for group lending, loans are small, and repayment terms are too frequent and not realistic for agricultural producers.

These nonregulated institutions are largely oriented to financing microenterprises because of their limited financial resources and the preferences of their owners. Their interest rates and other charges vary, especially when compared to those of regulated financial institutions, and are usually based on the preferences of the institutions' owners. The best of them charge above-market interest rates because they access their funds at high cost and must therefore realize a return capable of repaying these costs. However, a good number of financial institutions in this class are also able to source low-cost funds from donors and thus offer credit at lower charges. These institutions often operate in rural areas and are thus well placed to provide agricultural financial services.

### 2.4.3 Other financial services providers

Beyond the regulated and nonregulated financial institutions mentioned above, other providers of financial services to the agricultural sector exist. However, because they are not financial institutions, normally their terms aren't aligned with the activities they finance. Further, they may just provide financial services in an effort to plug the financing gap in a given sector in which they are interested. A few of these financial services providers are discussed below.

- **Moneylenders**—Though they are often viewed negatively as being out to cheat clients, moneylenders play an active role in financial services for agriculture. The actors in this business are either licensed or unlicensed and can range from a wealthy individual in the trading center lending from his house to a more formal lending operation with staff and an office. Their decision process is not subject to bureaucracy. Though they provide

\(^8\) INSPIRED, the authors of this primer, offer the service of providing due diligence evaluations of non-regulated financial institutions.
finance, they concentrate on the recovery of their credit and not much on what that credit is used for, as they neither appraise the activity nor monitor it. Many of them who lend for agricultural production are normally engaged in trading agricultural commodities and in many instances want repayment in the form of physical commodity at harvest time. Because clients approach them when they are in dire need of money, their terms are normally unfavorable, unlike more conventional buyer credit described below. In case of repayment in cash, the interest charged is normally exorbitant. In case of recovery in physical commodity, the commodity is usually priced below the fair market price. Also, because of the nature of their operation, moneylenders are an unreliable source of credit as they may not be liquid at all times.

- **Buyer credit**—Many agricultural commodity buyers provide credit to their suppliers. This may be in cash or in kind through provision of necessary physical resources such as inputs and equipment. This situation occurs mainly in commodities requiring immediate processing such as dairy, tea and tobacco, and high-value fresh horticultural commodities. In many instances, the operation takes the form of an outgrower scheme. Such buyers would want to be sure that the producers to whom they extend credit will supply the commodity within the agreed-on period, as their main objective is to realize enough volume to maintain their operations or to service their contracts with their clients. Where possible, the two parties sign a supply contract. However, many entities engaging in buyer credit encounter problems in recovering the credit where side selling is a problem. Thus, commodities with single marketing channels have always been the best preference for buyer credit. Providing credit is not the buyers’ core business, so they normally prefer not to engage in it if their suppliers can get credit from other sources, or if they are assured of getting sufficient volumes without offering credit.

- **Government**—A number of governments provide finance for agriculture, either by directly providing credit through nonfinancial intermediaries such as producer groups or cooperatives, or through financial intermediaries such as a bank or a Savings and Credit Cooperative Organization (SACCO). Such credit may target the agricultural products or value chains in which the government has a particular interest or groups engaged in agriculture that the government feels obliged to support such as women and/or youth. Usually, this finance is on concessional terms and is not aligned to normal financial market functions and thus tends to distort the financial markets. The beneficiaries often tend to default willfully, since they generally believe that this is their chance to get back what they pay to government and since they are unsure of any future access to such credit. This source of finance is unreliable, because its coverage is highly restricted, its provision is politicized and its administration (unless handled through financial intermediaries) has limited or no professionalism.
2.5 Financial products

All financial products have design features that allow the financial institution offering the products to maximize its profit (within the constraints of the market) while minimizing its risk. Financial products can be considered viable only when they allow both the financial institution and the client to concurrently satisfy their individual needs for:

- Timing for using or providing the financing;
- Costs of using or providing the financing;
- Priorities addressed by using or providing the financing; and
- Profits generated by providing or using the financing.

If only the priorities of the lender or the client are met, the product will fail to achieve its purpose in the marketplace.

Financial products cover a vast array of arrangements, whereby cash is both the commodity being traded and the medium for rents, premiums and fees charged. We will cover various types of financial products below, beginning with savings.

2.5.1 Savings products

Savings products are various types of deposits of cash to the financial institution by its clients that are owed back to the client. Savings products come in many forms; the most common are described below.

Demand deposits—These are cash deposits made by clients for safekeeping. They are called demand deposits because clients can demand their money back at any time. Normally, they accrue very little interest and sometimes even require the client to pay a fee for safekeeping the money. Financial institutions will usually not lend much of their demand deposits to borrowing clients who need medium- and longer-term financing because they can be claimed at any time by the depositor and the financial institution must always be in a position to pay the client back. Financial institutions will normally monitor the behavior of their demand depositors monthly to determine the likely pattern of deposits and withdrawals. For example, agricultural producers usually make deposits at harvest time and make withdrawals before planting, around large holidays, or for family expenses. These can be unexpected, such as funerals, or predictable, such as school fees or the cost of a planned wedding.

Fixed deposits—These deposits are made by the client for a fixed period of time for purposes of investment. The client expects a financial return for depositing relatively large sums of cash with the financial institution. Fixed deposits normally accrue financial returns for the depositor by offering attractive interest rates. Financial institutions will offer fixed deposits in order to have cash to lend to their longer-term borrowers. The institutions strive to match the duration of their
fixed deposits to the duration of their loans. If a financial institution offers a loan product for a specific purpose that requires two years to repay, it will normally offer a fixed deposit product to their depositors for that same two-year period. It will also be willing to pay attractive returns on such deposits. Normally with fixed deposits, the client receives the interest only if he or she leaves the deposit with the financial institution for the entire agreed-on time.

