Briefing on the Agribusiness Enabling Environment

AgCLIR LESSONS FROM THE FIELD: GETTING CREDIT

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The business of agriculture occupies a critical space in most economies. Distinct and special among industries, agriculture is the dominant source of employment for a large share, even a majority, of the population in developing nations.

Accordingly, governments treat the regulation of agriculture and food differently than any other sector. Unlike the output of other sectors, many agricultural products are basic necessities: agriculture provides the food, fiber, fuel, and construction materials necessary to sustain human existence. Governments everywhere assume responsibility for assuring that the distribution of agricultural commodities is great enough and equitable enough to provide a reasonable quality of life for its citizens.

Agriculture and Agribusiness: Getting Credit is a briefer that mirrors the analytical framework used by the World Bank Group's "Doing Business" series (www.doingbusiness.com) and adopted by USAID's Commercial Legal and Institutional Reform framework. Divided into four sections (Legal Framework, Implementing Institutions, Supporting Institutions, and Social Dynamics), this briefer highlights the specific issues that must be addressed in local legal, regulatory, and institutional environments if agribusiness is to be economically productive, contribute to environmental sustainability, and assure a safe and reliable food supply.

GETTING CREDIT: KEY CONCEPTS

Virtually all modern businesses rely upon credit: for operations, to bridge the gap between production of products and payment for them; for investment, as buildings and capital equipment are generally multiples of annual revenues; and to cover swings in supply and demand conditions. Farmers in developing countries often point to the lack of credit as the greatest barrier to increasing production and the profitability of agricultural enterprises.

The ability of entrepreneurs to borrow money at reasonable interest rates and for appropriate durations depends on a number of factors that collectively affect the risks associated with lending. These include a mix of policies, laws, and regulations; property rights; processes and standards for loan approval; the quality of registration systems; and enforcement mechanisms. In jurisdictions where these and other factors do not work to protect lenders (or borrowers), the risk of default is typically high, and this risk is reflected in the increased cost and, in many cases, decreased availability of credit. Further, certain types of borrowers are perceived as raising additional risks due to their limited capital, entrepreneurial history, or precarious social situation such as depending on rain for each crop cycle. As a result, agribusinesses and other less secure groups typically face significant obstacles in securing credit.

Many of the issues highlighting the special risks for providers of agricultural credit have already been mentioned elsewhere in this briefer series:

- seasonality of production—this leads to "lumpiness" in credit needs and repayments;
- high correlation of risks experienced by borrowers in a geographic area—drought, pests, and floods have widely shared impacts;
- producers' inability to use real or movable property as collateral; and
- difficulties in enforcing contracts for which the subject matter is intangible property.

The fact that many enterprises are family operations (and essential for the family's survival) raises social issues that are not encountered in lending to other small or medium-scale enterprises. Lenders have proved reluctant to seize agribusinesses' assets—even when legally allowed to do so—when it is clear that total impoverishment would result.

Agricultural production enterprises that are more diverse—i.e., include the production of several products and services—might seem better candidates for credit. Diversity of production could mitigate some of the risks associated with seasonality or the price risks associated with a large number of producers bringing the same product to market at the same time each year. Nonetheless, the complexity of diversified operations makes evaluation of their creditworthiness more difficult. The developed world has, in fact, moved in the opposite direction—toward more specialization and on a larger scale. Government underwriting of some of the risk through credit subsidies has been an important factor in making this possible.

Producers who join cooperatives gain a significant edge in accessing credit. Lenders' costs are reduced—the transaction costs of dealing with one cooperative are far lower than the costs of dealing with hundreds of individual producers. Lenders' risks are reduced to the extent that co-op membership is voluntary and members accept a level of mutual responsibility for loan repayment. Lenders' risks are reduced even further where services that enable cooperatives to succeed as business enterprises (e.g., training, information, technology) are provided by donors or government entities.

The possibility of expanding the microfinance model to an increasing array of agribusinesses, especially small and family-owned/-operated businesses, has been explored in some countries. Microfinance institutions are cautious about explicitly expanding their business in the agricultural sector because of two risks noted at the outset: the seasonality of borrowing and payback for most agricultural production enterprises, and the high level of correlated risk among borrowers as adverse conditions due to weather, pests, or diseases affect many borrowers at the same time.

