IMPROVING AGRICULTURAL MICROFINANCE THROUGH RISK MITIGATION

CARE. ACT. SHARE. LIKE CORDAID.

Photo: Resi Janssen

Wheat farmer in Bantu, Ethiopia

WHAT MFIs CAN DO TO REDUCE RISKS

The very nature of agriculture makes agricultural lending a risky business. Weather conditions, diseases, but also market access and price fluctuations make harvests and income and consequently the repayment of loans uncertain. A good reason for financial institutions to avoid lending to farmers and most banks and MFIs still do not lend for agricultural purposes or only on a limited scale.

However, agricultural production is becoming increasingly important. The global population is expected to grow from 7 billion people today to 9 billion people by 2050, resulting in a rising demand for food and the need for increased agricultural productivity.

It is estimated that the current agricultural production in Africa is only 45% of what it could be. This indicates a huge potential for increased food production and processing, which will require appropriate financial services in order to make it happen. More and more financial institutions have therefore become interested in lending to farmers. Risk management will help them to reduce risks as much as possible and make successful agricultural lending possible.

The ACP/EU funded MicroSave/Cordaid agricultural lending project has supported 7 African MFIs in developing or refining appropriate agricultural lending products, including risk management and elements of agricultural value chain development.

MFIs that participated in the project, and the crops for which they developed or refined a loan product:

- Wasasa MFI, Ethiopia, Coffee beans production
- ACSI, Ethiopia, Wheat production
- SMEP, Kenya, Poultry farming
- Opportunity Kenya, Dairy farming
- Opportunity Bank Uganda, Sugar cane production
- UGAFODE, Uganda, Cattle fattening
- SINAPI, Ghana, Maize production

This paper presents in four categories the risk mitigating measures that have been identified:

- **Preparation**: what MFIs can do to minimise risks before starting the development of a new agricultural financial loan product;
- **Product**: risk mitigating measures related to the product and its development;
- **Operations**: risk mitigating measures related to the MFIs internal operations;
- **Collaboration and linking**: mitigation of risks through collaborating with other value chain actors and agricultural service providers.

Cleaning de-hulled coffee beans, Ethiopia

1. Preparation: what MFIs can do to minimise risks before starting the development of a new agricultural financial loan product.

- **Do a sub-sector/value chain/stakeholder analysis** before making a decision in which crop and area to intervene. Choose a sector/crop with good demand, less risks, existing stakeholders for linking, with strong producer organizations, etc. Include gender aspects, to avoid a deteriorating position of women.
- **Select an area with lowest possible weather risks** and a history of good productivity.
- **Have in-house agricultural expertise**, also in board and management, that can make informed decisions.

2. Product: risk mitigating measures related to the product and its development.

- **Develop an appropriate loan product**, based on phased crop cultivation needs and household needs. Make a seasonality analysis (income/expenses). Think of disbursement in tranches to avoid loan diversion. Take price fluctuations into account in the repayment period (allow for a longer repayment period to enable farmers to receive higher prices than directly after the harvest).
- **Offer a savings product**. Loan repayments will be better if farming households have savings in case of emergencies or disappointing harvests. A specific, useful product is a term deposit, starting after sale of the harvest and released at the time of purchase of inputs for the next cultivation season.
- **Provide financial eduction**. Clients perform better when they know the principles of budgeting and saving. Providing financial education enhances both saving behaviour and repayment rates.

3. Operations: risk mitigating measures related to the MFI's internal operations.

- **Risk management**. Organize systematic implementation of the risk management cycle, from the identification of risks, the assessment, the identification and implementation of mitigating measures to the monitoring of risks and mitigating measures. It is advisable that the institution has a specific risk management department. Input from and close collaboration with the agricultural specialist of the MFI and agricultural credit officers is indispensable.
- **Limit exposure to certain crops or areas**: a risky event for agriculture will hardly ever happen in an entire country or in all agricultural crops or livestock at the same time. To limit the risks for its total lending portfolio, a MFI can diversify the agricultural activities it finances and limit its exposure to each region and crop to a maximum amount and/or percentage of its total portfolio.
- Make a **good analysis of the income, expenses and cash-flow** of clients' entire household, taking into account all income sources and expenses. By treating farming households as complex financial units, with a number of income-generating activities and financial strategies for coping with their numerous obligations, MFIs are able to increase repayment rates.
- **Close monitoring and supervision** of clients, and a good relationship, is always crucial for repayments. Even for loans with bullet payments only instead of regular monthly payments, clients should be visited at least once a month.
  If many clients reside far from branches, a satellite office could be opened. Think of close supervision of credit officers as well.

