VIEWPOINT: FINANCING SMALL FARMERS - QUO VADIS?

Gerhard Coetzee
Agricultural and Rural Development Group, Development Bank of SA, Midrand

Why do you not ask the ... (financier) funding? We are afraid of the catch... “I thought they would take credit failure into consideration when repayments are expected”...

“I think the loan was good because there was not enough money from ploughing fields to help pay off the loan.”

“What is bad is that this money has a lot of interest. Many people have had very bad experiences with the ‘children’ (interest). Some of us are very scared because of other bad experiences...they harvested nothing and the smallholders want his money. People are still paying up to now. Some are just paying for the ‘children’ and they have not even started on the ‘parents’ (capital).” “(financier) is quick to go the ‘children’ as long as you keep paying.”

(Quotes from DISA, 1991)

1. Introduction

The agricultural sector in Southern Africa is in the process of change. These changes will hopefully at some future date culminate in institutional arrangements into a comprehensive farm production and support system. In order to achieve this, all farmer support elements as embodied in different support institutions, have to be redefined in terms of target population. This is a factually true with respect to the services provided by the agricultural finance sector. This sector may be defined as that part of financial institutions, have to be redefined in terms of target population. This is an important function of small farmers and their financial needs

As groups of farmers differ according to the above broad criteria, different financial needs will be expressed by these farmers. This paper will address the needs of the broadly defined as the “Iron law” of interest rates which have to be taken into account in credit programmes. These assumptions invariably result in credit programmes that all but help the targeted population. Credit mostly lends in the hands of the larger farmers as depicted by the “iron law” of interest rates which have to be taken into account in credit programmes. These assumptions invariably result in credit programmes that all but help the targeted population. Credit mostly lends

Most of these credit programmes did not reach their intended target population and therefore did not show the intended results. The basic assumptions have therefore been questioned of new and look credit programmes and intervention in rural financial markets have come to the fore in recent years (Mayer and Currie, 1995). In South Africa these traditional assumptions are however still subscribed to by most public sector support financial institutions. The Land and Agricultural Bank of South Africa (Land Bank) followed it until the early 1990s when they brought their interest rates more into line with commercial banks rates for the first time. Low interest rates are however still seen as a necessary condition to enable farmers to produce profitably as is reflected in the various debt relief programmes. The recent announcement of the Land Bank to subsidize modest and be at 12 per cent is also instructive. Subsidized rates for small farmers are also to be found in all the developing areas of South and Southern Africa.

As international experience, confirmed in South Africa (Coetzee, 1988), however indicates that factors other than interest rates play the major role in determining the effects of credit in the production process. These factors include the timeliness of the provision of credit, the opportunity cost of time in the credit procurement process, the cost of credit administration, the accessibility of institutions to applicants, the time it takes to make decisions on application forms and requirements of the credit institutions, the level of information on the applicats and the risk profile of farmers and the lending institutions. External economies lump all these factors together and calculate transaction costs. Some of these costs are discussed in the next section.

2.1 Characteristics of small farmers and their financial needs

As already explained no clear definition of small farmers can be put forward. Certain characteristics of the broadly defined small farmer can however be highlighted. Financial institutions should take note of these characteristics as this will indicate the type of services or services that should be provided to meet the needs of small farmers. Small farmers are mostly women and part time farmers who derive only a portion of their gross income from farming. This portion ranges from 5 to 30 per cent at the most (Coetzee, 1988; Coetzee, 1986). It also happens that funds obtained for agricultural production purposes are mostly repaid out of other sources of income. This implies that repayment of credit be linked to increased output from agriculture. Production credit may be repaid after the harvest or conventionally, production credit may be repaid over a period longer than the production cycle.

In general, small farmers do not have title deeds to the land that they work. This implies no collateral for long term credit.

In the absence of other financial information, these farmers can therefore only be considered for short and medium term financial financing according to the criteria of the commercial banking sector.

In South Africa, contrary to the traditional settlement pattern of smaller more intensive farms near urban areas and larger more extensive farms in outlying and remote areas, the majority of small farmers are situated on the geographic and economic periphery, where most of the necessary support services are lacking. This means implies that inputs need to be transported to the great distances and these farmers are removed from the markets.

Coetzee (1986) indicated that 55 per cent of small farmers that took part in a survey in KwaZulu had savings, and of these per cent had substantial savings. The commercial banks only supplied loans to 7 per cent of respondents in this survey (Coetzee, 1986). The implication is that the commercial banks do supply a deposit facility but are more interested in extending this type of service in their credit programmes.

