

Six Myths of Farmer Finance

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Albert Einstein once remarked “*if I were given one hour to save the planet, I would spend 59 minutes defining the problem and one minute resolving it.*” Good advice, but unfortunately all too often forgotten. The British post office (Royal Mail) at one point tried to improve its next-day delivery rate from 98 to 99%, in an attempt to improve customer perception of its services. The effort nearly broke the organization, while it would have taken much less effort and resources to simply tell the UK public about the post office’s current performance — surveys showed people thought it was somewhere between 50 and 60%.

Whether in firm-specific innovation projects or in tackling global developmental questions, understanding the current problem and checking assumptions is a key starting point. This article presents contradicting evidence to a number of assumptions often made in the area of smallholder (or farmer) finance¹. It is not meant as academic research or a desk study — it combines a few data sources from around the world with my own observations in Indonesia and elsewhere. I would not want to replace one set of assumptions with others, but hope to stimulate some fact-checking on assumptions made in designing development projects or commercial credit products. To provide some structure, myths have been grouped into two areas: supply and demand.

Supply

Myth #1 - Farmers lack access to finance

“It’s a well-established fact that farmers lack access to finance”²

This is one of the most often-used opening phrases in agri-finance. It is easy enough to trace back – data on bank loans generally shows only a tiny portion of lending going to small farmers. Policy makers and project designers therefore conclude that any farmer credit offering will instantly meet with high demand. An important problem with this myth is that it violates an important rule of thumb: where there is demand, it is usually met in one way or another. The most important — and most often forgotten — answer to this puzzle is the informal lending sector.

In 2001, over 80% of world’s population relied on informal sources of finance.³ In Africa, of the 57% of families who used credit, the large majority (75%) did so from informal sources (mostly family and friends).⁴ If we focus on rural households, most survey results list family and friends, moneylenders, collectors, commodity traders and other informal lenders as the main source of

¹ In this article, the terms smallholder finance, farmer finance and agri-finance are all used to refer to providing credit to small farmers in developing countries. “Small farms” are farms of 5 hectares or less (note that this is not following official, country-specific definitions, but uses a global average to simplify our discussions).

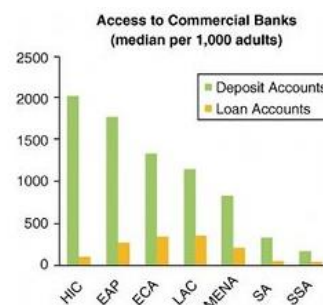
² The “quotes” presented are not taken literally from any one source, but paraphrased from discussions and texts.

³ WB, World Development Report 2001

⁴ AfDB, 2013.

credit.⁵ Research confirms that informal lending is a major source of credit for smallholders.⁶ Farmer household indebtedness in India in 2014 showed informal lending to be the largest source of finance, larger than banks and cooperatives.⁷ 86% of Chinese farm households were indebted in 2006, with 40% borrowing informally.⁸ In Africa, Nigerian informal lenders and cooperatives accounted for 75% of farm household borrowing in Oyo.⁹ Elsewhere on the continent, 55% of Ethiopian farmers had borrowed money; 50% from informal sources, against 28% formally.¹⁰ Vietnam, in 2010, saw only 28% of its farm households without any loans; informal lending was used by 37%.¹¹ In 2008, the large majority of Indonesian farming families (84%) indicated they knew where to go to get a loan; of those that applied, only 5% were turned down.¹² 46% of Indonesian cocoa farmers had experience with loans; 77% of them used informal sources.¹³

Another argument against this myth is that financial services (which ‘access to finance’ should refer to) includes more than just credit. In Indonesia, some 30% of cocoa farmers actually have a bank account, they just don’t use their banking relations to borrow money.¹⁴ We see a similar picture for most developing regions — deposit accounts with commercial banks are significantly more common than loan accounts (see picture on the right).¹⁵ We have to keep in mind that having a banking relationship does not mean farmers automatically have access to a loan with that bank, of course. Unfortunately, we have little information on bank loan application success rates; it does seem that access to financial services is much less an issue than farmers’ use of bank loans, however.



