Financing agriculture for a more profitable rural economy

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Farmers and other actors in agricultural value chains find it difficult to access or provide the financial services the sector needs – services that are critical for the development of agricultural products, and are integral to upstream and downstream processes. At the Brussels Development Briefing Revolutionising finance for agri-value chains[1], experts considered innovative solutions that could improve the livelihoods of smallholder and rural producers, and promote economic transformation in the poorest countries.

Policy action needed

- **Develop agricultural and finance policies** that are complementary and address finance from a whole-value-chain perspective
- **Revise legislation and regulations**, such as land and ownership rights and bankruptcy rules, to reduce duplication and the cost of compliance for parties
- **Increase support to upscale successful or innovative interventions** in agricultural lending, such as agricultural guarantee credit schemes and climate resilience finance
- **Enhance policy dialogue and partnerships** between government, policy-makers, financial institutions and farmers' organisations

Agriculture is financially underserved

Throughout Africa, concerted efforts have been made to achieve structural economic transformation in agriculture, moving from basic, low-skilled production to diversified, higher value, more sophisticated and competitive production. This is to replicate the economic and social progress seen in Asia and Latin America.

Yet commercial lending to agriculture is limited. Even though banking services are growing in Africa and other developing regions, farmers must still obtain loans from informal sources, with their associated challenges and risks. Existing finance mechanisms seldom provide the sector with the scale, sophistication and security needed to support the transformation of smallholder farming into higher value, sustainable agribusiness. Notwithstanding the benefits that value-chain finance presents for the sector, it is hindered by unfavourable legislation on land and property rights, gaps in the provision of agricultural support services, high costs of compliance with lending requirements, limited information and analysis about the agricultural sector which increases the real and perceived risks of lending, lack of interest from lenders, and so on.

If we are to achieve agricultural transformation, an enabling, inclusive and progressive policy environment on finance for agriculture is needed, which aims to remove the barriers and reduce the risks associated with agricultural finance.

> *"Governments must provide greater support to the private sector with a focus on upscaling successful finance interventions and facilitating public–private partnerships for agricultural finance."*

[1] https://brusselsbriefings.net/past-briefings/finance-for-agri-value-chains/

How can agriculture be financed?

How does agricultural value-chain finance work?

Financial services for agriculture can take various forms, depending on the needs of the parties. Value-chain finance (VCF) is the flow of funds to and among the various links within a value chain. It encapsulates financial services across three dimensions: short-term finance from buyers and suppliers; one-to-one finance from financial institutions to a value-chain player; and finance based on the relationship between two or more players in the value chain, provided by an internal or external intermediary. VCF thus creates a triangular relationship between three players in the value chain – the buyer, the seller and the financial institution. The financial service is provided under a contract that details four essential aspects of the transaction: the *product*, the *finance* needed, the *information* to be exchanged and the *risk* to be managed between the parties.

Where are the policy gaps and what responses are needed?

Potential gains made by the agricultural sector through VCF can only be realised if there is a sufficiently enabling policy environment. An added incentive for government action is the positive spillover effects that these reforms would have for other productive sectors such as manufacturing:

- *Identify and harmonise contradictory agricultural, trade, finance and business policies*
  Developing countries have policies for agriculture, business and finance that do not complement each other, and contradictory policy provisions make it riskier for VCF to develop. Governments should ensure that policies or instruments affecting agricultural services – through finance, insurance, transport and logistics, ICT connectivity, environment/climate change adaptation – do not duplicate responsibilities or costs, and are harmonised.

- *Introduce legal and regulatory reforms to bolster property rights, innovative finance and improve dispute resolution*
  Legislation on property and land ownership rights, licensing of foreign banks, regulation of non-commercial financial services and insolvency laws are still weak in most African countries. The ability to transfer and enforce rights and liabilities attached to agricultural goods as they move along the value chain is essential to the operation of VCF, so a key policy priority should be to strengthen property rights legislation and those regulatory bodies charged with the oversight of financial institutions and land rights.

  Enforcement of contractual obligations in Africa is often very expensive, time consuming and not always suited to the commercial needs of the parties. According to the World Bank, the average cost of enforcing a contract in Africa makes up 44.9% of the total claim, substantially higher than in Latin America and the Caribbean (30.8%) and South Asia (30.5%). Governments in Africa should adopt policies that reduce the costs of dispute resolution by increasing the range of alternative dispute-resolution mechanisms and institutions available to service rural areas. They should also support programmes to improve financial and contractual literacy among business owners and farmers' organisations.

"... there is a dearth of reliable public agricultural data. This contributes directly to the high costs of financing agriculture, as well as to poor policy-making and other deficiencies in agricultural value chain development."

- *Promote agricultural VCF through sensitisation campaigns, enhanced research and upscaling successful interventions*
  African governments must do more to actively promote agricultural finance, through various means such as sensitisation campaigns for both farmers and financers, especially for more innovative or emerging finance instruments such as climate-related finance or insurance. Funding for both private and public research in agriculture should be increased, as there is a dearth of reliable public agricultural data. This contributes directly to the high costs of financing agriculture, as well as to poor policy-making and other deficiencies in agricultural value-chain development.

  Lastly, financial institutions are not adequately supported in developing unique services for value chains at the early stage – often governments are more interested in macroeconomic reforms or large-scale interventions. Governments must provide greater support to the private sector with a focus on upscaling successful finance interventions and facilitating public–private partnerships for agricultural finance.

Conclusions

The gains that the agricultural sector could make through VCF can only be realised if governments and policy-makers work closely together with farmers' organisations and financial service providers to develop effective, comprehensive solutions.

VCF depends on the existence of *legal certainty* to reduce the risks associated with transactions at various stages in the value chain. It also requires parties to be able to *quickly access and share reliable information* on various parameters relevant to their contractual obligations – information such as the price of a commodity at the exchange markets, weather projections or other data. Governments can directly support VCF by *standardising property rights* and titles and developing *digital registration* systems. Whereas some governments may prefer to adopt very interventionist tactics to compel commercial lenders to service farmers, it is critical for the broader private sector to be encouraged to finance and invest in agriculture. In this way, government resources may be better channelled towards *providing seed finance* for pilot projects or towards supporting the growth of existing financial instruments that have been proven to respond to the needs of the parties in the value chain.

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Cutting delays in invoice payments

Since 2014 the Centenary Rural Development Bank Ltd, one of the leading microfinance commercial banks in Uganda, has been piloting a coffee credit scheme using the warehouse receipt system. Through contracts in the value chain that are tied to the farmer's use of warehousing, and subject to meeting quality and quantity stipulations for their coffee beans, coffee farmers can substantially cut down the delay in invoice payment for their crops – payment is made immediately rather than taking 90 days.

The Centenary Bank and its partners are looking at ways of strengthening the warehouse receipt system model (both the Ugandan Commodity Exchange and Centenary Bank adaptations) to respond to the risks posed by climate variability and change.

"... a key policy priority should be to strengthen property rights legislation and those regulatory bodies charged with the oversight of financial institutions and land rights."

Further reading

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