**Structured savings**—In a sense, structured savings deposits are a hybrid of fixed deposits and demand deposits. They are sometimes referred to as targeted savings or saving up. Normally, either the institution or the client will set a target for the total amount of money it wants to save, including interest accrued, to meet an investment or an expense target. The client will then save a fixed amount periodically (weekly, monthly, etc.) until the target is met, and then withdraw the cash. Clever financial institutions will often develop a structured savings product to meet a perceived need of the targeted client population, such as saving up for children’s higher education, or in agriculture saving up for an improved breed dairy cow or a maize huller, for example. This type of savings gives the financial institution stable cash for lending and it provides the client an opportunity to achieve a goal. Financial institutions normally pay attractive interest rates for such savings because their deposits are stable and predictable. Clients often prefer structured savings for acquiring assets versus borrowing for the same purposes, because using their own money is much cheaper than using the lender’s money. As with fixed deposits, the clients normally lose any accrued interest if they withdraw before the targeted amount is met.

### 2.5.2 Client appraisal and credit products

Because lending is risky, a financial institution will always appraise potential borrowers on capacity and willingness to repay before deciding to lend to them. During the appraisal process, many borrowers fail to meet the minimum expectation of the lender. To help readers understand what financial institutions expect of borrowers, we discuss the "five C's" of lending below.

**Character**—This reflects a borrower’s *willingness* to repay. Before making a loan, a lender must assess the borrower’s character by speaking to members of the community who know the person well; speaking to individuals and institutions that the borrower borrowed money from previously to assess if they were repaid without any problems; speaking to community leaders to assess if the borrower is considered honest; and asking the borrower to provide guarantors who can promise to repay the loan in case of default. Collecting this information on the borrower’s character requires the financial institution to incur some minimal costs during the loan appraisal. These costs are often best handled by charging the potential borrower a fee.

**Capacity**—This reflects a borrower’s *capacity* to repay. Before making a loan, a lender must assess the borrower’s capacity by reviewing the borrower’s loan application and business plan. The lender will determine if the plan is feasible, well thought out, and thorough. The lender will further assess whether or not the borrower has done this type of business before. The lender will
determine if the borrower has the necessary materials, skills, experience and experienced colleagues/ and employees to realize the success of the business. The capacity to repay may also be ascertained from other viable activities in which the borrower is engaged. The review of capacity during appraisal will take time, effort and expense. Again, this cost should be borne by the potential borrower through an appraisal fee.

**Capital**—This reflects both a borrower’s capacity and willingness to repay. Before making a loan, a lender must assess a borrower’s capital by reviewing the person’s loan application and business plan and verifying that the borrower has invested in the project the amount that he or she claims. A borrower who wants a loan for a business or project should normally have at least 50 percent of the total costs of the project from his or her own assets. A borrower would not qualify who tries to borrow part of the investment from one financial institution and then borrow the rest from another one. Appraising the value of the potential borrower’s share of the investment will again cause the lender to incur some costs, which should be covered by an appraisal fee.

**Collateral**—This also reflects a borrower’s capacity and willingness to repay. Collateral is an asset that the borrower pledges to the lender as payment in the event she or he defaults. Before making a loan, a lender must assess borrowers’ collateral by reviewing their loan application and business plan and verifying that the borrowers have the collateral they claim. It is desirable for the lender that a borrower always pledge some sort of collateral, even if it doesn't have immediate cash value. A borrower may pledge objects of personal value such as household furniture, wedding rings, academic certificates, and electronic items. The fear of losing such objects should compel the borrower to repay. The lender should charge the borrower a fee for evaluating and encumbering the collateral.

**Conditions**—Existing economic, political, social and environmental conditions will also influence the borrower’s success in securing a loan. Lenders must be aware of what impact external conditions might have on the borrower’s reliability and keep themselves informed of them.

A host of credit products are available throughout developing countries. In the section below, we outline a number of financial services and products available for rural agribusinesses.

**Working capital loans**—These are normally short-term loans used to finance the ongoing operation of a business. In agribusiness, the client normally borrows to cover expenses necessary to increase the productivity of the business operation. For example, a maize producer may borrow for improved seed, fertilizer, or labor to achieve the maximum yield possible. Dairy producers may borrow for feed, labor or transport to make sure that the milk yield is optimal and the product makes it to the market. Interest rates for working capital loans are usually high because the loans tend to be short term and the expenses of appraising the client and recovering
Inventory credit—These are working-capital loans secured by the deposit of a commodity. For example, agribusinesses may require labor to bring in the harvest. In this case, the initial harvest can be deposited in a secured warehouse, controlled in part by the lender and used as collateral for a loan to the agribusiness. This is sometimes called a warehouse receipt system. Producers can also use the system to store their commodity for the short term when its price is rising, and borrow against the commodity's market value to meet their working capital needs while the price appreciates. This type of working capital finance works only after the commodity is available for market, but it allows the agribusiness to borrow at much lower rates of interest because the lender does not need to appraise the borrower.

Term finance—These loans are longer term, normally repaid over a period of several years and used by clients for larger capital investments. They are usually used to increase the scale of operations, not just productivity, so that clients can multiply their operations. For example, an agribusiness client may use term finance to buy a tractor to open, plough, and weed more land; one or several dairy cows to increase milk yields; milk chillers to handle increased volume; or trucks to transport the commodity to markets. Interest rates for term finance are normally lower than interest rates for working capital loans because the costs of appraisal, monitoring and recovery are spread over many months or years. Further, term finance loans are usually funded with fixed deposits and thus require less cash flow management.

Leasing—Leasing is a variation on term finance in which the borrower receives a loan of the productive asset itself. The lender procures and supplies the asset to the borrower and collects rental payments for the asset. When the asset is fully paid for, the lender normally sells the asset to the borrower for a nominal fee (USD 1.00, say). The advantage is that the appraisal of the borrower is simplified because the lender maintains ownership of the asset until it is paid for. If the borrower defaults, the lender simply comes to the business, takes the asset away, and lends it to someone else under the same terms. Because management of a lease is normally far simpler than management of other types of term finance, leases are usually provided at lower rates of interest.

2.5.3 Cash management products

Financial institutions often offer cash management services that are of low risk to themselves and of high convenience value to their clients. As discussed in the introduction, cash management products include such things as overdrafts, factoring and transfer services.

Overdrafts—Based on predictable cash flows, a financial institution may allow its clients to overdraw their deposit accounts to pay invoices to their suppliers. The clients’ buyers then pay
the client through the deposit account. The credit from the financial institution is repaid with interest. This system enables businesses and agribusinesses to function when they are short of cash but can predict receivable income and prove that to their financial institution. Interest rates on this type of service are typically high on an annual basis, but because the credit is usually only extended for a short period (less than a year); the effective payment for the service is low.