Overall, it appears that the statement “farmers lack access to finance” is too broad. Farmer do not use *formal, bank-based credit* a lot, but they seem to know where to get loans, and they lean on informal credit much more than on banks.

⁵ IFC surveys in Indonesia confirm this; in Ethiopia, a similar situation was encountered by Kadale Consultants (2012). Supply chain finance (by commodity traders) has elements of both informal and formal finance.

⁶ IFAD, 2014, writes that “informal markets have been and remain a major source of financing for most smallholder farmers.”

⁷ JBEP, 2014

⁸ Hu & Chao, 2006

⁹ AEFR, 2014

¹⁰ Komicha, 2007

¹¹ Le Thi Minh Chau et al, 2012

¹² IFSD4, 2008

¹³ All this is not new or totally ignored – the Initiative for Smallholder Finance (2014) highlighted the role of informal lending at the initial stages of rural development, usually overtaken by government and commercial lending as economies develop. For a much more elaborate review of informal finance, see Adams, 1992.

¹⁴ Swisscontact, 2015

¹⁵ CGAP & WB, 2010. Note that this data is for the population in general, not specifically rural or farmers.

Myth #2 - Moneylenders take advantage of farmers

“Sure, farmers can get a loan if they are desperate, but this puts them at the hands of greedy moneylenders and into a debt-cycle they can never get out of..!”

The non-transparent nature of informal lending – interest rates may not be stated, penalties are not clear, repayment may be in-kind, and so on – can lead to the conclusion that informal lenders are usurious, and they prey on the weak and desperate to maintain a cycle of dependence.¹⁶ This leads people to conclude that farmers will instantly switch to more formal types of lending when available, or even that policy objectives should focus on eliminating the informal finance sector.

In essence, this characterization of informal moneylenders is not unlike what has happened to used-car salespeople or lawyers in the West; over time, their profession gets a bad rep due to the behavior of the worst. The reputation of informal moneylenders is certainly not helped by occasional media reports that link farmer misery to moneylenders; in 2006 in India, a high suicide rate among farmers was blamed on moneylenders perpetuating indebtedness and misery, and a number of them were locked up. Rather than proving this reputation wrong (probably impossible as there is not enough data available), it would be more useful for us to look at the market mechanisms at play, and see if we can find data to provide a more granular picture.

Farmer surveys — at least in Indonesia — usually list multiple sources of informal farmer credit; family, friends, village heads, full-time money lenders, crop collectors, and agro-input shops are all mentioned. In most situations where there is no monopoly, any one lender who consistently abuses his or her power will be in business for, well..., one or two loan cycles at most. This does not discount the many examples of where moneylenders have taken advantage of their position, but it does mean that the informal lending sector as a whole (I would not dare to make a size estimate, but definitely larger than the entire formal agri-finance sector) needs a certain balance between risk and reward to function. In the Indian example earlier, the Indian farmers actually demanded the release of moneylenders who were locked up, as they needed their sources of credit.¹⁷

Unfortunately, information about informal lending interest rates is difficult to obtain; rates are not always explicit and can vary a lot by source.¹⁸ The scarce evidence available does point to higher rates; farmers in West Bengal, India saw moneylender rates averaging at 26% in 2014, substantially above commercial and group lending rates¹⁹. Going back further in history, rates across countries in Africa (1997) were 50% higher than formal sector rates.²⁰ In 1990, informal rates in Thailand

¹⁶ MIT (2010) confirms this image, stating that ‘Moneylenders are routinely characterized as exploitative monopolists who systematically squeeze the poor. The poor, for their part, are seen as vulnerable, drive to pay usurious rates out of desperation.’ (p31). The LSE Asia Research Center (2010) goes as far as labelling informal money-lending in East Indonesia as a ‘problem’, stating that “rather than keeping the *rentenir* problem hidden, governments must address the money-lending problem head on.”

¹⁷ Confirming that the informal sector adheres to market dynamics too, The Journal of Development Studies (1987) found evidence of “... the reduction of moneylender monopoly power as a result of increased competition from formal lending agencies. It concludes that informal rural credit markets are sensitive mechanisms which respond to environmental as well as borrower characteristics.”

