

CGAP Case Studies in Agricultural Microfinance: An Overview

The Challenge of Agricultural Lending

Despite the disproportionate concentration of poverty in rural areas around the globe, microfinance—the provision of financial services to poor and low-income people—has tended to gravitate away from rural borrowers.¹ As the industry matures, however, practitioners are increasingly turning to the vast and largely underserved rural frontier, and to the thorny challenges of financing small-scale agriculture. Delivering small-scale loans and savings mechanisms can be particularly challenging in areas of low population density, where the distance between clients is great, transportation networks are often poor, and low income levels tend to translate into impracticably small financial transactions. Given that most rural citizens depend at least in part on agriculture for their livelihood, these conditions make the prospect of operating a self-sustaining, rural microfinance institution even more daunting.

Agricultural finance is notoriously risky. Many farmers need credit to purchase seeds and other inputs, as well as to harvest, process, market, and transport their crops. While borrowing on the basis of anticipated crop production might seem logical where collateral assets are few, such loans expose the lender to production and price risk. Natural disaster, a decline in market prices, unexpectedly low yields, the lack of a buyer, or loss due to poor storage conditions are just some of the factors that can result in lower-than-expected revenues. Such a fall in revenues can often lead to high default rates on agricultural loans. The overwhelming failure of state development banks that provided billions of dollars in subsidized agricultural finance to farmers in the 1970s and 1980s, combined with scant rural penetration by risk-averse commercial financial institutions, has led to a widespread dearth of agricultural credit. Yet new approaches are increasingly being developed to fill this gap in a sustainable and efficient manner.

The identification of *agricultural* microfinance as a significant remaining challenge to financial sectors that serve the majority of the poor spurred CGAP to undertake an analysis of current practices. With financial support from the International Fund for Agricultural Development (IFAD), CGAP in 2002 began desk research, consultant site visits, and stakeholder consultations to identify promising agricultural lending operations. An initial list of 80 candidates was slowly whittled down to a handful of representative examples. While many on the long list proved to be fundamentally unsustainable, or lacked the potential to achieve scale, about 30 were sufficiently promising to merit further research. Of that resulting short list, the case studies outlined here were selected as representative examples that merit dissemination.

Selection of Case Studies

These case studies present promising approaches to the sustainable provision of financial services to poor rural households reliant on agriculture. The five institutions or projects highlighted in the studies are:

- Bai Tushum Financial Foundation (Bai Tushum), Kyrgyzstan;
- Caja Los Andes, Bolivia ;
- Confinanza, Peru ;
- Cooperative League of the USA (CLUSA), Mozambique; and
- Equity Bank, Limited (Equity), Kenya.

¹ The important exceptions are Bangladesh and Indonesia, both of which have rural population densities significantly higher than most countries of sub-Saharan Africa or Latin America.

CGAP selected these cases on the basis of the following criteria:

- importance of agricultural lending to the overall portfolio and mission of the microfinance provider
- medium-term sustainability of the agricultural lending activities (and institutional ability to survive difficult years caused by weather, price movements, or government policies)
- potential for replication and/or scale
- illustration of a particular institutional or methodological approach to agricultural microfinance
- geographic distribution

Although CGAP considers the models represented by these six cases as promising, none can yet be declared an unmitigated success. Many methodological, financial, practical, and political challenges remain. In several cases, the agricultural portfolio has yet to achieve significant scale. The case studies are thus intended to offer insights, lessons learned, and analyses that will be directly relevant and useful to donors, investors, financial institutions, and others engaged in promoting financial services to the many millions of poor people dependent on agriculture.

Overview of Case Studies

The case studies span three continents and a variety of institutional characteristics. The organizations highlighted differ in portfolio size (ranging from about US \$2 million to US \$22 million); ownership (village-owned, membership-based networks; non-profits; and a commercial bank); and age (from 4 to almost 20 years). Their lending styles also run the gamut from individual to solidarity group and village banking loans. Some institutions finance loans through savings mobilization, others, via interest-bearing lines of credit from international donors. Finally, some institutions are devoted primarily to rural or agricultural lending, while others maintain a modest rural lending program as a mechanism to diversify their portfolio or enhance outreach.

While the institutions portrayed in the series are thus quite diverse, they face many of the same agricultural lending challenges:

- Reaching rural clients efficiently and cost-effectively (Caja Los Andes, Confianza, Equity)
- Maintaining liquidity in agriculture-dependent areas amidst seasonal income cycles, economic crisis, and/or regulatory constraints (Bai Tushum, Caja Los Andes)

- Mitigating covariant agricultural risk (Bai Tushum, Caja Los Andes, Confianza)
- Adapting loan products to meet the specialized needs of rural borrowers (Caja Los Andes, Equity)
- Overcoming poor lending precedents and improving repayment culture (Caja Los Andes, Confianza)
- Developing technical capacity at the local level (Bai Tushum, CLUSA)

The institutions featured in the case studies have adopted varying approaches to their respective challenges. Equity Bank, Ltd., is “taking banking services to the people” via high-tech mobile banking units. Caja Los Andes bases its loan analysis and repayment schedules on revenue flows from all farm, labor, and business activities that make up a family’s unique, multifaceted rural enterprise. And CLUSA is establishing linkages among farmer associations, agribusiness companies, and financial institutions to provide small farmers with greater access to input credit, crop advances, and commodity buyers.