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1. Introduction

The agricultural sector in Southern Africa is in the process of change. These changes will hopefully at some future date culminate in a sector that is fully integrated into a comprehensive farm production and support system. In order to achieve this, all farmer support systems as embodied in different support institutions, have to be redefined in terms of target population. This is particularly true with respect to the services provided by the agricultural finance sector. This sector may be defined as that part of the broader financial sector that provides financial services to the agricultural sector. This includes commercial banks, public sector parastatal institutions in the form of the Land and Agricultural Bank and various rural finance programmes, co-operatives, traders, money lenders and other informal sources of finance such as family and friends.

If all farmers arc to be served in an equitable manner, the participants in the agricultural sector and the target population of the agricultural financing sector will have to be broadly defined. These participants can range from full-time owner operator farmers to part time farmers and farmers who rent the land they farm on. Within such a comprehensive support system it will however be necessary in the short and medium term for farmers to be divided into small farmers if they are to emerge into fully fledged commercial activities. Although the targeting of specific groups of farmers is difficult it is known in broader terms that there arc those who receive only a portion of gross income from farming, who usually have production rights rather than ownership of the land, who usually make use of family and casual labour and whose production objectives can range from subsistence needs to income or consistent or sufficient production surplus for marketing purposes.

The financial needs of farmers, including small farmers, can be met in three ways. First, by using own funds (savings), second, by borrowing funds and third, by grants from governments and other bodies. The borrowing of funds can be from two sources, namely formal and informal sources. Formal sources include commercial banks and other financial institutions. Informal sources may be family and friends, or government departments, co-operatives, traders, money lenders and other informal sources of finance such as family and friends.

As groups of farmers differ according to the above broad criteria, different financial needs will be expressed by these farmers. This paper will address the needs of the broadly defined small farmers. The first part of the paper will look at the characteristics of small farmers. The second part of the paper will look at financial needs based on elements of the financial processes of these farms and the type of institutions involved. Second, the role of an agricultural bank as financier of these farmers will be discussed. Lastly, conclusions and proposals will be put forward.

2. Financing small farmers

Small farmers have been the target population of numerous credit and financing programmes the world over for the last fifty years. An indication of the scope of these programmes is that between 1964 and 1983 the portion of World Bank agricultural loans that went to credit programmes amounted to 15 percent (Yudelman, 1985). Most of these credit programmes were based on two assumptions. First, the assumption that small farmers need credit to initiate agricultural activity and second that small farmers, or in broader terms the rural population, can only be targeted through the informal sector. Past experience in other countries however has proved that policies based on these assumptions inevitably result in credit programmes that all but help the target population. Credit mostly lands in the hands of the larger farmers as depicted by the 'iron law' of interest rate discrimination, and new look credit programmes and intervention in the agricultural sector and thus the target population. The implications is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more interested in extending credit to those with title deeds. The commercial banks only supplied loans to 7 percent of respondents in this survey (Coetzee, 1988).

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In South Africa, contrary to the traditional settlement pattern of smaller extensive farms near urban areas and larger more extensive farms in outlying and remote areas, the majority of small farmers are situated on the geographic and economic periphery, where most of the necessary support services are lacking. This user also implies that inputs need to be transported because of distances and these farmers are removed from the markets.

Coetzee (1988) indicated that 55 percent of small farmers that took part in a survey in KwaNdwane had savings, and of these 66 percent had saved for the purpose of financing their agricultural production purposes are mostly repaid out of other sources of income. This implies that repayment of credit can be linked to increases in income from production. Production credit may be repaid before the harvest or conventionally, production credit may be repaid over a period longer than the production cycle.

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The two most important reasons why formal institutions such as commercial banks are apprehensive of getting involved in the financing of small farmers are the lack of collateral (in terms of the formal requirements set by these institutions) and the high transaction costs associated with small farmers (Table 2 shows the differentiation between formal and informal sources of finance). Formal institutions have more information on their clients and thus have an easy choice of clients' ability to repay loans (an informal form of collateral). Formal institutions' collection requirements do not apply to these informal transactions.

Formal institutions are not as flexible as informal institutions in receiving repayment. For the purpose of adjusting the payback period to suit the income stream of the client. In a number of cases in rural areas the purpose of the loan and the activities that generate funds for the repayment of loans do not correlate. In the case of informal institutions the lender relies on the rational decision-making of the client and the client's knowledge of his own cash flow position regarding the source of funds to repay a loan. It is possible for this purpose to be susceptible and perceptive in this regard. They are usually inflexible on regulations and procedures concerning loan period and method of payment (varying payments etc). Further, decisions do not rest with the small farmer's contact person at the institution. This involves more information and the ability in the making of decisions. In turn, this increases the transaction cost for both the borrower and the institution.