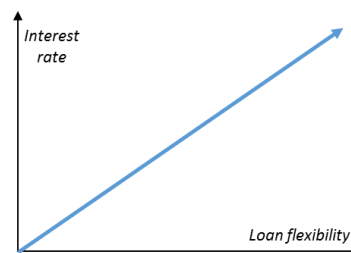
¹⁸ Credit from crop collectors or agro-input shops, for example, serves the underlying sale/purchase, and is therefore usually provided at lower rates.

¹⁹ Maitra et al, 2014.

²⁰ MIT, 2010 (The Economics of Microfinance).

were some 46-48% higher than commercial bank rates. In the Punjab region of India (1968), informal moneylender rates were found to be ‘far higher’ than commercial bank rates.

Other sources confirm that informal lending generally is more flexible, but comes at a premium over formal credit.²¹ It appears that where more flexibility is required (no collateral, fast money, more personal contact, individual loan terms, possibility to roll over, and so on), the cost of lending goes up. The diagram to the right present the simplified logic.²² Perhaps informal lending is somewhat like credit card debt for the modern, urban consumer — we all know card companies charge very high interest rates, but appreciate the flexibility, and do lean on it occasionally when we’re in need, without (always) blaming the industry for our woes.



Besides interest rates, we can also look at farmer preferences — if bank lending is so much cheaper, surely farmers must prefer it. In 2012, an IFC survey put farmer preference between banks and middlemen pretty much equal, even after 1-2 cycles of bank lending (banks scored 3.3 out of 5; middlemen 3.2). Farmers liked banks because they expand their (social) network, and provide a more transparent product. They like middlemen because loans are more flexible, can be turned over, and come to their house. Surveys in Ethiopia found that while farmers considered informal interest rates high and not suitable for longer-term borrowing, they appreciated the availability for when they urgently needed money²³. Recent surveys in Indonesia suggests that farmers who borrow from local traders actually receive a better price for their cocoa than those that do not.²⁴ It is not clear what exactly is at play here, but it seems to contradict the idea that farmers live at the mercy of middlemen who abuse their power position for their own enrichment.

The informal sector itself is far from uniform, and rates, terms and conditions vary substantially. Informal interest rates tend to be higher (at least with professional moneylenders), but lending is more flexible (more personalized and faster). Overall, farmers seem to appreciate the informal offering and accept the difference in terms, recognizing the limitations of using informal financing for longer term investments. All this paints quite a different picture from ‘usurious moneylenders praying on the weak and desperate’ that we find with some frequency in agri-finance discussions.

²¹ Note that I am not drawing any conclusions about whether informal finance is a useful replacement for bank-based loans. Given the higher cost of informal credit, it may be less suitable to help a farmer escape poverty by buying additional inputs, as she’ll be facing higher borrowing costs as well.

²² Only commercial informal lending complies with this logic, loans from family and friends should be excluded.

²³ Kadale Consultants, 2012. Komicha (2007) found that “...*The fact that most farm households borrowed from the informal sector, although this sector charges more interest rate than other sectors, suggests that factors other than the interest rate, e.g. loan-processing time, type of loan, credit information and loan size had more weight in determining farm households’ borrowing behavior from a particular sector ... Timeliness of the loans is thus an important factor, especially for farm households since they are engaged in farming activities where input uses need to match the natural process in agricultural production.*”

²⁴ SCPP, 2015.

Myth #3 – Banks only think that farmer lending is riskier than other types of credit

“Banks are unwilling to provide farmers loans because of the perceived higher risk of the sector”

Technically, this is not a myth but a factually correct statement. In most cases, however, the use of the word ‘perceived’ has the purpose of at least suggesting that banks only *think* the risks are higher, while this may or may not actually be the case²⁵. This suggestion leads to the conclusion that if only banks got informed and involved in the agri sector, they would find the risk to be manageable. So, is farmer finance really riskier than other lending?