- **MIS**
  - **Appropriate loan tracking.** Agricultural lending products often have different disbursement and repayment schedules than the MFI's more usual products. It is important that the MIS software can accommodate these features and gives automatic warning signs in case of non-compliance to planned activities by credit officers or clients.
  - **Data collection** and knowledge in general is extremely important to manage risks and make good decisions: portfolio data as exposure (portfolio) per crop and region, PAR and write offs per crop and region. But also data that enable monitoring of the risks that were identified and of the mitigating measures that were implemented. How often did a certain risk occur, how much was the loss (harvests/loan loss)? Based on these data the MFI can change product features, intervention areas, exposure limits, etc.
- **Human Resource Management**
  - **Hire people with an agricultural background** and train them as credit officer. Having credit officers with the right agricultural knowledge to deal with the specific agricultural lending product greatly contributes to a healthy portfolio. It is easier and more efficient to train a person with an agricultural background to become credit officer, than to equip a person with an accounting background with specialized agricultural knowledge.
    All this does not mean that credit officers should provide agricultural extension services to clients, but the appropriate knowledge will help them to analyse loan applications well and to implement proper monitoring of clients.
  - Have qualified staff. Agricultural lending products often have specific features and procedures, different than the MFI's usual loan products. Staff training should take this into account and special training and instructions might be needed, not only for credit officers but also for their supervisors. As the number of credit officers specialized in the product is lower, the impact of staff turnover or promotion is higher and careful staff planning is required.
- **Appropriate liquidity planning**. Most agricultural activities have specific cycles and finance needs. Late disbursements will negatively affect harvests and thus repayments. To insure on-time disbursements, the entire loan application and approval process should be carefully planned, beginning with the information to clients, and dead-lines should be respected.
- **Internal audit and compliance** should include compliance to the specific product features and procedures and check on possible fraud linked to the product.

Fattening of Ankole bulls, Uganda

"Good risk management is extremely important for us, as over 75% of our loans is used for agriculture. We take so many risks when lending to farmers, especially in case of rain fed agriculture. We diversify our portfolio in terms of numbers of loans to certain crops and areas. We give smaller loan sizes and have larger groups to absorb chocks. And farmers know how to mitigate risks. They cultivate different crops: early harvest crops and late harvest crops, crops that resist heavy rains and crops that resist droughts. Linkage is not always easy for us. We are good in finance, in disbursing and collecting loans. We don't have the skills or resources to facilitate value chains".

Amsalu Alemayehu,
CEO of Wasasa MFI,
Ethiopia

4. Collaboration and linking in the value chain: the mitigation of risks through the collaboration with other value chain actors and agricultural service providers.

- **Facilitate input supply**. Support farmers to secure timely and high quality inputs, to reduce production risks, increase yields and income and thus enhance repayment rates. MFIs can aggregate information on input needs collected in loan applications and transmit this information to input suppliers. They can even negotiate prices and coordinate supply through their lending system, which is often group based. MFIs can also cooperate with input suppliers by linking their loans to the use of specific inputs and tools. For example in Ethiopia, Wasasa's coffee improvement loan is linked to the use of a specific type of mesh wire for drying coffee beans. This gives the best quality coffee and thus enhances farmer incomes and loan repayment rates.
- **Arrange extension services for clients**. Training to farmers can reduce production risks and, more importantly, can often ensure higher quality products that yield higher prices. It can be attractive for MFIs to cooperate with extension agents in several ways. Extension workers can play a role in the selection of (potential) clients, they can train clients, they can monitor the production of clients and they can facilitate access to input supply and markets.
- **Facilitate access to price information (systems)**. For many agricultural crops, prices strongly and frequently fluctuate, over time and from place to place. MFIs can play a role in transmitting price information to clients through their group based lending system or branch network, enabling farmers to sell at the right time at the right place for the best price. If available, MFIs can link their clients to providers of price information through text messaging (SMS).