Trade financing for agricultural products can be secured by contracts for sale or against inventory as collateral. This requires significant organization and formalization of markets, especially regarding grades and standards of products traded. Many—and, in some cases, the majority of—agricultural traders on domestic markets are said to personally finance their business operations. Agribusinesses that engage in international trade, however, are generally forced to seek trade financing to manage cash flow between the time of shipping and payment.

Agribusinesses that deal in the import and distribution of production inputs and process raw agricultural materials into value-added products face credit conditions similar to those of other processing or manufacturing industries. Lenders' risks can be assessed using standard business evaluation tools. For this reason, "supplier credit," that is, credit provided to producers by input dealers and/or agricultural processing companies, is a major source of credit in many developing countries. Contract law is an essential underpinning for such credit, since the ownership of intangible property (a yet-to-be-realized harvest) serves as security for such agricultural credit.

LEGAL FRAMEWORK

The legal framework for getting credit or accessing financial services is comprised of a variety of laws. These laws, when well designed, enable lenders to reduce costs and manage their risks more effectively. This helps potential borrowers gain access to beneficial financial services, namely, credit, savings, and a guarantee for products by establishing their creditworthiness and managing institutional risk that can limit access to financial services, even to "creditworthy" firms or individuals.

A **real property law** and a **secured transactions law** provide the basic legal framework for agribusinesses registered under the company law to access bank credit and for lenders to seek recourse in the event of an agribusiness' default. Collateral, in the form of real or movable property, is provided by the borrower to the lender. With this method, the lender is able to seize and liquidate assets if the borrower defaults.

Collateral lending lowers the risk of non-payment because the borrower will normally pay off the loan instead of losing the property used as collateral. If the borrower does default, then the value of the collateral helps to pay off the debt, further reducing the overall risk of non-payment. Finally, enforcement provisions of a well-crafted collateral law allow secured lenders to seize and sell the movable property rapidly and more efficiently than would be possible through a longer lawsuit. This reduces the costs of collection. As an added benefit, collateral lending reduces conflicts over rights in property by establishing priorities and eliminating unnecessary legal claims. It reduces attempted fraud by borrowers because the lender's interest in the property follows the property—if the borrower fraudulently sells the collateral and hides the proceeds, the lender can still seize the property from the new buyer. Consequently, the system lowers the overall risk of loss through fraud for the banking community.

Well-structured collateral lending systems also expand the scope of property that can be used as collateral, and thus expand access to credit. Any property right that can be identified, used, defended, and transferred by the owner can be used as collateral. In modern systems, this ranges from tangible property like vehicles to intangible property such as accounts receivables or future crops. Livestock and inventory can also serve as collateral, even though the individual items may change over time.

In many countries agribusinesses are unable to claim ownership to real property, thus limiting their ability to borrow on the basis of collateral in the formal banking sector. This accounts for the popularity of supplier or buyer credit provided against a pledge of intangible property, i.e., the crop to be harvested, and for cooperative borrowing, in which members guarantee each others' ability to pay. This method, however, demands a reasonably sophisticated foundation for secured transactions. As Douglas Pearce concluded in a study done for a USAID-sponsored conference on rural finance:

> *Product-market credit is not a substitute for financial markets. Financial service providers offer more transparent credit than do most buyers and suppliers, can offer loans to a larger number of clients due to having more appropriate systems and procedures, and can also offer a more diverse range of financial services. Yet in order to overcome the risk, operating cost, and information constraints that have limited their involvement in agricultural lending to date, financial service*

providers may need to establish linkages with suppliers and buyers, either directly or through intermediaries.[1]

The European Bank for Reconstruction and Development (EBRD) Agribusiness Operations Policy reflects this kind of thinking: "the Bank has concentrated its efforts down-stream of agricultural production, mostly in agro-processing, marketing and distribution… Direct commercial financing to primary agriculture has proved to be more difficult due to higher risks prevailing in the sector."[2]

The legal and regulatory structures governing the operation of credit registries, both public and private, help to ensure that lenders have adequate and correct information about borrowers' creditworthiness—whether "upstream" in the primary production business (or input supply business) or "downstream" in the marketing and processing of the product. Academic research shows, however, that public credit registries affect borrowers' behavior as well.[3] Credit registries have been growing in many developing countries, but are still considered to be weak.

A **bankruptcy law,** which should allow agribusinesses that "have a chance at viability, the opportunity to extend, reduce, or wipe out debt and protect themselves from pursuit by creditors," complements the laws that provide for the extension of credit in the first place.[4] The core issue is the extent to which the interests of secured creditors are met in the course of the bankruptcy and how these creditors are able to seize and sell collateral to resolve debt.