Practically, we run into a few problems answering this question. We can look at the default rate of farmer loans, but if banks are already more selective in financing farmers, this may not provide a good comparison. Any evidence is almost necessarily not conclusive, because so many different experiences and models exist across the world. Also, it is surprisingly difficult to find data on default rates in the first place, given how important this is to assess loan risks.

We know from global experiences in smallholder finance that farmer defaults are influenced by a range of parameters: production and income levels, understanding of where the loan comes from (anything government-related is usually not great for repayment²⁶), behavior of the (peer) group, perceived consequences of default (collateral), the organizations involved (where there is more than one partner), and probably a number of other factors we have not fully mapped out yet. Large, limited-time government credit schemes usually fare the worst; conservative, commercial lending based on existing relationships tends to get more positive results²⁷.

For smallholder finance, risks tend to divide out into four groups: market, crop, weather, and farmer risk. The first three risks all relate to the business of farming. All businesses face these risks, but volatility tends to be less severe. Some data are helpful -- comparing market (price) risk between agriculture and, say, manufacturing, data suggests agricultural (crop) prices showed 19.6% annual volatility, while manufacturing prices only varied by 2.4%²⁸. We could express weather risk in the same way, but given that both crop and weather risk ultimately play into agricultural output, we can simply look at that and compare it to the output of a shop or small factory. Between annual volume of agri production in Indonesia and retail sales volume for 2000-14, we find that volatility for corn and green coffee are 11.4% and 13.7%, respectively, while retail sales volatility only measured 3.2%. In other words, both volume and price of agricultural production are more volatile than comparable sectors like manufacturing or services²⁹. Note that we are not disproving a myth

²⁵ Note how this topic relates to the discussion on interest rates further on – if rates are an expression of the riskiness of a loan, higher risk means higher interest rates.

²⁶ For example, Uboh (2008) found that 59% of farmers in Akwa Ibom, Nigeria defaulted on a government-initiated agri-finance scheme during 1990-2003.

²⁷ IFAD (2003) lists various examples of commercial, private sector farmer loan schemes in Africa that have achieved (near) 100% repayment rates (Zambia, Mozambique), while it also mentions a government fertilizer scheme with a recovery rate of just 6% (Zambia).

²⁸ Data for 2009-2015 from StatCan (Canada), looking at monthly price indices for crops and manufactured goods. Percentage represents annualized standard deviation of index differences month-by-month. The choice of Canada is random, but as most prices follow international market movements, this is indicative for a general trend.

²⁹ Note that to be complete, we would need to look at correlation between price and volume as well. Given that this would only worsen the picture for agri commodities — if both are strongly correlated swings are extra pronounced, while if they are not correlated they may reinforce or soften each other — I have not done that here.

here, we merely analyzed the available data to find out if the assumption that agricultural production is indeed more risky than other productive activities.

On willingness to pay back, there is unfortunately almost no data to compare farmers to other groups of borrowers at this moment. There are some promising developments in this area; EFL, a ‘fintech’ providers that tries to measure people’s willingness to repay, has developed a questionnaire that financial institutions can take on their loan applicants, and arrive at a risk segmentation. Unfortunately, not enough data is available from these recent data-based innovations to allow us to compare farmers with other groups. At times, we encounter arguments like ‘farmers are superior repayers’, based on a mix of wishful thinking and the concept of ‘nobility in poverty’ around smallholder farming. Still, there is no data or generally accepted psychological or economical argument for farmers being any more or less inclined to repay a loan than small business owners, salary workers or any other group of borrowers.

Data on repayment is so scattered it is almost impossible to draw any conclusions – there are a number of examples where zero defaults have ever happened with particular farmer groups, while IFC experienced up to 88% default rates during one of its cocoa loan programs in Indonesia. Risk-based data suggest that smallholder finance involves risks that are significantly larger than for other productive sectors, without considering the additional risks incurred when partnering with supply chain companies to reduce repayment costs and effort. Overall, the idea that banks would become comfortable with agri lending as soon as they would get involved in the sector is hard to sustain.