**Factoring**—This is used when a supplier of goods has a reliable buyer. The financial institution purchases the supplier’s invoice to the buyer at a slight discount. A dairy bulker who has short-term cash needs to pay its suppliers may be paid by the processor it sells to on a monthly or even bimonthly basis. Factoring allows the bulker to sell the outstanding invoice to a financial institution at a slight discount and receive the cash immediately to pay the supplier. This situation is more favorable for the financial institution than an overdraft because the financial institution is not taking the risk on the bulker but rather on a processor, which is probably a better capitalized operation. The fees in this case rarely exceed 1 percent of the invoice value.

**Transfers**—This is simply an arrangement where clients can the infrastructure of a financial institution to make and receive payments. Rather than move cash from one location to another and risk robbery or loss, the financial institution receives the cash on the client’s behalf and transfers it to the local account. This is appropriate for moving large payments from processors to smaller, rural businesses. Fees for this service are typically very low. Indeed, the recent rapid growth in the use of mobile banking—using a mobile phone to transfer money within countries—is an example of how technology can aid such transfer systems.

### 2.5.4 Insurance products

Financial services that pertain to risk management are often overlooked in developing countries, yet reputable firms often offer insurance for assets, the health, safety and lives of the agribusiness professionals and livestock, and crops. The client pays a premium to the insurer and, in the event of a loss, the insurer pays a high percentage or the full value of the loss. The costs of insurance are dictated by the probability of an event happening. To insure a large hard asset, like a milk-chilling plant, against fire is a small annual cost, but if it should burn down, the payoff can be the full value of the asset. Other risks that are more likely to occur carry higher insurance premiums.

### 2.5.5 Others

Other complex financial products may in time provide tangible benefits to rural agribusinesses. Two products gaining attention lately are risk management products for protecting against price volatility and weather conditions.

**Options contracts**—All agribusinesses suffer from an inability to predict the price of the commodity they will sell. To mitigate against this risk in developed economies, agribusinesses...
buy or sell commodities before they are actually produced, at a pre-agreed price. This ensures that the agribusinesses either buy below their breakeven costs or sell above their breakeven costs. These products are called forward contracts or future contracts. Financial institutions offer option products for a premium based on forward and future contracts. That is, for a premium, a financial institution offers to compensate buyers and sellers for the lost income should the actual price at which they sell their commodity fall short of the predicted price. An example: A dairy producers’ cooperative pays a premium to an option seller for an option on a large quantity of milk for delivery in six months time. If the price of that milk when it is sold is less than the price specified in the options contract, the option seller will pay the cooperative the difference between the actual price and the option price.

The use of options is slowly gaining momentum, but it will be some time before they are widely available. Options are currently used by larger traders of cash crops such as coffee and cotton with the benefit of the options contracts often extended to suppliers and outgrowers through a contract price. However, the ability to use options is driven by volume and organization within the relevant markets. High-volume, well-structured markets are attractive to options sellers (called writers in financial vocabulary).

**Weather insurance**—Weather can have a major adverse effect on an agribusiness’s ability to produce, process, or deliver the commodity it is engaged in. With a weather insurance contract, the agribusiness can offset the risk by paying an insurance premium. Weather insurance payouts are based on weather events, and although few agents sell weather insurance, some retailers will link the use of quality inputs to the opportunity to purchase weather insurance. Syngenta Foundation in Kenya, for example, is partnering with a local insurance company to offer crop insurance linked to rainfall for those farmers who want to buy new technology—essentially, fertilizer and hybrid seeds and crop protection products—to increase their yields but are risk averse, since rainfall is the single largest determinant of crop success or failure, even when using the new technologies.

### 2.5.2 Availability of complementary financial services

As a last note on financial products, combinations of products are often more beneficial to agribusinesses than a single product. Three examples follow.

**Savings and credit**—While saving up for an asset is a good idea, and particularly good when an agribusiness is not considered creditworthy from an appraisal perspective, a combination of savings and credit may offer a better solution. Some financial institutions offer products whereby a client can save half of the value of an asset in a structured savings program and, when the savings target is reached, offer credit to finance the remaining half of the value of the asset. This enables clients to prove they have financial discipline, by showing they are committed to making periodic savings, and enables the financial institution to share half the risk in the asset with the
borrower. Obviously, if both the financial institution and the client have equal risk in the loss or misuse of the asset, the financial institution will be much more comfortable.

**Insurance and credit**—Lending to a client may itself be risky. The client can get sick or die, and the asset or business being financed can be damaged. These risks can be mitigated by various types of insurance in the credit contract: life, crop, theft, fire, etc. That way, financial institutions can greatly reduce their risk and appraisal and management costs, so they can offer their clients credit at a lower cost.

**Term financing and working capital**—Financial institutions often combine term finance with working capital as a package, to ensure that clients have the cash to make the best use of the asset. For example, if a dairy adds six improved breed dairy cows, those dairy cows will need feed, veterinary care, and labor to care for them. The dairy producer and the financial institution both have an interest in ensuring that term finance is available to purchase them, and cash is available to care for them.
3. Supply-Side Development Interventions

Development projects and programs can use several strategies to encourage the supply of financial services to rural agribusinesses. Such interventions range from providing quality information identifying market opportunities to potential lenders to actually providing cash to offset financial institutions’ operations costs and financing risks. The following paragraphs discuss potential interventions, from lowest-cost to most expensive.

3.1 Market research

If anything brings a financial institution closer to supporting the agricultural sector, it is a detailed market research report. Market research documents and details the often immense opportunities that a certain market can offer, especially when the report offers quantitative hard numbers. A useful report should document the relationships between buyers and sellers within the various supply chains; quantify volumes, revenues, costs, margins, and returns; and discuss the timing and seasonality of related cash flows. Such a report must be based on well structured, scientifically determined, statistical sampling. It should be designed and implemented by qualified professionals to identify both simple demand (what a client wants) and qualified demand (what a potential client can pay for). Accurate market research can be costly, but a financial institution reluctant to enter a certain market will find it very convincing.