A factor complicating agribusiness lending is government intervention in the provision of credit to agribusiness, as well as in the commodity markets essential to a borrower's ability to establishing an agribusiness' viability. The establishment of state-owned agricultural development banks in developing countries has resulted—or has been intended to result—in a steady flow of credit to the agricultural sector. Too often, however, these banks have failed by responding too readily to uneconomic but politically supported agribusiness proposals, being insufficiently sophisticated in risk management, and finding themselves with inadequate capital to meet the needs of even a small share of potential borrowers' needs. However, the very existence of a state-owned agricultural development bank tends to steer other banks away from agricultural lending, especially to commercial farms and cooperatives, and has actually contributed to shrinking the amount of capital available to agribusiness borrowers.

Special laws and regulations for microfinance also have a bearing on credit availability for the informal agricultural sector. Start-up microfinance institutions typically try to establish portfolios with lending to different sectors and few, if any, specialize only in agricultural lending because of the higher risk. However, for small agribusinesses seeking to assure stability through off-season off-farm employment/entrepreneurism, microfinance could be an important factor in business growth. Microfinance institutions frequently allow group guarantees or "social collateral" to maintain loan security in lieu of more traditional individuals' collateral to secure a given loan.

IMPLEMENTING INSTITUTIONS

The range of implementing institutions pertaining to getting credit tracks the vast range of laws affecting this area.

Financial institutions of all sizes are critical to agribusiness credit, either directly or indirectly, through, for example, the provision of trade financing or supplier credit to businesses that then lend to agribusinesses. All such financial institutions are subject to the oversight of national central banks and/or other banking supervision structures. These may affect the level of competition in the banking industry, rates and fees charged for various kinds of loans, and the ability of banks to tap global capital.

Some financial institutions have access to guarantees offered by international donors that help them manage risks inherent in agriculture and agribusiness. These include the International Finance Corporation (IFC), USAID's Development Credit Authority (DCA), and the Overseas Private Investment Corporation (OPIC). Credit insurance is available to borrowers through other mechanisms as well, although at a higher cost and with less technical assistance.

As already noted, many developing countries continue to support state-owned development banks and agricultural development banks that operate without using strictly financial criteria. Such banks may offer agribusiness preferential access to credit in order to stimulate investment in particular sectors or geographic areas. The presence of such an institution, however, may create a non-competitive playing field for agricultural credit and drive private financial institutions away from the very agribusinesses the state, as a matter of policy, wishes to favor.

Some NGOs continue to use privately raised wealth or donor funding to manage revolving loan funds that provide credit to small agricultural enterprises. Revolving loan funds are often established outside of the regular financial market, charge low interest rates, and generally decapitalize over time.[5] It is not known what share of agribusiness credit comes from these sources.

Judicial institutions are essential to settling disputes between borrowers and lenders and are responsible for ensuring that judgments, once entered, are enforced. In some cases, special commercial courts have been established to ensure that judges are capable and that business cases can be speedily settled. In other cases, alternative dispute resolution mechanisms have been established to settle cases.

SUPPORTING INSTITUTIONS

Registries for property (real and movable) are needed so that lending institutions build confidence in their access to collateral in the event of default. Most such registries are in the public sector.

Credit rating agencies, both public and private, provide important information on borrowers for all financial institutions, thus lowering lending risks.

1 Douglas Pearce, "Buyer and Supplier Credit to Farmers: Do Donors Have a Role to Play?" *Rural Finance Innovation Case Study, Paving the Way Forward for Rural Finance: An International Conference on Best Practices* (Washington, D.C. 2002–2003), at 16.

2 *See* www.ebrd.com/about/policies/sector/agri.htm.

3 *See, e.g.,* Martin Brown and Christian Zehnder, *Credit Registries, Relationship Banking and Loan Repayment* (April 8, 2005), *available at* http://www.philadelphiafed.org/econ/conf/consumercreditandpayments/Brown_Zehnder.pdf.

4 *See,* the BizCLIR website, *available at* http://bizclir.com/

5 A short paper by the Economic Research Service (ERS) at the U.S. Department of Agriculture entitled "Are Revolving Loan Funds a Better Way to Finance Rural Development?" (USDA/ERS Agriculture Information Bulletin No. 724-05, October 1996) provides a concise review of the pros and cons of revolving loan funds in the United States. Many of the observations are likely applicable to NGO- or project-managed revolving loan funds in developing countries as well.