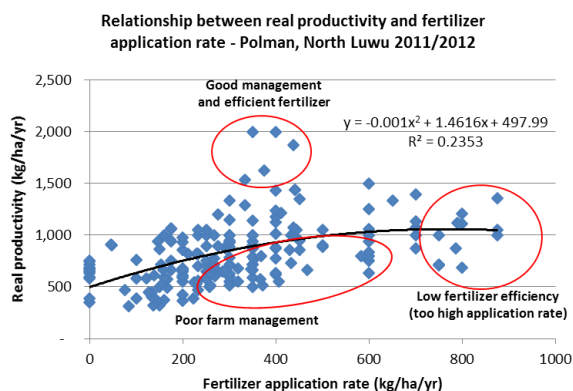
Demand

Myth #4 - Farmers don't apply fertilizer because they can't afford it

“Farmers would love to buy fertilizer and increase yields, they just don't have the money”

Many people approach the topic of smallholder finance by assuming farmers really want to buy fertilizer and other costly agro-inputs, but don't have the funds (this reasoning is often used to explain low farmer productivity). The consequence of this myth is straightforward; provide credit and farmers will purchase and apply fertilizer.

Our field-level data do not confirm this myth, however. First off, agronomically speaking not all application of fertilizer is money well spent. For various crops, farms need to be ‘fertilizer-ready’ before additional nutrients results in higher yields. Farmer surveys done for the IFC’s Indonesia agri-finance project found only a weak correlation (R^2 of 24%) between the fertilizer application rate and real productivity³⁰ hectare (see figure to the right). In that same project, we also found that most farmers were applying fertilizer already, just not in



³⁰ Normalized for 1,000 trees per hectare.

the recommended amounts³¹. Macro-level data for Indonesia confirm this—farmers (overwhelmingly smallholders) were using an average of 192 kg/ha in 2010-12³². Other countries have different characteristics, of course, but fertilizer is used almost everywhere to some degree.³³

So the crucial question appears to be why farmers do not apply the optimal amount of fertilizer. The results of research around farmer decisions do not tell a clear story, unfortunately. Econometric models of farmer decisions apply the concept of ‘risk aversion’ to explain why farmers do not apply fertilizer to the point where the cost equals the expected return.³⁴ In cocoa in Ivory Coast, research found most farmers (87%) to be ‘extreme to moderate risk averse’.³⁵ Other studies highlight the importance of a myriad of decision factors. In Kenya, having off-farm income is an important reason not to apply fertilizer (no further explanation given);³⁶ another important factor is social interactions.³⁷ In Vietnam, a general lack of trust between farmers was an important reason for limited cooperation and input buying between them.³⁸ Malawi farmers’ household wealth and food security are important determinants for fertilizer use.³⁹ In Northern Ghana, research found many significant factors contributing to fertilizer use intensity with smallholders, but access to credit was not one of them.⁴⁰

The honest conclusion is that in 2015 (the time of writing of this article), we do not know enough about farmer decisions to draw firm conclusions. Fertilizer and agro-input application is not always a guarantee for higher yields.⁴¹ Farmers seem to understand that taking out a loan to finance inputs that may or may not result in higher income is risky – not the ‘no-brainer’ it is often assumed to be in agri-finance discussions.

Jared Diamond noticed the difference in approach between farmer decision-making and modern profit-maximization strategies. He argued that historically, having one bad year for farmers meant they would perish. As a result, their ‘investment decisions’ have to be based on loss minimization rather than output-maximization. This applies to loan decisions as well—farmers know that if the 1-in-10 event happens (floods, plagues etc.), they will literally lose the farm.⁴² While this

³¹ Cocoa farmers used 300 kg/ha fertilizer without project intervention (recommended dose is 500-700 kg/ha).

³² <http://data.worldbank.org/indicator/AG.CON.FERT.ZS>.

³³ In Kenya (1998), for example, Hassan et al noted that “*Kenyan farmers apply lower rates of inorganic fertilizers on their maize crop than is considered economically optimal.*” Note that Africa still very much lags behind other parts of the world; here, the argument that farmers do not use fertilizer is more difficult to disprove there.

