PN-AAY-055 0

The Business of Small Farmer Credit

By: Jim Cotter

A recent study of AID's small farmer credit projects contains both bad and good news.

The bad news is that many rural credit institutions charge too little interest, have excessive overhead expenses, don't get money to the intended poor farmers and would be bankrupt without bail-out subsidies from donors and host governments.

The good news is that AID now recognizes that rural credit can and must charge sufficient interest to pay its own way and that this will not discourage farmers from getting production loans. AID has also been successful in convincing host governments that subsidizing credit institutions which offer loans below actual market costs is counterproductive and wasteful.

"Our study of AID small farmer credit projects showed that many rural loan organizations are not financially viable," said Joseph Liebenson of AID's Center for Development Information and Evaluation (CDIE). "Their operating costs greatly exceed income and there is little immediate prospect of financial solvency. In fact, if donor LDC funds were removed they would be rapidly decapitalized and become bankrupt."

The CDIE study strongly advises AID and other donors to abolish or set time limits on those subsidies and force institutions making loans to small farmers to charge sufficient interest to cover real costs.

The study found that good farmers, using efficient technology, were able to profitably increase their output and pay market rates of interest without subsidies. Many of these farmers were already paying above market rates of interest to local moneylenders.

The CDIE study conducted an extensive review of some 150 evaluations of small farmer credit projects and a detailed assessment of 50 projects.

"An examination of both the original project design and project operations showed that many projects were not structured to reach financial viability," Liebenson's report explained. "While 90% of the projects had institutional development as a goal, only 18% included financial viability as a goal. We were also struck by the fact that only about half of the evaluations examined loan delinquency rates and very few quantified default rates."

The study showed that unsuccessful projects had delinquency rates ranging between 10 and 75%, with the majority within the 25 to 50% grouping. Successful projects tended to have delinquency

rates below 5% and not exceeding 15%.

The relative ability to cope with inflation was a critical factor. Raising oil prices affected inflation rates in 1973. But the second oil shock in 1979 made inflation a serious problem in nearly every LDC credit project. When loan terms don't reflect high inflation rates, the institution will steadily lose capital. Institutions which are able to recover loans, but are being repaid in rapidly depreciating currency cannot survive for long.

For example, when inflation is running at 10% , the nominal costs of lending to small farmers would be in the range of 27 to 35%. Lending programs which were charging a nominal rate of 6 to 12% were experiencing negative rates of return because farmers were not paying the true cost of that credit.

Administrative overhead also tends to be higher for institutions making loans to small farmers. The World Bank estimates that institutions making loans to medium and large farmers can operate at an administrative cost of 3%. However, efficient small farmer administrative costs ranged from 5 to 10% of their total portfolio. Unfortunately, many of these institutions proved to be far more expensive to operate.

"A number of projects were designed to create and support LDC cooperatives and credit unions,"the LDC report explains. "In Africa, they often required large doses of commodities, capital, expatriate advisors and training. It was also necessary to provide technical assistance to establish effective bookkeeping and a funds-control mechanism.

"At the end of five or more years, many of these projects had created a respectable and in some cases impressive institutional framework. However, the high manpower and administrative costs meant that financial returns were low. Many of these projects were able to cover only 10 to 30% of their operating costs. Overhead costs were way out of line with the revenue base."

The report cited several project experiences which tended to follow that pattern. The Lesotho Credit Union Development project had significant technical assistance and training inputs which generated rapid growth in co-op membership. It also resulted in the creation of new co-ops and large increases in savings and loans. However, low interest rates, a loan delinquency rate of 25% and extremely high administrative costs meant that co-op revenues covered only 30% of expenses. Without concessional capital, it would have been rapidly decapitalized.

The Union of Cooperative Projects in Malawi had similar success in encouraging co-op development, but failed to reach financial viability.

One adverse effect of low interest rates is that they create an excess demand for credit which tends to force financial

institutions to ration credit. Rationing discriminates against small farmers who are seen as too risky to serve because they lack traditional collateral and require costly additional service time. Rationing of credit takes several forms including: loan refusals, increased costs for loans, the need to fill out exhaustive forms, bribes and the need to spend long periods of time waiting in lines.