3.2 Support for product development

Even when a bank agrees to work in a certain agricultural sector, it may not have the specific products that would best serve a particular market segment. Financial services are fairly standard, but some small tweaking of an existing product based on a deeper understanding of a client's needs is often necessary. Many product lines have been customized for the agricultural sector, such as:

- **Structured savings**—The client regularly saves a specific amount toward financing a business goal as opposed to a demand deposit where a client saves on an ad-hoc basis. For example, producers may save a portion of their daily milk sales to purchase veterinary drugs or other inputs after one month of saving, whereas they may not have adequate cash for such a purchase on a daily basis.

- **Leasing**—A client receives access to a productive asset but the lender maintains ownership of the asset until all payments are made by the client. Since many financial institutions don't offer leasing products, just introducing a new leasing product is itself innovation. Suppose a client wants to buy a milk chiller, but does...
not have the collateral to buy it with a standard loan. In offering the client a lease, the financial institution owns the equipment, which allows the client to meet borrowing and collateral terms.

- **Payment systems**—Access to payments from a processor can be moved by the financial institution closer to the client’s home. For example, clients can make payments through an ATM or a point-of-sale facility.

Product areas such as those above can be developed to fit clients' specific needs and their financial partner's institutional capacities. Getting the products right for the specific market segment can make all the difference for the uptake and use of a financial institution’s services.

### 3.3 Informational materials

Informational materials can be critical in convincing clients to join financial institutions and access their services. If marketing materials come from the financial institution themselves, an already hesitant population may perceive them as untruthful or deceptive.

But when an impartial, reputable development partner creates informational material that is factual and provides unbiased information, clients will value it greatly, especially clients who have either been marginalized by the formal financial sector. Trust is powerful and can be used as a tremendous resource to educate clients and foster relationships between the agricultural and financial sectors.

### 3.4 Training field staff

Formal financial institutions' field staffers are often not educated about agriculture, so training them is important. They are on the front line and will have the most interaction with producers. The staffers don't need to become producers themselves, but they need to have a general understanding of how these unique businesses operate. Farming is a business and field staff must be able to assess its basic components, such as risk, cash flow, collateral, and seasonality. Without training in these areas for the agricultural market segment, analysis becomes guesswork or is based on previously held assumptions—or does not happen at all. Training can take many different forms: study tours, classroom training, and practical fieldwork, for example. The key is to “fit for purpose” and find and use the appropriate training for the intended outcome and the intended trainee participant.

### 3.5 Training branch staff

Training of a financial institution’s branch staff is often overlooked. Farmers don't look or act like a typical client. They are often not highly educated, don't dress up, and have been historically marginalized by formal financial sector institutions. They often come into a branch
with hesitancy and the fear that they will be mistreated. Agricultural clients need to be treated with patience and understanding so that they are not “turned off” by a branch staff member from a different background. Speaking with farmers in the local language, helping them to complete bank documents, and directing them to the right person or counter to answer a specific question are all ways to gain their trust. Though customer care and service are emphasized in most financial institutions, specialized training for agricultural clients, especially the needs of rural women in agriculture adds value and understanding. Land O'Lakes believes that if women are the farmers in an area, at least some of the service providers and managers at their local banks should also be women.

3.6 Training senior management and board members

There is probably no better way to increase access to financial services to the agricultural sector than to organize training for financial institution decision makers. Financial institutions tend to operate in markets they already understand and that fit easily into their established operations. Market segments that don't fit the established mold are often deemed risky, too different from their existing operations and are therefore not viable.

Training provides information, a forum and knowledge to overcome misconceptions. Training can provide technical knowledge of how to service the agricultural market segment as well as lessons and experiences from other financial institutions that are already servicing the sector successfully. Perhaps most important, training allows managers to remove themselves from their daily work schedules and be exposed to information and knowledge in a neutral, unbiased environment where they can assess and process the larger questions of why and how agricultural lending can be useful to their organization.

3.7 Training clients

It is obviously critical to train clients to access financial services, so they can expand their businesses and increase efficiencies. They often don't understand what the products are and how they work to help them and their businesses.

Training clients is rarely a core activity of a financial institution, so support in this area can be of considerable value. The communication gap between a formal financial institution and agricultural communities can be bridged by directed, broad-based training as discussed in Section 4.1, Developing the Creditworthiness of Clients.

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9 In fact, financial institutions often shy away from training borrowers as they fear they may blame inadequate training as a justification for defaulting on a loan.
3.8 Financial product marketing

Even if clients have a basic understanding of financial services, financial institutions need to market their products and services to them. Marketing ranges from newspaper and radio advertisements to basic training to one-on-one discussions with bank field staff. If clients don’t know a product or service exists or don’t understand the product’s attributes, it is difficult to get them to access the product no matter how useful it may be. This is especially important for women, who may not have or be allowed access to financial services. Gender-sensitive marketing of financial services and products is essential in order to ensure gender-equitable financial service provision.

A danger of marketing is that a financial institution may not live up to what it offers when advertising its products and services. For example, advertised price and actual price may vary (there may be unadvertised fees), or the speed at which a product is delivered may be much slower than advertised. Marketing errors like these can be very harmful to small-scale farmers and turn them away from accessing financial services. Marketing must be supported, but monitored as well.

3.9 Guarantees

Financial institutions are often concerned about the risk of lending to the agricultural sector, particularly to small-scale farmers. Reasons for this vary from a lack of effort to understand the business to a lack of sufficient collateral on the farmer’s side, to lack of transparent recordkeeping on the borrower’s side. Financial institutions can mitigate these risks, whether perceived or actual, through a loan guarantee. A loan guarantee is the sharing of risk by a third party (in this case the development institution), which allows borrowers to get loans who would not fulfill credit requirements on their own.

