

*The financing of family farming
in the context of liberalisation
What can be the contribution
of microfinance?*

ATP – Cirad 41/97



THEME SYNTHESIS

THEME 2

**Microfinance and securing credit
for family farms**

Keynote paper for theme 2.

**Dominique Lesaffre – Inter-réseaux
Denis Pesche¹ - Inter-réseaux**



International workshop – 21/24 janvier 2002, Dakar, Sénégal

Summary.

In Sub-Saharan Africa, the situation of agricultural finance is now well known. There is a huge need for finance in order to ensure the day to day running of farms and to assist in their development. This huge demand is faced with a very limited (supply of) credit, in time and in space: few rural areas benefit from access to credit facilities today. The current credit supply is concentrated within a few commodity chains and benefit mostly to medium to large scale farmers. Most of the poorest rural households do not have access to credit. This gap between credit demand and credit supply is often justified by the difficulty of securing credit. In other words, agricultural activities in Sub-Saharan Africa are considered too risky and therefore, due to the lack of proper instruments to secure credit for rural areas, financial institutions (FI) have no incentive to expand their agricultural credit portfolio. How can we tackle the issue of securing credit ?

As a first step, we can identify the various factors leading to credit insecurity. They are both exogenous (linked to the wider financial environment) and endogenous (linked to the FI themselves). The issue of securing credit can therefore be tackled from two separate angles:

From the lenders' point of view, we will find the whole range of classic instruments to cover credit risk developed by FI as well as those requiring a third party. We will also encounter practices attempting to better coordinate the delivery of different FI operating in the same area, and methods to improve the operation and performance of FI. All these tools assist the FI in covering their own risk but tend to transfer the burden of financial risk to agricultural producers or to a third party. They may therefore constitute satisfactory tools for FI but are unlikely to solve the problem of securing credit which lies mainly in the insecurity of rural incomes.

On the borrowers' side, that is the family farms, the problem is of a totally different nature. The efficiency of the tools designed by the FI to secure credit can lead to outstanding debts or even bankruptcy with sale of the land. For family farms, the real issue is that of securing income. Tools and mechanisms to face numerous vagaries (health and life insurance, agricultural insurances, mechanisms to stabilize agricultural markets...) can be set up. Their design and implementation rely on the will of the international community and governments to sustain and develop agricultural activities in the rural areas of developing countries.

Traditionally, the issue of credit security only tackles the tools and instruments designed to reduce the risk exposure of FI. However we consider that designing a policy to secure rural credit must be articulated with a rural and agricultural policy designed to secure and improve the incomes of rural households.

1. Factors leading to credit insecurity.

In order to envisage policy and instruments to secure credit, one must first consider and analyze the factors leading to credit insecurity. Among those factors, we will find agricultural risks, family risks and more broadly all the factors that tend to weaken credit policy. If we consider FI¹ and its clients as a system, we can classify these factors in two broad categories.

1.1 Exogenous factors.

These factors depend on the environment of FI and their clientele, the farms. They can be divided into three types.

- Natural factors: climatic vagaries, large scale plant or animal epidemics.
- Economic factors: volatility of agricultural products and inputs prices, hyperinflation.
- Political factors: they can be linked to the malfunctioning of the political system (malfunction of the justice system, corruption, negative state influence on FI...) or to ineffective sectoral policies (land issues, poor structuring of agricultural markets, poor health policy, inadequate banking regulation, inefficiency of the justice system which does not condemn irregular practices...).

1.2 Endogenous factors.

These depend directly on choices made by FI. We can divide them in two broad types:

- Conception faults (flaws?): inadequate institutional setup, financial products unsuitable for the agricultural sector, deficient internal decision making support tools, poor appraisal of credit applications, poor understanding of the socio economic conditions of the clients, inefficient guarantee system...
- Governance issues: poor strategic management (excessive concentration in an area specialized in a specific crop with highly volatile prices, unsustainable development of funds...) or poor operational management (bending of procedures for credit of convenience, poor personnel management leading to staff demobilization...).