³⁴ See for example Sheahan et al (2012). Researchers often use a factor 2 for this risk aversion, implying that farmers only apply extra fertilizer if the expected returns are at least twice the cost of the additional fertilizer.

³⁵ Ben-Houassa, 2011. The two most important other determining factors were education and coop membership; access to credit (having had a loan in the past 12 months) was not statistically significant.

³⁶ Mathenge and Smale, 2013.

³⁷ See Gathiaka, 2011 in ESJ.

³⁸ SNV, 2012.

³⁹ FAC, 2012.

⁴⁰ SAN, 2013.

⁴¹ SCPP (2015) found that in Indonesia, 75% of cocoa farmers did not think unsubsidized fertilizer was profitable.

⁴² See for instance Diamond (2006) – How Societies Collapse.

observation is not a conclusion, it provides an alternative hypothesis to farmer decision making—more research would be required to test it.⁴³

Myth #5 - Farmers desperately want to borrow money

“The demand for smallholder finance is enormous – only a tiny portion of it is met”

This is a slightly more complicated myth, based on various underlying assumptions. Dalberg, in an oft-quoted study, put the global demand for smallholder finance at around \$450bn, for example⁴⁴. There are many smallholder finance projects and initiatives that use aggressive growth targets, assuming that once the product is available demand will instantly be strong⁴⁵.

If we leave aside the distinction between financial services and loans for now, there are three arguments against the simplification/assumption that most/all farmers need credit. First, an argument from economics. Demand for a product depends on the price. Saying there is a \$450bn demand for credit but not specifying at which price is an incomplete statement at best. As one of my favorite (albeit somewhat silly) ‘counter’-examples, I am sure there is a high demand for \$100 Ferrari’s, but sadly no one foolish enough to provide them. If the (implicit) argument is that there would be a \$450bn demand for credit at very low interest rates, the question then becomes whether any provider is able to issue loans at this rate and survive.⁴⁶ Unfortunately, the dynamics of banking in general (and agri banking in particular) usually do not allow for this.

Second, recall the earlier rule of thumb that a demand usually is met in some way or another. This means that if there really is a desperate demand for this much credit, at least part of it will be met by other sources (informal sector). So ‘filling the gap’ between demand and supply in effect means changing the money flows from the informal to the formal sector. Not a bad thing, of course, but it does have implications for the current situation (one of them being slightly peeved informal lenders...). We consistently find that farmers appreciate the informal offering (flexibility, speed, personal care). Assuming that by simply offering a cheaper product all that demand will instantly shift is usually not borne out in practice⁴⁷. Moreover, the point of ‘unmet’ farmer credit demand is contentious – credit is available, just not at conditions that appeal to farmers.

⁴³ A testable hypothesis would be that farmers purchase and apply agro-inputs to a level that they are comfortable with – one that does not risk losing the farm if a calamity happens. This may explain under-utilization of fertilizer by smallholders; it would also suggest that weather or crop insurance could be a useful instrument.

⁴⁴ In a ‘directional’ estimate, Dalberg assumes half of the world’s 450m smallholders are non-subsistence (and therefore need credit), and estimate their needs at \$1,000 in short-term and \$1,000 in longer-term financing.

⁴⁵ Examples: myAgro, a Malinese non-profit providing a range of services to farmers, was serving 3,500 farmers in 2014 with an agri-finance product, and aims to increase this to 75,000 by 2017 (NPM, 2014). In 2012, DfID funded Stanbic Bank in Nigeria for an agri-finance project of 5m farmers in 5 years (BIF, 2012).

⁴⁶ A good example can be found in Pavliashvili (2009), who writes that “Over half of the respondents said that they would very or pretty likely (55%) take up a loan that would be tailored to their needs. These findings show that overall credit demand is very high.”

⁴⁷ IFC’s farmer lending project in the cocoa sector in Indonesia (2013), for example, saw only 50% of its farmer targets reached due to lower-than-expected demand for bank lending.