Loan guarantees can be adjusted to the comfort level of the partners. Guarantees should always be a way to overcome lender ignorance, and not to encourage reckless lending. Guarantees are normally offered when a development program or government knows, based on analysis, that risk is low but the lender is not yet convinced of that reality. The guarantee therefore sets the lender’s mind at ease as they penetrate a new market and explore the opportunities that await them. Here are some areas to consider:

- How they are structured. (That is, the financial institution usually has arrangement with third party guarantor and pays fee to access guarantee. Access is usually for a fixed time period with a renewal option).
- How much of a loan they actually guarantee. (Normally it is not more than 50 percent of the principal).
• How they are accessed. (Guarantees usually offered to qualified financial institutions are determined by due diligence and if the financial institution meet development objective of the third party).
• What they cost. (Costs to both the financial institution and the guarantor. Costs tend to vary depending on development objective but range between 1 to 2 percent of the guaranteed loan amount.)
• Reporting requirements. (Are they monthly, quarterly, semiannually?)
• Sectors authorized for guarantee cover. (This may include production, housing, utilities, etc.)
• When the guarantee can be exercised and the funds claimed. (This tends to be within one year and corresponds to the lender’s write-off as recognized by the financial system regulator.)

The three most common structures are described below.

• A development program agrees with the financial institution on a set of criteria under which a loan would qualify for a loan guarantee. If a loan meets the criteria, the loan automatically qualifies for the guarantee and the financial institution simply registers the loan with loan guarantee program on a case-by-case basis. This is typically done monthly.
• An agreement with similar criteria and automatic qualification as above, but where for efficiency the loans are only registered once or twice a year as a group.
• A loan evaluation is completed by the financial institution and the file is sent to development partner for its own evaluation. If the development partner agrees, the loan guarantee is issued. This is usually done for larger loans because the process is much more time consuming.

3.10 Soft loans

Soft loans provide funds at a subsidized rate to the financial institution. Soft loans are priced below the market rate in order to encourage the financial institution to lend to a sector they may not normally lend to, such as agriculture. This is particularly effective in the initial phase of lending, but as the financial institution becomes more knowledgeable about the sector, subsidies will normally be reduced or eliminated entirely to promote long-term sustainability. There are some risks associated with this product. The financial institution may never fully commit to the sector and make loans only because of the subsidies. Also, the institution may not develop operational efficiencies because of the subsidy.
3.11 Lines of credit

Lines of credit provide additional funds for an institution to use for lending. They can be useful, as often a financial institution may not have extra funds or, if it does have funds, may not be willing to lend to the agricultural sector. There are two primary forms a line of credit may take:

- A development institution provides the funds directly to the financial institution. When the development institution has its own funds, but does not want to do the lending itself, this option can work well. Providing the funds to a professional lender is often more efficient and offers more rigorous monitoring. The major drawback to this option is that it does not allow the financial institution to leverage more funds, as the pool of funds from the development institution is usually limited.

- The development partner helps the financial institution arrange a line of credit from a third-party financial institution. The line of credit can be arranged using different means; including having a fixed deposit at the third-party institution. The development partner can also simply sign a legal agreement guaranteeing the line of credit. This option can be advantageous because it allows the financial institution to engage with third-party institutions who may not have considered extending credit to the primary financial institution. Involving a third party, however, can delay the process and increase the costs of the entire lending program.

3.12 Subsidy of infrastructure

Despite the growth of the financial sector in many developing countries, rural areas continue to be marginalized from the extension of financial services or left out entirely. A major reason this sector is neglected is the high cost of infrastructure. Rural trading centers are often remote, with low population density, which makes setting up infrastructure more expensive than to in urban, more populous areas. Once the infrastructure is in place, however, operations are usually sustainable.

An infrastructural subsidy is often an effective tool to encourage a previously reluctant financial institution to move to a more rural or remote area of the country. The subsidy can reduce the fears of management and the board of directors, who often have limited resources, tight budgets and limited understanding of rural markets. Infrastructure subsidies allow for a greater margin of error and an initial slower growth trajectory to convince the institution to enter these markets.

Infrastructure subsidies should be based on a solid feasibility study that identifies the costs of establishing a branch or agency; the costs and availability of security and communication, the costs of staffing and the expected revenues of the financial products and services to be offered, including both reliable sources of income, such as managing civil service payroll; and more speculative products, such as lending to agriculturalists.
4. Demand-Side Development Interventions

Development projects and programs can employ various strategies to encourage the demand for financial services by rural agribusinesses. Interventions include providing education and various types of support to both individual clients and producer organizations and providing ongoing business development support, which by its nature makes rural clients more creditworthy. We discuss potential interventions below.

4.1 Developing creditworthiness of individual rural clients

4.1.1 Education

Clients need a broad understanding of what financial services actually are and how will they help them. Lack of understanding can be overcome through general client education in some primary areas, including:

- Budgeting, including cash-flow projections
- Debt management
- Savings for business objectives
- Financial products
- Bank services
- Financial negotiations

Without this kind of general knowledge, it is hard for clients to access financial services—or even find a reason to do so.

4.1.2 Practical workshops on recordkeeping, business plans and loan applications

The previous paragraph referred to general financial education knowledge; this section addresses more specific shortcomings of many agricultural clients. Financial institutions often speak a different language from most other kinds of institutions, a language consisting of cash-flow statements, balance sheets, audit reports and business plans. Agricultural clients have varying levels of competence in these areas, so training in the language of financial institutions is critical to achieving success in having access to their services. Specific technical training, even at a basic level, can be very helpful.

4.1.3 Clients’ introduction to financial institutions

Bringing clients and a financial institution like a bank together and making them comfortable with each other is important. Potential clients are not likely to find their way to a bank, and the bank may not be looking for clients. Events that bring the two parties together in both technical and casual forums will help to foster a relationship. These events can include seminars, question-
and-answer sessions with financial institution staff members, fundraiser sponsorships, and corporate social responsibility community events. Banking should be about relationships, and events build relationships and trust will help both parties learn to work together.

4.2 Developing creditworthiness of cooperatives/networks/organizations

4.2.1 Education

Like individuals, cooperatives, networks, and other organizations need to be able to advise their members about accessing financial services. Leadership of these organizations must acquire a general knowledge of what financial services are and how they can best assist their members. Financial issues can be much more complex and sophisticated at an institutional level than at an individual client level.

4.2.2 Practical workshops on record keeping, business plans, and loan applications

See Land O’Lakes AgPrO system for training information on basic record keeping, basic business plan development, strategic business plan development, and bankable business plan development.