A further difference between formal and informal sources exist in terms of level of interest rate charged (see Table 3). A stereotype view exists that the higher interest rates of informal institutions are exploitive and therefore rural people should utilize formal sources. Another interpretation is that these higher rates are justified and compared with these loans. The argument that interest rates alone do not play the major role in the decision to take up a loan is therefore supported.

Concerning the ability to save it was found in Africa and other less developed countries that rural populations can save. Savings proportions of up to 30 per cent in rural areas have been reported (e.g. Nayaoud, 1989). Savings mobilization by financial institutions in rural areas is that savings serve as a major source of funds for on-lending and can be utilized for economic activities with the resultant potential economic linkages in these areas.

Policy regarding the provision of credit, and in broader terms financial services to rural development organizations is to provide a number of small farmers with cheap credit, while they have to rely on informal deposits to pay off their loans.

3. Demand driven services

The greatest challenge to specialized agricultural credit institutions in availing of low transaction costs away from supply-lending finance to a demand driven services. This can only be accomplished if these institutions can identify the nature of demand, their target clients and the characteristics of rural financial institutions in a flexible approach knowing the different requirements of the required broad spectrum of farmers in the agricultural sector. It also entails a deviation from the procedures and practices adhered to by these institutions in the past as well as most of the actors in the formal financial sector.

In terms of the discussion on the financial characteristics of small farmers (see Section 2.1) the specialised agricultural credit institutions have to drive their policies and the loan structures for the both the financier and the borrower. The specific characteristics of rural financial markets have to be take into account during policy and procedural arrangements.

3.2 Reducing transaction costs of financial intermediation

Transaction costs have been identified as the major influence on the stability of informal financial systems as well as the decision and situation of the borrower. The reduction of transaction costs of financial intermediation in developing countries requires improvement in reducing financial regulations, and implementing risk reducing mechanisms so that both procedures and practices of financial transactions can be streamlined and simplified (Meyer and Cuevas, 1990). Several types of improvement between informal and internal to financial intermediation are suggested by Meyer and Cuevas (1990) along with some examples of how they are being implemented in selected countries.

Improving the economic environment

In order to ensure that small farmers are in a position to take up the challenges of commercial agriculture several improvements in the related policies in which they operate are needed. Improved transportation and communication systems can help increase the efficiency of financial institutions. Market information will help both borrowers and bankers to better project the returns and risks associated with different types of loans.

Overall measures may include the provision of elements that will influence the access of small farmers to the market (Van Rooyen et al., 1987). Resultant impoverishedness in farmer income will make farmer borrowers more attractive, less risky customers for loan and deposit services.

Improving banking regulations

Cheap credit policies do not benefit the farmers, nor does it benefit the credit institutions. Interest rates at very low levels do not benefit the farmers, nor does it prove lending efficiency for the borrower. Likewise, it was found that for small loans (U.S. $200), a reduction of interest rates of one percentage point was accompanied by an increase in loan use of 20 per cent. Subsidized interest rates also have a negative effect on deposit mobilization. Although it is difficult to conclusively prove, there is evidence that savings are sensitive to interest rate changes. A private bank in Honduras experienced lending costs of 5.33 percent using own funds versus 7.22 percent for similar funds from the World Bank credit project (Meyer, 1986 in Meyer and Cuevas, 1990).

Reduce risks

Risk profiles of farmers should be rationalized in a decision to extend a loan. The greatest risk arises often given by financial institutions for not making more loans to agriculture, to low income households, and to small businesses is the perception of the high risks associated with these borrowers. Reported default rates suggest that in fact some of the clientele groups that are identified as high priority for financial assistance in developing countries contribute to high default rates.

One way to reduce this risk is to accumulate information of prospective clients. This is possible if a specific institution provides deposit facilities and uses the financial profile of a clients deposit track record. Group schemes can also be utilized. The groups accumulate savings that are deposited in the financial institutions that make loans to group members. The joint liability of the group members covers the balance of the risk for loans made to members without collateral. This type of group scheme is also expected to reduce transaction cost for its members, besides giving them access to loans otherwise denied to them. Organizing and participating in these groups however, can represent fairly high transaction costs for itself.