Faced with a generally unfavorable environment, FI have a tendency to invest carefully in the agricultural sector and to limit the share of agriculture in their credit portfolios. They concentrate their operations in areas where secure commodity chains enable them to limit

¹ By FI, we mean, unless stated otherwise, all bodies involved in finance : micro finance institutions (or MFI), agricultural banks and development banks. When necessary, we will explicit the specific aspects of micro finance institutions.

their exposure to risk (irrigation schemes, integrated commodity chains...). As a result of this, most farms have little or no access to finance.

Endogenous factors are linked to the functioning of FI (good governance, efficiency of audit and management procedures...) and to their ability to adapt (strategic vision, creation of new financial products...).

On the FI side, securing credit is largely based on the implementation of tools and instruments to guarantee against default.

2. Securing credit: the creditors' point of view.

The quest for a better credit security by FI involves risk management policies and guarantee functions² that may combine several elements:

- Different guarantees: physical guarantee, signature or financial tools.
- An improvement of the management practices of a given FI or of a group of FI operating in the same area.

Securing credit is generally made on a contractual basis either directly between the FI and the borrower or with a third party, in order to strengthen the guarantee function.

Type of safety	Physical	Signature	Financial
Nature of relation			
Direct relation between FI and borrower	Mortgage, pledge	Guarantee	Security deposit
Indirect with a third party	Warrants	Delegation of payment	Against-guarantee.

Mechanisms of security presented in the above table are detailed in part 2.2.

2.1 Some issues regarding the security function.

² A few definitions regarding the guarantee concept. A guarantee function : whole set of elements that condition and enable the guarantee. Guarantee Mechanism (GM) : set comprising legal, institutional and technical aspects used for implementing the guarantee function. Guarantee instrument : financial and banking technology used.

In order to design appropriate credit and security tools, one must have an in-depth knowledge of the constraints and calendar of agricultural production. This relies on an in-depth involvement in the field. It also requires flexibility in decision making in order to constantly adapt the quality, quantity and timing of the offer to the dynamics of demand and the environment. An appropriate credit offer has a good chance of being successful (if we do not take into account the climatic vagaries) and therefore of being repaid without any difficulties (that is, without having recourse to the safety function) if the following criteria are met:

- Effective availability of funds on a timely basis, especially for working capital purposes.
- Duration of credit must be adjusted to the cycle of production and marketing. The due dates must coincide with cash income periods of the activities concerned.
- Credit must be granted through a negotiated contract. The contract must be recorded in the FI's books and the borrower's books, with explicit mention of rates, duration, collateral...
- The guarantee mechanism shall not contribute indirectly to standardized financial products that would not be suited to the needs of the farmers. This will therefore lead to a great variety of credit products tailored to different types of production, albeit taking into account the constraints in term of liabilities management.

The efficiency of guarantee mechanisms is determined by the following factors:

- speed: the guarantee mechanism must enable the granting of funds with a timeframe suited to both FI and client³.
- availability: the above mentioned funds must be backed by liquidity.
- flexibility: GM will not be attractive for MFI if the real conditions for its fulfillment are too unwieldy.
- ownership: who is the owner of the resources involved and who defines the management rules.
- sharing out of risk between FI in order to achieve a multiplying effect that maximizes the use of limited financial resources.
- effective legislation in place to enable guarantee.
- an honest appraisal of its quality by the credit institution.
- meticulous formalization of the contractual aspect.
- the monitoring carried out by the creditor in order for it to be available if it has to be implemented.
- credibility: for it to be effective: a GM must be credible. This entails that the amount set aside as reserves matches an identical financial asset.

³ Untimely disbursements are generally useless.

2.2 Different mechanisms to cover contingencies.

There is a wide range of instruments to cover contingencies⁴.

1. Mortgage: It is an interest (?) in. The property owned by the borrower is used as a security for a loan.(?) The property may be sold to the profit of the lender in case of default. Mortgaging requires heavy legal procedures and is therefore quite expensive. Its implementation is not always easy. In sub-Saharan Africa, more and more people talk about mortgaging the land to secure credit. However, very few situations would enable the implementation of mortgaging. Furthermore, mortgaging puts a huge burden of risk on the borrowers should the price of agricultural commodities fall. They then face bankruptcy and have to give up their land. In Africa, banks generally do not consider land assets to be a valid collateral.