4.2.3 Producer organization introductions to financial institutions

Bringing producer organizations and financial institutions together and making them feel comfortable around each other is important. Constant dialogue between the two parties is critical to the success of any financing intervention. The process may stall if the two parties feel uncomfortable around each other and can't discuss and strategize to improve programs. Events that bring the two parties together in technical and casual forums will help foster these relationships. Seminars, question-and-answer sessions with financial institution staff members, field visits to producer groups, fundraiser sponsorships, corporate social responsibility community events and other events begin to build relationships and trust that will enhance business relationships.

4.2.4 Linkages

Development institutions can play an effective role by linking a farmer organization to stakeholders who may be able to assist it. As an example of linkage banking, an established trader may serve as a third-party intermediary to a farmer organization, providing payment services to its members, who then don't have to travel long distances to receive their payments. Other linkages can be made with parties such as insurance companies, input suppliers, buyers and training programs. Often farmer organizations or third parties aren't aware what the other is doing. Facilitating such linkages can bridge the gaps.
4.3 Helping agribusinesses improve the way they do business

There are clear interventions that can assist agribusinesses in conducting their businesses better. An obvious example is training and extension services for producers and the other businesses they link to in the supply chain. Training has a direct impact on productivity by imparting better skills or correcting past mistakes. Proper training can improve the experience and skills of the agribusiness actors and foster pride in the commercialization of agribusiness.

Actors interested in supporting the development of financial services for agribusiness include donors, projects, NGOs, large farmers’ organizations, governmental ministries, and buyers. All have individual objectives that will yield benefits to themselves, to rural agribusinesses, and to the financial institutions that wish to finance them.

Other key interventions underpinning business development and increasing businesses capacity to support financing include:

- Strengthening producer groups to improve productivity, access better markets, and lobby for conducive policies and regulations
- Supporting infrastructure development for warehousing, bulking equipment, postharvest facilities, and quality-enhancing equipment such as for cleaning and drying
- Supporting development and implementation of standards for quality differentiation
- Supporting market development, negotiation skills and market linkages among buyers and sellers
- Strengthening supply networks and ensuring effective and safe usage of inputs, disease surveillance, and control
5. Risks and Rewards Associated with Agricultural Financial Services

5.1 Overview of risks

The cardinal rule of any financial service provider is to maximize profit and minimize risk. Risk is a negative event that can't be predicted or controlled such as war, natural disasters such as floods, and disease outbreaks. In the financial services context, risk refers to potential of nonrepayment (default) and late repayment (arrears) of credit. This is the greatest threat to financial services providers. Credit default not only means that the institution loses its investment, it may also mean that the institution will be unable to pay back its depositors and lenders. Credit arrears, though not as severe as default, can also lead to problems of illiquidity. Here are four serious consequences of illiquidity:

- Depositors’ funds may not be available when they want them, which can undermine client confidence in the financial institution.
- Borrowers may not receive their loans on time, which hurts both the borrowers’ businesses and the perception of the institution in its market.
- Financial institutions’ profits may stagnate, forcing them to reduce operations.
- In severe cases, regulators may actually suspend, take over, close, or liquidate the financial institution’s operations.

The risk of borrowers failing to pay on time or at all is broadly termed credit risk. Credit risk may be beyond the borrower’s control or it may be willful. The following paragraphs describe various risks in greater depth.

Willful default risk—This is the risk of a client accessing credit, performing the activity successfully, realizing a profit on that activity, but refusing to repay or delaying in repaying the credit. It relates to the borrower's personal traits, including trustworthiness and integrity. Many people default on repayment, even for money borrowed from friends or relatives, and agricultural borrowers may be no exception. Financial services providers can mitigate default risk in many ways. These include obtaining collateral from borrowers, insuring the credit itself, providing structured credit that ensures that the proceeds from the sale of the commodity pass through the lender, and rescheduling the credit, if necessary.

Production risk—Unique to agribusiness lending, this risk refers to the situation in which what the producer plants or raises never reaches a salable stage. Causes include bad weather, pests and diseases, and outright failure to execute the programmed activities. This is a real risk in agriculture, and if not mitigated can directly affect borrower creditworthiness. Mitigation can be achieved through irrigation, improved crop varieties, mechanization, and pest control for crops,
water storage, scheduled veterinary treatments, proper shelter, commercial feeds for livestock, and providing expert advice to both lender and borrower before the loan is made.

**Price risk**—The risk that the price for the commodity realized on the market is lower than the cost of production for that commodity is a serious concern in agribusiness. It is the risk that the actor will incur loss on sale of the commodity and thus will be incapable of paying back the credit accessed to accomplish that activity. It is highly related to market volatility of the given commodity’s price or the producer failing to manage the cost of production. This directly affects borrower creditworthiness unless it is mitigated. Mitigation can be achieved by production under a contract guaranteeing a fixed or minimum price with a large, reputable buyer; insuring the price with a willing counterparty; or using sophisticated hedging techniques such as forward sales, future sales and options.

**Operational risk**—This is the risk that the financial services provider will fail to provide the required financial services because it lacks the systems and expertise to do so. If the provider’s staff resources are few or unskilled, they can be overwhelmed by the clients, especially for agricultural production and trading, which tend to have peak demand at specific times. Physical resources as well are needed to quickly respond to client requests and efficiently monitor those clients. Physical resources include transportation, telephones, and appropriate technology such as management information systems. If physical resources are constrained, the financial services provider will have serious operational risk. The obvious management strategy to mitigate operational risk is for the financial institution to hire qualified people and train them to understand the agribusinesses they support. Also, to develop and improve logistics and management systems on a regular, methodical basis.

### 5.2 Overview of rewards

Any business that is willing to take a risk must do so in anticipation of a reward. Providers of financial services to agriculture expect to reap the benefits associated with taking the risk of providing those services. The benefits become evident when the financed portfolio generates sustainable profits for that provider. In most developing country rural economies, financial service providers are few. Being one of the first firms to penetrate a profitable, but poorly understood, market enables that firm to thrive with limited or no competition. Five key rewards to financial institutions engaging in banking agribusinesses are covered below.

**Large credit market**—In many countries, the agricultural sector provides a vast market for credit. There are many players in agricultural supply chains, including inputs suppliers, producers, primary consolidators, transporters, large traders, processors, wholesalers, exporters, and retailers. Many of these have the capacity to absorb credit on commercial terms. This array of actors provides a great opportunity for financial services providers to increase their operations.
With proper analyses of the agricultural supply chains with respect to demand for financial services, the market is virtually inexhaustible.