The CDIE report on project experiences suggests several alternatives to using land as traditional collateral which tend to be more successful in responding to the needs of small farmers:

- Appraising the productive capacity of small farm holdings to determine the credit-worthiness of loan applicants.
- Assuring that the loan will be used for productive and economically viable purchases rather than for consumer goods.
- Use chattel mortgages on equipment, cattle, chickens, etc.
- Make liens on crop production. This tends to work best when repayment is coordinated with crop marketing and is most effective with cash crops.
- Use group loan guarantees. This approach tends to work well when the loan is made publicly to groups such as co-ops and the members are collectively and individually responsible for the loan.

AID has made significant progress in becoming more responsive to the needs of small farmers. In recent years, largely because of AID's increased emphasis on policy reform, credit projects have begun to face the interest subsidy issue.

In the Egypt Small Farmer Production Project, the AID mission negotiated over time to raise project lending rates from Egypt's normal bank rate of 6% to 10% and eventually it was increased to 14%.

In Bangladesh, the Rural Finance Project and its predecessors included an experiment to test interest rates of between 18% and 36%. The project was able to demonstrate to the government that agricultural credit could be successful at rates much higher than had been previously used.

This illustrates that farmers can and will pay market interest rates. In most countries, they are already repaying loans to village money-lenders at substantial rates of interest.

The CDIE study showed that most small farmers are reluctant to borrow money. When they do, it is from friends , relatives or moneylenders rather than from formal lending institutions. The informal money-lender enjoys certain advantages over formal

lending organizations because his or her operation is usually limited to one village. Therefore, he or she tends to be better at:

- o Selecting borrowers
- o Controlling response time
- o Enforcing repayment
- o Adjusting loan terms
- o Maintaining lower administrative costs

However, informal sector money-lenders tend to be relatively ineffective at:

- o Mobilizing savings
- o Providing any technical assistance
- o Making loans for productive purposes rather the consumption (they tend to have no preference).
- o Making loans for large investments in new technology

The money-lender is also often a wealthy member of a religious or ethnic minority. He or she often attracts animosity for this reason or because the interest and/or hidden charges are believed to be too high and exploitative.

Small farmer's access to institutional credit varies in different regions. For example, in Taiwan, nearly all farmers have access to institutional credit. However, in many African countries, less than 1% of the farmers use institutional credit. The World Bank estimates that about 5% of African farmers receive institutional credit compared with about 15% in Latin America and Asia.

The report cites several reasons which help explain why small farmers tend not to utilize institutional sources of credit. They are also at a significant disadvantage when competing with mid and large scale farmers.

"Small farmers lack the socio-economic advantages (literacy, language competence, confidence in dealing with an institution) that larger scale farmers possess. They are often intimidated by the lending agency's rigid procedures for processing loans.

"These procedures can include having to complete complex forms by farmers who are often illiterate and a breadcit of the borrower which requires a visit by an official to his or her landholding. When the loan is eventually made, the funds and documents have to be collected at the lending institution's office which is often far from the farmer's landholding. Also, repayment terms tend to lack the flexibility needed to accomodate the natural hazzards of farmers."

Even when small farmers are specifically targeted to recieve loans, agricultural credit agencies tend to channel the majority of their lending to medium and large scale farmers. World Bank estimates for Pakistan, the Philippines, Thailand, Tunisia and

Bolivia show that 5 to 10% of the farmers in those countries receive 70 to 80% of available institutional credit.

The study also includes cases in which relatively wealthy farmers were able to "capture" projects and draw benefits away from AID's targeted small farmer beneficiaries. For example, in the Bolivia Small Farmer Project ', better-off members gained control of the co-ops. Project funds were then, to a large extent, used for land-clearing, tractors and other equipment to benefit larger land holders.

Even when benefiting small farmers is the stated policy of an LDC, loans are frequently diverted from small farmers to their relatively more wealthy neighbors. For example, the Government of Kenya had a policy to make the co-op system the major conduit of loans for small farmers. However, an evaluation summary of the Kenyan Agricultural Credit Project complains that only 25% of the loans went to small farmers.

There are LDC policies which tend to discriminate against the rural sector. These include cheap food prices for urban consumers, high taxes on export crops, cheap capital and others. The report advises the LDCs who want credit to reach small farmers should focus (at least initially) on short term production credit. Medium to long-term credit tends to be "captured" by wealthier farmers.