2. Guarantor: the guarantor, a third party, promises to repay the loan if the borrower fails to do so. The guarantee can be individual or collective, simple or based on a solidarity group. It is a good loan guarantee if the guarantor is creditworthy and if the implementation is straightforward. In Africa, group guarantee is a widespread practice. However, it runs into numerous problems as it is often imposed indiscriminately onto large groups (village associations for instance) without taking into account existing social relations. In order to be effective, the groups, generally comprising between 5 and 10 people, must be organized by the borrowers themselves according to existing trust relations and common interests⁵.

3. Pledge: the article pledged can be impounded by the lender if the borrower fails to repay his loan. Pledge is generally applied to registered vehicles that cannot be sold without certifying that the vehicle is not subject to a credit purchase agreement. It is a simple, rapid and cheap system. The attractiveness of the system lies in the possibility for the borrower to recover full ownership of the good and on the maintenance of its predicted value over time. In Uganda, CERUDEB, a FI has set up a system of securing debt that relies on consigning goods from the borrower according to the value perceived by the client himself. The objective is not to set aside an asset that will cover the full value of the outstanding balance of the loan but to make the client aware that he will share the burden of risk should he default on his loan. CERUDEB consigns goods such as bicycles, furniture, cattle or even land without official title but with usufruct rights granted by customary law⁶. Leasing also constitutes a secured form of credit as the good remains under the ownership of the FI until full repayment is received⁷.

⁴ For more details, one can refer himself to a paper by Andre Neveu (Inter-Réseaux, 2000, in french). It can be downloaded from : <http://www.inter-reseaux.org/themes/financement/RTF/Neveu1.rtf>

⁵ See the paper by François Doligez (Inter-Réseaux, 2000, in French). <http://www.inter-reseaux.org/themes/financement/RTF/Doligez.rtf>

⁶ http://microfinancement.cirad.fr/fr/syntheses/docs/CERUDEB_final-04.htm

⁷ See the leasing example in Madagascar :

4. Agricultural warrant: it is a pledge on a harvest that cannot be sold until the loan is paid back in full. Stored harvests or harvests still in the field can be pledged. Although it is slightly complex in terms of management, it is a reliable and cheap way of securing credit providing the necessary legislation is in place. Collateral management through warehouse receipts is a similar system that is gaining more and more coverage. The farmer delivers his harvest to a warehouse and the warehouse gives him a bill of pledge for the bank. This system can finance, with a minimal risk for the banker, a harvest stored in good conditions. The farmer has access to cash at harvest time and can benefit from fluctuation in commodity prices during the following marketing campaign. This type of operation requires volumes large enough to cover storage costs. It is feared that such a system will mainly benefit traders who collect on their behalf the farmers' harvests⁸.

5. Delegation of payment: the buyer of the harvest will pay directly the lender on behalf of the farmer-borrower. The borrower must respect the agreed marketing arrangement and should not have access to alternative marketing channels (it is generally the case for cotton production). Straightforward and cheap, DP has a number of drawbacks: it removes all sense of responsibility from the producers organizations which can no longer evaluate the true need for credit of their members. Furthermore, this secure system creates an incentive for FI to develop in an inconsiderate manner their credit programs, officially taking into account the "complete range of expressed needs"⁹.

6. Security deposit: amount raised by the borrower in order to have access to a line of credit from a FI. This amount is generally given back to the borrower upon completion of the transaction. Many MFI have implemented the system of preliminary savings which is a form of security deposit. That deposit is generally the first resort of the FI in case of default.

<http://www.inter-reseaux.org/themes/financement/RTF/CECAM.rtf> and a general methodology paper on leasing : http://www.mip.org/pdfs/mbp/technical_note-6.pdf

⁸ Jonathan Coulter, Collateral management and warehouse receipts : tools for rural development in Sénégal, USAID and NRI, December 2000 and a comment paper by André Neveu for Inter-Réseaux. There is also a general presentation at : http://www.mip.org/pubs/mbp/warehouse_receipts.htm

⁹ Paper by Dominique Delacroixon securing credit, Inter-Réseaux, 2001.