There is usually very little competition in the market for financial services to the agricultural sector because providers usually see agricultural financing as risky and are unwilling to enter the market or restrict their portfolios. With some effort, the agricultural financial market can be well understood by financial services providers that can then reap low-hanging fruits because of the limited competition.

**Mobilization of savings**—Most credit is funded by savings deposited with the lender. Because rural people are characteristically eager to have a secure and convenient place to save, many institutions that mobilize savings don't pay interest on them, or they pay minimal interest compared to the interest they realize when they lend these savings out.

Generally, the level of liquidity in the agribusiness sector is high, particularly at the time of harvest and marketing. The high level of liquidity combined with the many potential savers provides huge opportunity for successful savings mobilization by financial services providers.

**Transfer fee income**—Beyond savings opportunities, agricultural transactions are characterized by exchange of physical cash. Traveling with cash or holding onto it until the transaction is to be accomplished is highly risky and people are extremely sensitive about it. Traders and transporters must move with cash when going to buy and after selling their agricultural merchandise. Financial services that focus on cash transfer services can reap enormous returns in the form of transfer fees. Similar rewards can be reaped from structured payments, whereby the financial services provider offers to receive payment on behalf of the seller from the buyer. This is highly feasible in the case of marketed commodities with continual or regular production, such as dairy, tea, poultry, and fruits, and is equally feasible for one-off transactions.

**Diversifying out of urban markets**—Competition can be intense within the urban financial services markets, leading to high costs associated with attracting and maintaining clients, including continual promotion, competitive reductions in charges, and high operating costs for attracting and maintaining front-line and back-office staff. Conversely, rural areas present untapped potential for financial services provision, especially in the agricultural sector, which dominates the rural economic profile. For this reason, financial services providers that focus on expanding into the rural area gain opportunities to establish niche markets can earn sustainable profits at lower operational costs. Further, in targeting rural areas for provision of agricultural financial services, other opportunities present themselves such as managing school fees payments, banking rural commercial businesses and services, managing transfers for rural-based civil servants, and banking the rural-based public and private institutions.

**Increasing resources through collaboration**—Many donor, NGO, and government programs directly target increasing the provision of financial services to rural areas and agribusiness.
Typically, these entities are in dire need of collaborating with financial services providers. Such collaboration may include support for developing relevant financial products that are appropriate to the sectors targeted; supporting the increased outreach for financial services provision such as subsidized rural bank branch expansion; and provision of outreach support equipment such as transport, MIS and ATMs. Subsidies for training financial institutions in engaging the rural sector with agricultural financial products are often available. Finally, many donor programs and governments provide credit guarantees to financial services providers targeting the agricultural sector, thus helping to reduce the lending risk. With diversified opportunities that may arise from the collaboration, rural and agricultural financial services providers should be able to reduce risk substantially and reap enviable and tangible rewards.
6. Lessons Learned

The following brief chapter covers observations and lessons learned from actual financing operations in East Africa.

6.1 Decisions to enter a market must be based on data

Many financial institutions and the donor programs that support them have encouraged branching into areas where operational income can't cover the costs of operations. Before entering a new market, careful, quantitative feasibility studies must be done to ensure that revenues will exceed costs. Markets must be well understood in terms of the level of liquidity they generate, the seasonality of the agribusiness operations to be financed, and the staffing levels and time required to make the operation perform profitably. Many rural operations in Kenya, Rwanda, and Uganda have failed to earn enough revenue to cover their costs. As a result, staff levels are reduced and local opportunities ignored, and potential local clients lose confidence in the benefits of financing.

6.2 Specialized financial products and training are necessary

Financial institutions often enter agribusiness markets without having a clear idea of how the markets function, how the agribusinesses they want to partner with actually work, or what the real risks are. The authors of this primer could easily provide more than a hundred examples from East Africa where well-intentioned financial institutions entered the rural market with their existing financial products and either failed to recover their loans or, due to their misunderstanding, completely discouraged their potential clients from working with them.

The issue here is operational risk. Because financial institutions often don’t understand the businesses they want to finance, they either try to force clients to behave like urban clients or they require assurances through their appraisal that don’t mitigate the actual risks they face. In trying to manage what they perceive as risk, they may ultimately create more risk, by underfunding clients, delaying the provision of services, forcing clients to incur unnecessary costs, or simply alienating them.

Financial products must be developed that take into consideration the unique aspects of the agribusiness being financed so the financial institution can maximize its profits and minimize its risks while enabling the client to do the same. There is absolutely no shortcut to financing agribusiness. Specialized products, proper training, and appropriate systems must be developed within financial institutions if they are to succeed.
6.3  **Financial services must be specialized**

Frequently, development partners assume that a nonfinancial business can effectively provide financial services. Cooperatives, among others, are often trained to provide savings and credit services in addition to the management of input supply and output marketing. But managing cash and protecting depositors’ moneys is far more risky than managing any other commodity. It is difficult to misplace 5,000 liters of milk but it is easy to misplace the cash equivalent of 5,000 liters of milk. Managing financial services is complex and requires specialized skills, systems and oversight by a regulator, where possible.

6.4  **Savings is critical and often undervalued by technical programs**

Throughout the 1980s and 1990s, strong emphasis was placed on provision of credit by the intellectual leadership and donor programs engaged in development finance. Recently, the importance of savings has come to be realized. In fact, savings is probably more important, all things considered, than traditional credit to rural agribusinesses. Savings provides many benefits, by:

- Enabling financial institutions to enter the rural market without risking all of their own money;
- Providing a lower-cost option for highly liquid agribusinesses to accumulate and reinvest their revenues. It is always cheaper to use your own money than borrowing someone else’s;
- Enabling agribusinesses to forge relationships with the formal financial sector;
- Encouraging other businesses to move out of urban areas and into rural areas where they know there is money; and
- Helping rural people cope with life’s emergencies.

Critical factors in terms of offering savings products have been identified through research in East Africa, which concurs with research from elsewhere in the world. These are:

- **Convenience**—Savings services must be located close to people and be easy for clients to initiate.
- **Accessibility**—Once savings are deposited with an institution, the process for withdrawing must be well understood and easy.
- **Cost**—Savings services must not be too expensive for the clients.
- **Security**—Savings deposits must never be lost.