Finally, the broad assumption that most or all of the farmers need credit does not hold⁴⁸. To start, a number of farmers operate very thin margin or loss-making operations. These farmers should not get credit simply because they can't afford even subsidized costs of lending. At the other end, farmers who do well hopefully don't need credit because they have been able to save enough to pre-finance their operating expenses. That leaves only an inbetween group of farmers (let's call them 'progressing'), who are running a decent farm but can use a loan to help further improve their operations until they have enough retained earnings to pre-finance their expenses themselves⁴⁹. Surveys from 2008 in Indonesia indicated only 17% of farm households had sought a loan in the preceding year⁵⁰.

Even if a majority of households is indebted in one way or another at any one time, there is very little evidence that most or all farmers should be indebted as a sign of best-practice. The most direct way to measure this demand are farm-by-farm surveys asking farmers whether they would be interested in a loan product with conditions x and y; unfortunately, most organizations do not invest the time and money in this type of market research before rolling out agri-finance loans.

Myth #6 - Farmers should get a fair interest rate

"Smallholder cannot afford the high rates charged by micro-finance and moneylenders – they deserve affordable loans..!"

This topic tends to evoke a lot of passionate debate, probably because it includes both assumptions about farmer preferences and personal policy preferences around interest rates. On the latter, the agri-finance world is littered with examples of where people and projects have used that approach to govern their work. This is definitely not a bad thing by itself—it is probably the reason for the widespread government involvement in farmer lending, offering farmers a cheaper (albeit usually more cumbersome) source of finance⁵¹.

Emotions can run high; just a few years ago, Latin America saw various governments instigating campaigns to occupy micro-finance organizations to protest the high interest rates charged, and led to *usura zero* (zero usury) government loan schemes in a number of countries. Some argue that farmers in the developed world enjoy so much protection and subsidies it is only fair for farmers in low-income countries to receive some support as well. When discussing agri-finance opportunities with corporate partners, a number of them argued that the reputational risk of being

⁴⁸ To be fair to Dalberg, they did acknowledge that 'subsistence farmers' were probably not good loan candidates, and excluded 50% of global farmers from their estimate based on that. This still gets us to where all commercial farmers, in their view, demand \$2,000 in credit each.

⁴⁹ The SCPP in Indonesia divides their farmers in 3 groups. On the lower end, their 'unprofessional' farmers are not considered viable loan candidates (around 55%). At the top, 'professional' farmers are good prospects, but do not always need loans (9%). The middle category (36%) is the prime target for their banking partners.

⁵⁰ IFSD4, 2008.

⁵¹ ISF (2014) argues that governments often become dominant in agri-lending as a 'second wave' – after informal lending, but before commercial lending.

associated with charging farmers high rates trumped their desire to provide. More in general, the high rates paid by farmers often evoke a sense of injustice.⁵²

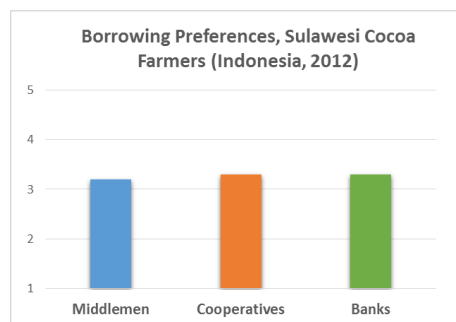
Let's first deal with the uncomfortable truth. Large, collateralized (safe), urban loans are just cheaper and easier to provide than small agri-loans in our current financial infrastructure⁵³. There is something perverse about the fact that a millionaire can borrow money at 1-2%, while a small farmer needs to pay up to 20 times that rate – it's just not something that we can easily change.