7. Guarantee funds: a reserve of money managed in an autonomous manner in order to cover default on loans. Risk is shared out between the borrower (MFI), the lender (the Bank), the guarantor (the guarantee mechanisms) or even the final beneficiary of credit¹⁰. FI can set up their own GF¹¹ or join an interbank fund. Replenishing the fund (through transfer and contributions by borrowers) is the main issue as the total amount of secured loans cannot exist five to ten times the fund. The added security provided¹² by the fund is subject to debate along two major positions. Opponents consider that the GF creates no add and is therefore an obsolete instrument¹³. On the other hand, its supporters consider that, if used under certain conditions, GF is an effective development tool (supports entrepreneurship), although the issue of currency risk¹⁴ has still to be addressed. The pursuit of permanence of GM must no be detrimental to their purpose: the permanence of FI is more relevant than the permanence of GM.

8. Joint liability union: managed by informed professionals, its selects credit beneficiaries and provides a guarantee for a portion of the outstanding balance. They are very selective as their financial situation is often precarious. They mostly involve traders, small and medium enterprises and artisans¹⁵ which created substantial amounts of added value and benefit from comfortable profit margins that enable them to deal with future risks. For the very same reasons as above, they rarely involve farmers.

9. State guarantee: the state provides a guarantee to FI under specific conditions for loans granted to some specific borrowers.

Instruments and rules may exist to improve the operations of FI and to harmonize the policies of different IF operating in a given region. They complement the above mentioned range of tools for securing credit available to FI.

2.3 Improving management practices of FI.

Decision making and monitoring tools.

¹⁰ The borrower's understanding of the guarantee mechanism must not be an incentive for default. His contribution must therefore be important.

¹¹ With the possible participation of the State, producers' organizations and farmers.

¹² Mesure de l'accès effectif d'un emprunteur à des ressources grâce à la garantie

¹³ Classic GF can lead to lax management of funds by FI, MFI and borrowers therefore becoming inoperative.

¹⁴ MFI borrowing from overseas must be covered against currency risk. PRODIA in Burkina Faso had obtained a line of credit with AFD in FF prior to the devaluation of de FCFA and to repay the full amount...

¹⁵ See study on joint liability associations presented by PASAL (Guinea).

In order to secure credit, MFI must also make adequate decisions regarding their management practices and their policies regarding institutional strengthening, research, evaluation and control¹⁶. Among those measures, we will mention training programs for leaders from farmers organizations (to raise their awareness to their functions, responsibilities and tasks), organizational change and growth management, customer relation management (identification and care) and product innovation. Focusing on the above mentioned aspects should improve credit security through a better understanding of the borrowers, their environment and constraints.

From users associations to credit comities

Involvement of producers in the borrower selection process (Burkina Faso).

The year 2000 saw the creation of credit comities at the departement level (district). They bring together UNPCB, SOFITEX and CNCA to monitor the inputs requirements expressed by the GPC and brought forward by the ATC and CC. Every single application is appraised on the basis of the production trends of the past three years. The final decision is generally made at the provincial level. According to the UNPCB, out of the 2500 GPC having arrears and therefore not eligible for input credit, 1300 have been allowed to take out further credit (provided their arrears amounted to less then 1 million or they paid back 15 % of the outstanding balance) and 1200 have been eliminated. According to the same source, this year saw the stabilization of the debt after many years of increased debt¹⁷.

Credit reporting agency or credit bureau.

These agencies are often set up by the lending organisms and are there to assist MFI to manage arrears. They can be accompanied by a statistical institution that monitors indicators from the member FI¹⁸.

The members agree amongst themselves to update and disseminate information regarding clients with arrears as well as their financial statements and management indicators.

In order to manage the credit risk, a lender MFI makes an online request to the other MFI member of the database. The query deals with the client's debt level and his history as a borrower. It is above all a preventive measure. It tries to avoid putting clients in an excessive debt situation and to prevent them from taking a new loan from an MFI in order to repay an

¹⁶ See annex 1.

¹⁷ See paper by Jean-Claude Devèze (AFD).