6.5  **Structured trade arrangements are promising**

Recently, many successful financing experiences in East Africa have recently relied on structured trade arrangements. Rural agribusinesses frequently have a single large buyer.
Financial institutions can lend to rural agribusinesses and then recover their credit from the buyer by having the client sign a contract with the buyer and having the buyer agree to pay the client through the financial institution. Such arrangements have been very successful for tea, sunflower, and dairy production.

6.6 Finance leasing is an easy point of entry to rural finance

We discussed leasing above, under credit products. There are two principal types of leasing: operating leasing, where the asset is leased to the client for a fixed period of time and then recovered by the lender, and finance leasing, where the asset is leased to the client until the full value of the asset and the interest are recovered by the lender and the asset is then sold to the client for a nominal payment. Recently in East Africa, the market for finance leasing has been very successful. It enables lenders to reduce client appraisal costs, because if the client defaults for any reason, the lender can recover the asset quickly because it belongs to the lender. This has been done in every agribusiness sector, but has yet to be fully used by most lenders.

6.7 Existence of qualified demand

Many agribusinesses have qualified demand for financial services (credit, savings, and cash transfers) and are willing to access those services if offered. But far too often, these financial services aren't offered for a variety of reasons explained throughout the document, but most notably, lack of knowledge of the existence of the qualified demand by the financial institutions themselves. Examples of this qualified demand have been documented in several research papers throughout East Africa in almost every agribusiness sector, including dairy, coffee, and grains.
7. Recommendations

7.1 Land O'Lakes staff

Land O’Lakes staff needs to understand better how financial services can enhance agribusiness. The staffers don’t have to become bankers, but they must know what kinds of products and services are being offered by financial institutions and how to determine whether those services will help their farmer partners. Deep understanding of financial services takes years to develop, but it is critical to linking farmers to financial institutions. An objective third party, who can make a knowledgeable assessment and offer informed and sound advice, will be invaluable. Far too often, the deeper understanding is absent, and parties make decisions and undertake services that do more harm than good.

More technical understanding would also be useful. Financial institutions like to see accurate records, business plans, projections and documentation. If Land O’Lakes field staffers don’t know how to do these things themselves, it will be hard for them to advise their farmers. Again, the staffers don’t need to write business plans to submit to an investment bank, but they need to understand the fundamental components of such documents. If this can be accomplished and passed down to the farmer clients, it will bridge a major gap that has prevented farmers from accessing financial services.

7.2 Market research on dairy value chains

A detailed study that analyzes the dairy market and clearly articulates the areas to increase value across the chain and for all stakeholders is powerful. Stakeholders want to grow and improve their lives, organizations and institutions. If there is a well-researched and well-written document, such as Inspired International & USAID KARF Project, Dairy Value Chain Findings – Kenya, 2009, that explains how this can be done and the amount of value that can be added, stakeholders would seize the opportunity. Often, stakeholders have incorrect or no information on which to base informed decisions. Stakeholders often prefer to stay in their comfort zone and not venture into new areas, especially financial institutions. Completing and distributing reliable market studies would greatly further the agenda.

Once a market study is complete, it must be distributed and discussed with the appropriate stakeholders in the appropriate forum. Discussion and presentation are key to effective adoption of a program to address areas in the dairy value chain. One-on-one discussion with stakeholders is probably the most effective means to accomplish this intervention. In that situation, stakeholders are free to ask specific questions and raise concerns that they may not feel comfortable discussing in a larger forum.
7.3 Linkages to financial institutions

This primer has emphasized the training of Land O’Lakes staff. As important as this training is for a basic understanding of financial services, the provision and implementation of financial services can be complicated and confusing. The training of Land O’Lakes field staff is not intended to make them experts, but to allow them to understand in a deep and relevant manner how these services can benefit farmers. We therefore recommend that a full-time financial/agricultural technical advisor be employed as a permanent resource for Land O’Lakes. Such a technical advisor can be involved in a variety of areas, including:

- Negotiations
- International trade agreements
- Regulatory issues
- Financial instrument development
- Monitoring and evaluation
- International market linkages
- General advisor to various country programs
- Ongoing staff training

An individual who serves as a permanent financial services technical advisor would begin to improve communication between farmers and financial institutions by being able to understand both parties’ goals, objectives, strengths and weaknesses.

The technical advisor and Land O’Lakes staff could be the catalyst for linking farmers to financial institutions in a much more positive way. But communications must be improved. Far too often, presentations, seminars and even one-on-one dialogue with financial institutions and development partners are superficial and superfluous. Communication needs to be focused and narrowed so that the needs, goals, funding and constraints of all stakeholders are recognized, discussed and understood. Then programming can be devised that works for all parties. If this can be done, programs will be implemented much more effectively.

7.4 Access to regional resources around East Africa

Multiple resources exist that can assist Land O’Lakes in helping its clients in the dairy sector to access and benefit from financial services.

Donor programs—Many existing donor programs in East Africa support the research, development and roll-out of rural financial services. These can sometimes fund Land O’Lakes but are more frequently able to fund project beneficiaries to receive qualified training from consultants and specialized NGOs to complement Land O’Lakes objectives.
In Uganda there is the aBi Trust funded by Danida, Sida, the E.U., and the Belgian Technical Cooperation. It is tasked with the development of financial services for agribusiness and guaranteeing agribusiness loans. There are also various local and regional USAID programs, including LEAD and COMPETE with complementary objectives.

In Kenya, the Financial Sector Deepening Trust is funded by multiple donors, including DFID, Danida, the E.U., the Gates Foundation, and others. It is similarly tasked with the research, development and roll-out of financial products and services for rural agribusinesses. There are various local and regional USAID programs, including KARF and COMPETE, with complementary objectives.

In Tanzania, the Financial Sector Deepening Trust and the PASS Trust are both funded by multiple donors, including DFID, Danida, the EU, the Gates Foundation and others. These are also tasked with the research, development and roll-out of financial products and services for rural agribusinesses.

**Consulting firms**—Several firms working in the region have expertise in both training clients and assisting financial institutions. Notable are Aclaim Africa’s *Accounting for Non-Accountants* Training and the various products offered by INSPIRED International, the authors of this manual.