If we accept that interest rates are a reflection of loan costs and risk, it may become somewhat easier to accept that farmer credit is more expensive than large corporate loans. The question then becomes whether we should promote lower interest rates or leave it to 'market forces'. Here, there are few misperceptions at play – it is simply a matter of political and policy preference. However, it is important to accept that we cannot have our cake and eat it; if we agree farmers should benefit from lower rates someone will have to pay for it (usually a donor or the government). If we leave it up to the market, we avoid that bill, but we may have to live with higher interest rates. What is not 'fair', however (and yes, pun intended...), is to blame the financing industry for higher rates as if they purposely increase interest charges to take advantage of a poor and powerless population.⁵⁴

But do farmers actually care as much about the interest rate as we believe? It's probably safe to assume that all else being equal, farmers would prefer lower interest rates over higher ones. Still, through our project work we have often been surprised by farmers' pragmatic approach to interest rates – if they get flexibility in return, they are often quite happy to pay the higher costs. We found farmers tended to look more at the cost of the loan (e.g. I get \$300 and I have to pay back \$350).

When IFC started a project providing loans with the above characteristics to farmers (for nine months), we immediately took out our calculators to get at the annualized, compounded interest rate of our loan product (and it took us a while...) You can imagine a farmer with limited financial education not being that interested in knowing the rate he is paying up to the basis point – she just wants to know she can afford it, and that she'll get more out of it than what it's costing her.

Taking surveys from our farmers, we also had difficulty getting to the rate they were paying with local collectors. The most often-heard answer was "*I don't pay any interest to my collector*". We may smile and put this on a lack of understanding, but it should not be ignored that farmers think they do not pay 'extra' for borrowing money. Another interesting observation from our project work was that even after working with formal banks, farmers still had overall similar appreciation of the two sources of finance (see diagram to the right). Recent data from the cocoa sector in



⁵² LSE Asia (2010), for example, states that "as long as the poor must pay 10% to 50% per month they will remain poor," and calls for the government to address the problem and get rates down to 3-5% monthly.

⁵³ Put differently, cost of lending is critically determined by loan size, transaction costs and risk profile. Farmers are on the expensive end of all three of these parameters.

⁵⁴ The question of whether the global agricultural system itself is fair to smallholder farmers is different, and left out of scope for this article.

Indonesia found that up to 42% of ‘professional’ and 46% of progressing farmers thought that ‘high interest rates are ok, if I earn my money back.’⁵⁵

Overall, the question whether farmers deserve low interest rates is impossible to answer with just data (since it is a policy preference statement). What we do find is that ‘fairness’ of interest rates is a difficult topic (both loan risk and costs suggest farmers should pay a higher interest rate), and that farmers themselves are often not as focused on interest rates as we assume.

Conclusions

The only true conclusion of this article can be “challenge your assumptions, and use factual information to guide whatever project efforts you are planning”.

Still, looking at the prevalence of the myths presented in discussions, documents and presentations on agri-finance, perhaps some more practical tips for anyone about to set up a new smallholder finance project somewhere.

- **Farmers may already have access to finance**, just not to lower-interest bank loans. Understand the current landscape, and define your loan products’ key benefits (instead of assuming farmers will all immediately flock to you because there is nothing out there)
- Despite the bad apples, the flexibility offered by informal lenders (middlemen etc.) is generally appreciated (and used) by farmers. Don’t assume that just because the interest rate you offer is lower, you will reach 80% of your target population within 1-2 years. Again, **spend time telling farmers about the benefits of your product** compared to others, do not assume the product will sell itself because farmers have no choice.
- **Farm risks are real**, and higher than for many other sectors. For a bank, this means extra provisions, so be aware of that – in particular when talking to banks – and do not assume they have stayed out of agri lending only because of ignorance or unfamiliarity.
- The decision on agro-input use is determined by a lot of factors, and in some cases access to finance plays only a minor role. If an agri-finance project’s aim is to promote yield and income increase through more professional farming methods, **collect data on farmer decision making** before getting started.
- **Not all farmers should get loans just because they are farmers.** Take this into account when setting targets, and if insurance could help farmers in dealing with adverse nature events, consider it.
- **Farmers may not care as much about interest rates as you think.** If you’re set on low rates, get donors or governments to subsidize – don’t expect a commercial operator to provide a flexible, risky loan at a low rate. Mostly, make sure your loan product is what farmers need and want, and the discussion on percentage points usually loses its urgency.

⁵⁵ SCPP, 2015. Note that only 17.3% of ‘unprofessional’ farmers agreed.

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