¹⁸ See paper by CIDR.

older one due to a different MFI. In order to shorten and facilitate queries, the databases of bad debtors can be centralized.

3. Securing incomes: the farmers' point of view.

The previous chapter and its range of instruments dealt mainly with securing credit for the FI. There is therefore a risk of witnessing the emergence of healthy FI dealing mostly with wealthy clients in rural areas where impoverishment processes and vulnerable groups are still widespread.

From the farmers and rural households point of view, securing income is more important than securing credit. The producer will try to minimize the inherent risks of agricultural activities in order to secure its income base.

When dealing with the issue of securing income, one has to distinguish mechanisms to cover individual risk from those dealing with general contingencies (natural or economic). More generally, such mechanisms involve agricultural policy choices as well as public health choices. Although the direct instruments to cover risk (insurances, disaster funds) may be developed in some instances, their sustainability will rely on their articulation with sound rural and agricultural policies that, beyond securing credit and incomes, create a quality service environment.

3.1 Individual risk cover.

One of the main causes of default on loan lies in family accidents (illness, death) that generate unforeseen expenses and impede on agricultural activities¹⁹. With regards to the above, it would be interesting to develop health and death insurance. Such insurance products may be offered by the FI themselves or by specialized bodies, based on mutuality principle.

Mutual insurance Company of Bouahoun (Burkina-Faso).

¹⁹ Impact assessment study on 1000 borrowers of rural finance in 3 African countries (Benin, Burkina-Faso and Guinea) showed that 20% of loans failed to bring benefits because of health problems (F. Doligez).

The mutual insurance company of Bouahoun (MUSAB), organized around a health center, was created in 1992 on the doctors' initiative. The latter were looking for a solution to the problem of access to health services by the population. In 1997, for a monthly individual fee of 300 CFA, about a fifth of the population got free access to the health center services, an 8% rebate on prescriptions and free medical evacuation. A rise in attendance at the health center, resulting in a fall in epidemics (meningitis), a rise in maternal services has been noted. In 1997, the company contributed to about 10% of the center's budget.²⁰

However, the reduction of individual exposure cannot eliminate general contingencies inherent in agriculture in developing countries.

3.2 Managing general contingencies.

312. Individual responses to general contingencies.

In order to deal with the instability in harvests and incomes caused mainly by natural vagaries and with economic risks (price volatility), most family farms devise diversification strategies, in terms of production and income generating activities (non-farm activities). The involvement in social networks is another strategy deployed to minimize risk and face unforeseen events. These “de facto” strategies are rarely taken into account and supported through agricultural policy or development interventions. Most interventions rely on the development of a particular commodity chain without taking into account the diversity of farming and non-farm activities.

From this perspective, agricultural services reform, particularly technical and economic advisory services, is certainly a medium to long term factor that should contribute to securing the incomes of family farms. In order for it to be successful, one must give up standardized technology transfer models and move towards advisory formulas that take into account the diversity in farm and non-farm activities conducted by family farms. Several interventions have experimented with new advisory services involving management advice, technical and economic consulting, but also support for peasant exchanges and promotion of indigenous knowledge. This field of intervention may seem far removed from the issues facing FI. We can however foresee that the implementation of new types of advisory services to family farms will assist them in having a better command in the management of their farms. They will therefore become valuable clients for FI.

²⁰ Excerpt from Mia Adams (ADA Luxembourg) on mutual insurance companies.
<http://www.globenet.org/horizon-local/ada/c183.html>. CGAP website offers numerous documents on insurance products being experimented in developing countries.
http://nt1.ids.ac.uk/cgap/microinsurance/documents/doc_types.html

Numerous micro finance institutions foster, through their loans, the development of non farm activities. The sustainability of such endeavors and the ability of borrowers to honor their debts still rely on the existence of an enabling economic, commercial and legal environment supported and encouraged by adequate public policies (see workshop N°6).

These informal strategies are threatened by current trends (market liberalization, poor state of basic services) that increase social differentiation in rural areas and further weaken vulnerable groups. One must therefore imagine collective mechanisms, supported by the community (national and international), likely to minimize the damage done by contingencies and the shocks that they induced.