Diversify financial institutions

A characteristic of the many specialized farm credit institutions that were created during the 1960s and 1970s is that it rarely engages in significant informal mobilization. More frequently, they relied on subsidized external funds. This also occurred with many credit unions in Latin America that originally relied upon their own funds but gradually increased their dependency on external funds.

The institutions that begin to mobilize deposits may find that they reap several benefits (Meyer and Cuevas, 1990). First, the present external funds that appear to be cheap may actually be quite expensive when the opportunity cost of money, the reporting and administrative costs the donors and central banks usually require to supply resources, and the variety of external funds are not completely risk free for a lender interested in establishing long term financial institution for its customers. However, with the elite and flows in interest and funds of donors and the government, an institution may at one time find itself awash in funds, but starved at another time.

Second, a financial institution that has an active deposit relationship with a custodian or depository institution knows about custody's reliability, cash flows, and savings potential. This information may be useful when the institution appraises the customer's financial needs. When the customer's financial needs are less liquid, they may have to warehouse their funds that they know represent their neighbours' deposits.

Third, deposit mobilization may contribute to superior loan recovery. By lending funds that have been mobilized from depositors, the institution can accumulate information about that custodians' reliability, cash flows, and savings potential. This information may be useful when the institution appraises the customer's financial needs. When the customer's financial needs are less liquid, they may have to warehouse their funds that they know represent their neighbours' deposits.
The two most important reasons why formal institutions such as commercial banks are apprehensive of getting involved in the financing of small farmers appear to be the lack of collateral (in the terms of the normal requirements set by these institutions) and the higher transaction costs associated with these loans to these farmers (Table 2 shows the differentiation between formal and informal institutions in terms of savings mobilization). Informal institutions have more information on their clients and thus have an idea of the clients' ability to repay loans (an informal form of collateral). Formal institutions' collection requirements do not apply to these informal transactions.

Formal institutions are not as flexible as informal institutions in terms of interest rates. They are more rigidly adhering to the prevailing interest rates that are applied for the repayment of loans. It is only to a limited extent that clients are informed which form of interest rate applies to their loan. Potential clients may find themselves at a disadvantage because of this. It is also a disadvantage for formal institutions because the risk involved in granting a loan is already known at the time of granting the loan. This means that the potential of default is already included in the interest rate.

Savings mobilization by financial institutions in rural areas has the advantage that it serves as a major source of credit and other financial services. For example, the specialized farm credit institutions are providers of supply-lending finance to a demand driven service. This can only be accomplished if these institutions can identify the nature of demand, their target clients and the characteristics of rural financial markets have to be taken into account during policy and procedural arrangements. Table 3 shows that differences between formal and informal institutions in terms of the interest rates applied to loans exist.

The biggest advantage of informal institutions is that they provide their services at a low transaction cost to the farmer and for themselves as they have far better sources of information to base their decisions on. In addition to the recognition of the importance of transaction cost and savings mobilization, the type of finance that provides the financial services also plays an important role.

Specialised farm credit institutions are defined as a class of financial intermediary primarily engaged in the provision of loans to farmers, ranchers, and others undertaking agricultural production (Von Pischke, 1978). This type of intermediary is characterized by the specialization of its loan portfolio, and also by the reflection of that loan portfolio in a narrow range of financial services offered. Normally, specialised farm credit institutions do not engage in any significant scale of deposit taking. Specialized farm credit institutions are established by governments in low income countries to provide financial assistance for agricultural production (Von Pischke, 1978). In their role as development finance agencies, specialised farm credit institutions are providers of deposit and loan services to their target client group and contribute towards the inability of the institutions to recover cost incurred in advancing loans. This retention is often accomplished by creating additional procedures and delays in loan processing and repayment. Borrower transaction costs are also increased. Cueva (1984 in Meyer and Cueva, 1990) found that borrowing costs and interest rates were higher in the formal than informal financial sector suggesting that as interest rates were allowed to rise the lenders found ways to improve lending efficiency for the borrower. It was also found that for small farms (U.S. $200), a reduction of interest rates of one percentage point was accompanied by an increase in area cropped by 3%. Subsidized interest rates also have a negative effect on deposit mobilization. Although it is difficult to conclusively prove, there is evidence that subsidized interest rates are sensitive to interest rate changes. A private bank in Honduras experienced lending costs of 3.13 percent using own funds versus 7.82 percent for similar loans using the Central Bank credit project (Meyer, 1986 in Meyer and Cueva, 1990).
The use of mobile services has been suggested in a number of small scale studies to individual farmers, with variable success (Coetzee, 1988).