- **Apply value chain finance.** A good value chain finance product reduces risks and costs for both MFIs and their clients. Value chain finance is based on a tripartite agreement in which an MFI lends to farmers, farmers sell their produce to a buyer and the buyer repays the farmers' loans to the MFI. The buyer can be a cooperative, processor, trader, exporter, etc.
  In terms of risk management, value chain finance is attractive for an MFI:
  1. Loans can be secured by the assets of the buyer;
  2. Buyers often know their suppliers well and can select the least risky farmers;
  3. Farmers have a secured market through the buyer;
  4. The buyer can secure training, quality inputs, etc.

  The system is also attractive because of reduced transaction costs due to more efficient client selection and repayments in bulk. It can be a win-win situation for the MFI, the buyer and the clients since the former two can expand their business and clients can receive better services.
- **Work with/through (strong) producer organisations.** Working with organized farmers reduces the transaction costs and risks. Leaders and staff of producer organizations know their members and their needs and capacities. A producer organization may also play a role in client selection, monitoring of clients, distribution of information, agricultural extension services and loan collection. Caution is advised however, because producer organizations on their turn can at the same time constitute a risk. They may have conflicting interests, are open to government interference and more often than not, are inefficient, under-resourced and poorly managed.
- **Participate in Multi-Stakeholder Meetings.** Multi-Stakeholder Meetings (MSMs) and multi stakeholder processes gather different stakeholders from within and from outside a value chain with the purpose of coordinating efforts to reach a common goal. MFIs can reduce their risks by participating actively in multi-stakeholder processes as it will allow them to team up with the right partners. However, as support actors in a value chain, MFIs in general do not have the capacities, resources or power to initiate and drive multi-stakeholder processes and enforce agreements.
  MSMs can result in MoUs, in which several actors agree on their common objectives and on what each actor contributes and delivers on what conditions, when and how. MoUs are not legally binding documents but more about commitments of actors to make contributions to the process that ultimately should be beneficial for all.
- **Link clients to insurance providers.** Insurance can be the ultimate remedy for risks. MFIs can link clients to existing insurance providers for input, crop, index based or other type of insurances. But insurance is expensive and still rarely available. MFIs should not solely rely on insurance as a mitigating measure.

Experience suggests that MFIs often better leave the initiative of developing new value chain finance relations to other actors. They often don't have the budget nor the expertise. They should rather monitor innovations in value chains. These often lead to higher margins which can be the base of a new agricultural loan product. MFIs should also aim to cooperate with strong partners: a primary chain actor with a good reputation ("lead firm"). Chances for success are further enhanced by a strong external development partner working on quality issues, chain coordination, innovations, marketing, export promotion etc.

Disclaimer This document has been produced with the assistance of the European Union. The content of this document is the sole responsibility of Cordaid and can in no way be taken to reflect the views of the European Union.

ABOUT MICROSAVE

MicroSave is an international financial inclusion consulting firm with 15 years of experience, 10 offices around the world, 125 staff, managing projects in ~ 40 developing countries. It provides customer research, strategy, and ongoing imple-mentation support to donors such as UN, IFC, and the Gates Foundation and rural or regional financial institutions. MicroSave has developed a step-by-step client focused product development and pilot test process.
www.microsave.net

ABOUT ACP/EU MICROFINANCE

ACP/EU Microfinance is a programme of the ACP Secretariat funded by the European union. The objective of ACP/EU MICROFINANCE is to contribute to the alleviation of poverty through economic growth facilitated by the development of inclusive financial systems adapted to the needs of the poor in African, Caribbean and Pacific countries.
Duration: 2010-2015.
Funding 15 mln EUR.
www.acpeumicrofinance.org

ABOUT CORDAID

Cordaid is the catholic organisation for relief & development aid, with its headquarters in The Netherlands. It has been fighting poverty and exclusion in the world's most vulnerable areas since a century. Cordaid has been investing in scalable, sustainable financial models in rural Africa, Asia and Latin America since 1998. Its Rural and Agricultural Fund (RURAF) invests in Microfinance Institutions and SME funds that have a rural and agricultural focus. To date, Cordaid investments has a committed capital of 51 mln EUR in 80 Institutions. www.cordaid.org/en/topics/investments

CONTACT

Resi Janssen
Resi.Janssen@cordaid.nl
www.financingsmallholder-farmers.com

Cordaid the Netherlands
Lutherse Burgwal 10
2512 CB The hague
+31(0)70-31 36 300
cordaid@cordaid.nl
www.cordaid.org

CARE.
ACT.
SHARE.
LIKE CORDAID.