About AgCLIR:

AgCLIR, or the Agribusiness Commercial Legal & Institutional Reform diagnostic is a unique tool for agribusiness enabling environment analysis that identifies the root causes of an inefficient or underperforming agricultural sector. AgCLIR is a sector-specific adaptation of the United States Agency for International Development (USAID) CLIR approach, which aims to improve the business enabling environments through sound analysis and strategic interventions. This series, Briefings on the Agribusiness Enabling Environment is intended to shed light on some of the most important, and least understood, components at the intersection of agribusiness and commercial law and institutional reform. All issues are available at http://egateg.usaidallnet.gov/EAT

Information and communications technology (ICT) is becoming increasingly important to the credit sector. Both lenders and borrowers are finding that ICT is an essential tool for business. The explosive growth of cellular telephony has made an important contribution to the operation of rural credit systems. The Consultative Group to Assist the Poor (CGAP) noted that "transformational branchless banking"—the use of ICT and non-bank retail channels to reduce costs of delivering services to clients beyond the reach of traditional banking—is growing rapidly. It is now not considered a "banking activity" under domestic regulation, but its presence in so many rural markets is challenging governments to seek "how to formulate proportionate regulatory policy that gives space for innovation and permits branchless banking to scale up safely."[6]

Statutory marketing boards, also known as statutory marketing authorities or control boards, are the most common types of state-trading enterprise (STE) in the agricultural sector and play a role in making credit available to producing agribusinesses. Such boards may have any or all of the following objectives: domestic price stabilization, market regulation, and control and promotion of exports. They are usually producer-controlled, state-sanctioned monopolies with exclusive authority for a wide range of market interventions, such as regulating and purchasing domestic output, setting consumer and producer prices, controlling domestic distribution, and conducting foreign trade.[7] STEs often provide credit in the form of production inputs. Repayments are deducted from payments for delivered crops at the end of the marketing season. This works well as both the STE and producer increase the security and volume of their production. The downside risk is that STE accounting is not transparent and the true costs of the credit are not known to the borrower.

Many private firms, often agribusiness firms that process or market an export commodity, also provide supplier credit to smaller agribusinesses, generally through contracts against commodity delivery (known as contract farming). "Side-selling," where the producer sells all or part of the harvest to another buyer, thereby avoiding loan repayment, is a common issue with such arrangements; if credit access and market outlets are limited and contract enforcement is possible, this practice can be controlled.

SOCIAL DYNAMICS

Increased access to affordable credit is much more than a matter of good laws and proper procedures. Underlying assumptions, expectations, and vested interests, among other issues, influence the social dynamic in which finance reform takes place. Factors include supply and demand for finance and for reform, conflicting norms, transition in governmental roles, and differing conceptual definitions of the problem. Many of these have implications for design, implementation, and prioritization of reform efforts.

It is a given that agricultural/agribusiness debtors would like to see lower interest rates and easier terms. Agriculture is a highly competitive business. Since no policymaker can envision a future without a stable and secure food supply, however, governments are often willing to provide both subsidized credit and loan guarantees—as well as insurance against the possibility of default when bad weather occurs or global prices drop—to large segments of the agribusiness community.

History in much of the developing world indicates that erratic interventions on the parts of donors or governments in the agricultural credit markets have inhibited stable growth in the availability of and agribusinesses' access to credit. Periodic forgiveness of agricultural debt for political reasons, for example, makes it more difficult to maintain credit discipline and keeps private lenders out of the business. Donors' intermittent provision of agricultural inputs on a grant basis leads to producers questioning the need to repay loans for those same inputs.

Largely because of the microfinance experience, however, there is greater appreciation of the need for financial institutions serving rural areas and micro and small agribusinesses to put viable, sustainable financing models into place. Women borrowers, especially those who have built up a credit track record with microfinance, are now a particular client group seeking to move up the credit scale. They are, in some cases, looking for greater access to agribusiness credit. Laws or rules that require husbands to co-sign or for "heads of households only" to be considered to be eligible for cooperative members are not helpful in expanding women-led agribusinesses' access to credit.

6 CGAP Focus Note No. 43 (January 2008), *available at* http:/cgap.org/p/site/c/template.rc/1.9.2583/.
7 *See* http://www.fao.org/DOCREP/005/Y3733E/y3733e07.htm.

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