The CDIE report stresses that subsistence farmers require large amounts of training, institutional development, support services and infrastructure without which there is a high risk of failure.

"Successful projects included technical assistance and training for loan officers and bookkeepers. Projects that failed almost always lacked an effective training component.

"The key factor in the success of these programs was the ability of the local loan officer to judge the character and credit-worthiness of a borrower and the profitability of a proposed investment. An additional factor is the accounting and loan monitoring system because many institutions don't know who owes how much and when payments are due."

The report contains a brief check list for rapid assessment of management and institutional capabilities:

- o Did loan officers know how to assess credit needs?
- o Were loans provided in a timely manner?
- o Were accurate records and controls maintained?
- o Did the lender have a management information system which could identify problem loans at an early stage in order to work with the borrower to assure repayment.

The report also listed factors which do not seem to influence project success.

"The thoroughness of a loan application form and the number of bureaucratic levels of loan review had little relationship to repayment rates. The same could be said of the type of collateral used or whether a borrower had co-signers."

The report's recurrent theme is that it makes little sense to start a credit program without suitable technologies and support services such as inputs, extension and marketing. However, in many projects these factors exist but proved to be inadequate. This resulted in:

- o Yields well below anticipated levels
- o Improved seed, fertilizer and extension services not available in a timely manner
- o Crop prices and marketing arrangements failed to meet expectations

For example, the Tanzanian Resources for Village Production and Income Project was designed to strengthen rural delivery systems. However, a shortage of production inputs contributed to the failure of the project.

The Small Farmers Development project in Haiti failed because an improved technology did not exist.

Another central point in the report is that farmers are businessmen competing for scarce capital resources.

"The farmer, like any other businessman, must have profitable investment opportunities or it makes little sense to lend him or her any money," Liebenson explained.

For example, in Niger's Niamey Development Department project, the rate of return achieved by farmers in good years was only 17%. In bad years it was 8%. Such a low rate of return, and the fact that every third year was bad, meant that farmers could not generate a rate of return high enough to cover the costs of purchased inputs. It made more sense to use traditional, unimproved technology which required few purchased inputs and yielded a more assured return.

The report was critical of the assumption that providing credit will convince farmers to purchase new technology to increase production and profits. This 'supply led' approach was seen as a potential solution to problems of food self-sufficiency.

A number of countries, particularly in Africa and the Caribbean, are unable to grow the food they need to generate enough foreign exchange to meet their growing food import requirements. Over the last decade, per-capita food production in most low-income countries has declined. Food production must increase by 3 to 4% annually to reverse this trend. This situation appeared perfect for the "supply led" approach. But local farmers proved reluctant to use newly available credit to purchase production enhancing technologies.

"In many LDCs, yield enhancing technologies exist but small farmers don't use them. It was assumed that they don't use them because these farmers are poor and lack capital to invest. Therefore, give them credit which will become the catalyst to help farmers modernize, increase production and increase earnings. It was also assumed that improved farm technology will have such a high rate of return that risk-averting farmers will be eager to use credit to get these machines and quickly pay off their loans."

But this set of assumptions frequently proved to be simplistic and not workable. The report suggests that several basic questions need to be asked before this "supply led" approach is used.

- Whether local cultural and risk-aversion factors may prevent farmers from responding satisfactorily.
- Is the rate of return from the new technology great enough to assure clear profitability?
- Has the technology proven successful off the research farm, on actual farmer's plots for two or more seasons?
- Are supporting services and inputs available and dependable enough to support the new technology?

"Money can't grow anything by itself, Liebenson explained. "Farmers must spend borrowed funds on physical inputs and the surplus production must be transported to market and sold. Whether this happens depends on the farmer's attitudes, technology choice, markets, infrastructure and service institutions. The lack of institutions and a suitable technology package were often the undoing of AID credit projects.

"At the start of every project it was assumed that profitable small farmer investments existed and concern was focused on agricultural extension and credit delivery mechanisms. We have found that concern should have been placed on determining whether those investments were really there before putting the support systems in place. Many times they prove to be bad investments and credit-led technology up-grading only leads to debt or justifiable farmer resistance.