322. Collective responses to contingencies.

We can distinguish natural vagaries (climatic and epidemics) from economic contingencies (price variations). One must also consider political and military risks (military instability, conflicts, disintegration of States...) although responses to such events rely on politics and diplomacy and not FI and agricultural policy.

Managing such contingencies requires a global handling and an active political and financial involvement from the governments and the international community.

Climatic and sanitary risk.

Such risks are very high in developing countries. Several attempts at setting up disaster funds have failed as the funds could not face the high incidence of climatic disasters. Most voices tend to say that such countries do not have the means to set up proper cover, even of a partial nature. It is an easy way out of this outstanding issue. The World Bank is currently studying the possibility of designing suitable climatic insurance for developing countries. Such a cover is currently being experimented in Morocco²¹.

Drought insurance: what's new?

Specialists are currently experimenting with a drought insurance based on rainfall indices. Insurance would be based on the climatic accident itself rather than on the consequent agricultural losses. In the case of drought insurance, the policy would cover in case of severe

²¹ Jerry Skees and al., Developing Rainfall-based index insurance in Morocco, Policy research working papers n°2577, World Bank, 2001.

²¹ Source : Jaffee, Steven, Ron Kopicki, Patrick Labaste, Iain Christie. 2000, Promoting Agro-Enterprise and Agro-food Systems Development in Sub-Saharan Africa. Background paper prepared for the Vision to Action Update.

rainfall deficit (30% below average, for instance) measured in a regional meteorological station. The policy would be sold with a standard unit of insurance. All subscribers would pay the same premium by unit and all victims would receive the same compensation by unit bought.

In economically successful areas, initiatives may be developed by producers as long as they are linked to global mechanisms (reinsurance).

Peasant response to harvest risk (Mexico).

In the nineties, a new approach of self insurance funds is implemented. Funds are constituted by the fees from farmers and managed by farmers organizations (cooperatives, credit unions...). This fund is reinsured by an insurance company (AGROASEMEX). This approach, relying on peasant participation has been a success (142 funds in 1993) and enables the protection of farmers from harvest risk. However, it is limited to irrigated areas in Northern Mexico and only covers 3% of the national cultivated area²².

Price and market contingencies.

A major risk in agricultural is linked to the instability of agricultural markets and its consequences in terms of price volatility. Although the issue is well documented, no concrete measures have been set up to limit these contingencies. In some developed countries, mechanisms are in place to offer insurance against price and market risks to farmers²³.

This issue is linked to the debate on the regulation of international trade. The international community sees the need for the creation of sub-regional areas where price protection mechanisms could be put in place to support lucrative product prices for family farms. This perspective goes against the dominant liberal position but should be thoroughly discussed if the preservation and development of agricultural activities in rural areas remains an international priority.

Annex 1: Range of tools to improve FI practices.

Field	Tools	
Strengthening	Management	Monitoring portfolio and operations.
		General, analytic and financial accounting

²² See F. Doligez.

²³ The World Bank has a team actively working on the issue : <http://www.itf-commrisk.org/>

		Information and management system
	Strategy	Strategic and technical decision planning (includes legal framework)
		Operational planning (action plan, projections...)
		Training for elected leaders (roles, responsibilities and tasks)
		Recruitment and human resources advice
		Organizational change and growth management
	Tools	Applied computing for MFI
	Management	Elaboration of procedures manuals and specifications.
	Marketing	Technical approach to client identification and support (market study)
	Coordination	Identification and resolution of conflicts
		Human resources: “self esteem”, leadership, communication, negotiation...
Research	Financial products	Innovation, products and methodologies testing (insurance, savings, leasing...)
		Financing and sustainability of MFI (balance between actor, product and object).
	Non financial products	Information on commodity and outlets, trading, wholesale marketing
Evaluation	Techniques	Auto evaluation
		Institutional and external evaluation
		Impact assessment: development of financial, social, economic and environmental criteria

Controlling, audit and advisory services.	Practices	Rating ?
		Training of internal and external auditors
		Advise in structuring branches network
		Computerization of systems and audit: technical diagnosis, tailor made software, application to retail finance