Each case study begins with basic information about the institution’s history and goes on to present a set of key challenges and responses related to agricultural or rural finance operations. A brief institutional assessment of the financial provider is then followed by information on donor and investor support, plus a section on lessons learned. The principal lessons identified in the cases are:

For Microfinance Providers

- A diversified portfolio that complements agricultural loans with other loan products, such as business and mortgage loans, can better serve the needs of borrowers while simultaneously reducing institutional risk and improving operating margins. A rural portfolio provides an opportunity for market expansion and can help offset losses in an urban portfolio during an economic recession.
- Adapting practices that have proven effective in traditional agricultural finance, such as incorporating crop income-cycle models into loan analysis and tailoring repayment schedules to household income flows, can assist microfinance institutions to expand into agricultural lending. Flexible, high-quality technical assistance can help financial institutions successfully adapt their product offerings to rural client needs and market opportunities.
- Lenders should not assume that a loan product intended for agriculture will necessarily be used

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for agriculture, and should take into account all household income sources and expenditures in loan analysis, not only those related to agriculture.

- There is substantial demand for savings by rural households, provided that savers are offered the right combination of security, convenience, liquidity, and positive return. Access to deposit and transfer payment services (for remittances) is important for agriculture-dependent poor people, as these services help smooth seasonal agricultural cycles and meet large or unexpected expenditures.
- The high cost of reaching rural clients and operating in remote areas remains an obstacle. Strategies to overcome this obstacle include the use of technology, lending to groups or associations, and flexible delivery mechanisms. It is frequently necessary to invest in product design and an underlying management information system, which underpin the performance and utility of technology, before developing more sophisticated technological solutions (such as personal digital assistants, mobile-phone banking, or automated teller machines).
- Farmer groups and associations can reduce client analysis and selection costs for lenders, as well as enhance the access of farmer clients to agricultural inputs and markets. Bringing small farmers together in well-organized farmer associations or locally run village banks can make them more attractive and cost-effective borrowers, leading to greater availability of rural credit from financial institutions and agribusinesses.
- Financial institutions can be profitable even when half of their loan portfolios are in agricultural activities.
- Interest rates to end-clients should not be subsidized, nor should donors try to force institutions to focus exclusively on agricultural lending.

For Donors

- Long-term donor commitment (greater than five years) in the form of technical assistance and financial investment has been a crucial ingredient of success for many of these institutions.
- Flexible, high-quality technical assistance can help financial institutions successfully adapt their loan and savings products to rural client needs and market opportunities.
- Donors need to avoid taking actions that would distort the market, particularly when working to

improve supply chains. Instead, they should focus on building the capacity of local players to work with and influence change within the system.

- An independent technical service unit can provide ongoing fee-based financial monitoring and assistance to community finance models and should be created early to avoid dependence on an expensive external NGO or technical partner.
- A decentralized structure with largely autonomous, locally managed operations can provide sustainable financial services in rural areas. However, the cost and effort to establish such a structure can be significant and rigorous preliminary cost-benefit analysis is advisable to ensure that the resulting outreach justifies the required investment.

Case Study Summaries

The following executive summaries provide an overview of the central themes of each case study.

Bai Tushum Financial Foundation, Kyrgyzstan

Bai Tushum Financial Foundation (Bai Tushum) began agricultural credit operations in Kyrgyzstan in 2000, after it assumed the foundering, three-year-old portfolios of several small agricultural credit associations. A number of international donors, including CGAP, have collaborated effectively to support Bai Tushum's development in the face of a difficult macroeconomic environment, legislation unfavorable to the provision of microfinance, and lack of a credit culture. Through dedicated attention to building a sustainable institution and creative solutions to cultural and legislative barriers, Bai Tushum has quickly evolved into a strong local institution serving a range of rural and urban borrowers' needs.

Bai Tushum has half of its loan portfolio in agriculture, offering crop production and livestock loans, as well as a mixture of agro-processing, trade, and mortgage loan products. Yet it is profitable, achieving 230 percent operational self-sufficiency in its first year of operation. By early 2004, its active portfolio had grown to 1,543 loans worth US \$2.5 million, with a portfolio at risk (PAR > 30 days) of 4 percent. Difficult conditions for agricultural lending have resulted in lower returns on Bai Tushum's crop and livestock loan portfolio. The institution's commitment to agricultural lending appears to have superseded profit maximization however, with trade and other loans sometimes cross-subsidizing the agricultural portfolio.