Greater accessibility of institutions to prospective borrowers is possible by linking informal with formal finance, as is being done in Zimbabwe with great success (Chimdelza, 1987). Access to the agricultural market for small farmers has been a critical success factor for the loan to farmer cooperation (Cuevas, 1990).

If the low incomes and performance of farmers are caused by the milieu in which the farmers operate, this should be changed. The development of a country's infrastructure, greater security in land tenure arrangements, and a legal framework that protects rights and the enforcement of contracts increases farmers' productivity and reduces transaction costs and, in this way, promotes rural financial markets. In addition to the price policies, taxes and subsidies that critically influence farmers' income, appropriate macro-economic management and financial policies are crucial for the promotion of rural financial markets. Rigid financial policies have repressed growth in many developing countries. In addition to non-repressive policies and a more adequate regulatory environment, promotion of rural finance require viable, independent, permanent, and efficient institutions. Inconsistent objectives reduce intermediary viability. Excessive specialization increases risks. Lack of deposit mobilization weakens institutions.

The negative view of informal finance is being replaced by a recognition that it can be a valuable source of credit for many individuals. For the borrowers, the transaction costs per unit borrowed may be reduced compared to individual loans. By linking informal with formal finance, all the participants in the transaction costs of both borrowers and lenders. This negative view of informal finance is being replaced by a recognition that it can be a valuable source of credit for many individuals. For the borrowers, the transaction costs per unit borrowed may be reduced compared to individual loans.

2. That is, the more restrictions on the provision of credit and more specific the level of interest rates, the more funds do not land in the hands of the target group.
3. This section is taken from the work of Meyer and Cuenas (1990) who provide a comprehensive summary of the many efforts to replace it, may provide suggestions on how to improve formal finance. There is also greater recognition for the need to tap the strengths of informal finance by linking it with formal finance.

By linking informal with formal finance, all the participants in the financial transactions may experience a reduction in transaction costs, and/or they may be a transfer in transaction costs from the participant less able to absorb them (usually the financial intermediary) to the one more able to do so (usually the borrower or saver). Linking savings clubs with financial institutions, such as is being done in Zimbabwe with great success (Chimdelza, 1984 in Meyer and Cuenas, 1990), represents an example largely oriented towards savings. These clubs are formed recently by small groups of peasant farmers from the same village or cluster of villages. Similar arrangements are popular in South Africa, and are usually called stokvels. It is estimated that these stokvels mobilize about R50 million per month in the urban areas alone (Lukhele, 1990). Many of these stokvels keep their deposits in specially structured deposit accounts for stokvels at a major local building society and a commercial bank.

1. That is, the more restrictions on the provision of credit and more specific the level of interest rates, the more funds do not land in the hands of the target group. This negative view of informal finance is being replaced by a recognition that it can be a valuable source of credit for many individuals. For the borrowers, the transaction costs per unit borrowed may be reduced compared to individual loans. By linking informal with formal finance, all the participants in the transaction costs of both borrowers and lenders. This negative view of informal finance is being replaced by a recognition that it can be a valuable source of credit for many individuals. For the borrowers, the transaction costs per unit borrowed may be reduced compared to individual loans.

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The use of mobile action costs. The following advantages are claimed for group lending:

1. Greater accessibility of institutions to prospective borrowers is one of the prerequisites to decrease borrower transaction costs.
2. Group lending (Adams and Ladman, 1979 in Meyer and Cuevas, 1990). For the lender, 1) default risks are reduced because of joint liability, 2) loan transaction costs are reduced per unit of lending (Greene, 1979 in Meyer and Cuevas, 1990). For the borrower, 1) transaction costs per unit borrowed may be reduced compared to individual loans.

Group lending is implemented in two main ways: 1) Savings and Credit Associations (ROSCAs) have been seen as mere precursors to more formal financial institutions. Operating costs are reduced through decentralized decision making. Loans to farmers and small enterprises are sanctioned by the branch manager with the advice of technical staff (Meyer and Cuevas, 1990). Reporting procedures are confined to collecting and documenting information relevant for decision making either at the branch or the head office. In addition micro-computers could be utilized to administer the deposit accounts, develop lists of past due loans, print demand letters, prepare ad hoc reports, and generally rationalize the bank's daily office routine.

3. That is, the more restrictions on the provision of credit and more specific the level of interest rates, the more funds do not land in the hands of the target group.

4. This section is taken from the work of Meyer and Cuevas (1990) who provide a comprehensive summary of the research on the provision of credit to smallholder farmers in rural areas.

5. "Stokvels" are known as "stokvels" in South Africa, and are usually called stokvels.

References