Caja Los Andes, Bolivia

Caja Los Andes (CLA) has distinguished itself as a profitable, diversified provider of individual loans in the highly competitive Bolivian microfinance market. After inheriting a three-year-old urban lending portfolio from its parent organization (Procrédito) in 1995, CLA immediately began expanding its operations to rural areas and adding agricultural loans to its portfolio. CLA's rural lending technology combines a loan analysis that incorporates all of a rural borrower's cash flows and expenditures (agricultural and non-agricultural), and a range of disbursement and repayment schedule options to fit agricultural income and expenditure cycles.

CLA has performed well, despite a difficult recession that began in 1999. The organization's approach demonstrates that agricultural lending can be viable when combined with other rural and urban financial services, making small-farmer clients attractive when competition is strong in urban areas. The experience of Caja Los Andes illustrates both the potential and the limits of expanding microfinance operations into rural contexts and agricultural activities. The agricultural portfolio represents less than 10 percent of CLA's overall portfolio (partly due to socio-political problems in rural Bolivia in recent years), and poorer clients in remoter areas are not served in the initial stages of expansion into agricultural lending. The case focuses on CLA's expansion into rural areas, the adaptation of its urban lending methodology, risk management techniques for agricultural finance, and socio-political constraints on portfolio growth.

Confianza, Peru

Confianza is a small regulated financial institution in central Peru that provides a mixture of rural, urban, small business, agricultural, housing, and consumer loans to low-income clients. From its beginnings as an Inter-American Development Bank-funded NGO program in 1993 until it became a regulated microfinance provider in 1999, Confianza's loan portfolio was almost exclusively devoted to solidarity group loans for agricultural purposes. When a combination of factors, including plunging commodity prices, led to over half the portfolio suffering from late payments in 1999, Confianza was forced to make a set of swift, substantial changes in order to survive.

Confianza altered its lending methodology, adding urban and individual loans to diversify its portfolio. Confianza successfully matched the agricultural finance approach of designing loan products to better fit agricultural production, with the microfinance principles of sustainability and

close client monitoring backed up by a well-functioning management information system. The MFI's agricultural lending continued to grow, almost quadrupling in volume over the following few years, although its non-agricultural portfolio grew even faster. By the end of 2002, the organization was financially sustainable, lending more than US \$4 million annually, with a respectable portfolio at risk greater than 30 days (PAR > 30) of less than 4 percent and a 19 percent adjusted return on equity that topped its peers. About a quarter of its portfolio remains in agriculture loans; the portfolio delinquency rate on these loans has been notably lower than that of the portfolio as a whole.

Cooperative League of the USA (CLUSA), Mozambique

The Cooperative League of the USA (CLUSA) has helped link small farmers in a number of developing countries with sources of credit from agribusiness and financial institutions. CLUSA launched its Rural Group Enterprise Development Program in Mozambique in the mid-1990s, when the country was still overcoming a long period of armed conflict and settling into a market economy. As a supporter of market-oriented business associations, CLUSA focused its efforts on organizing impoverished, isolated farmers in the northern provinces, where the commercialization of cash crops (e.g., maize, cotton, and cashews) was gaining momentum. CLUSA worked with local producers to form and strengthen farmer associations, then trained the associations to pool and market their crops to commodity traders, leading to higher farm gate prices and an 85 percent (inflation-adjusted) increase in average annual farm revenues.

CLUSA also assisted the associations to establish better relationships with local agribusinesses that provide input credit and short-term crop advances to smallholder farms prior to purchasing their harvests. In addition, CLUSA brokered a partnership with a financial services provider, Gapi, to offer loans to farmer associations for agricultural purposes. In 2003, 10,000 farmers in CLUSA-supported farmer associations accessed more than US \$300,000 in agribusiness company credits and nearly \$100,000 in loans from Gapi, with average repayment rates of close to 100 percent. While the cost of CLUSA's support over a number of years may be high compared to short-term benefits in terms of access to credit and increased sales for small farmers, the longer-term benefits should be more significant, if the enhanced production performance and credit worthiness of the small farmers is maintained.

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Equity Bank, Limited (Equity), Kenya

Equity Bank, Limited, (previously Equity Building Society, until it received a bank license on December 31, 2004) provides microfinance services to more than 250,000 low- and moderate-income citizens in Nairobi and Kenya's Central Province via a network of branch offices and mobile banking units. After a decade of extending long-term mortgage loans to an untargeted clientele with meager results, Equity altered its approach. In 1994, it began tailoring its loan and savings products to a microfinance market, eventually adding two loan products for tea and dairy farmers that are secured by agribusiness contracts. By the end of 2003, the

deposit base of Equity had grown to US \$44 million and its outstanding loan portfolio topped \$22 million.

Equity initiated a mobile banking program in 2000 with the goal of efficiently reaching more clients in remote rural areas. Mobile banking operations have been introduced successfully and by the end of 2003 accounted for more than US \$1.3 million in deposits, serving over 12,000 clients in 30 rural communities. This case study outlines the strategy – including mobile banking - employed by Equity to expand its rural outreach.

