



THE INITIATIVE FOR SMALLHOLDER FINANCE

BRIEFING **06**

**LENDING A HAND:
HOW DIRECT-TO-FARMER
FINANCE PROVIDERS
REACH SMALLHOLDERS**

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LENDING A HAND: HOW DIRECT-TO-FARMER FINANCE PROVIDERS REACH SMALLHOLDERS

The vast majority of smallholder farmers are financially underserved. Providing these smallholders with access to appropriately structured financial products and services can help bridge the smallholder finance gap and, in turn, combat extreme poverty by supporting over two billion of the world's poorest people who live in households that depend on agriculture for their livelihood.

Globally, over 150 finance providers currently offer direct-to-farmer finance. These providers use a range of approaches to address core challenges associated with lending directly to these smallholders, but their lending activities still remain small in scale when compared to the vast demand for smallholder finance. Closing this gap will require additional learning, knowledge sharing and blending of distinct approaches, and continued development and testing of innovative products and services.

ABOUT THIS BRIEFING

*This briefing is the sixth in a series by the **Initiative for Smallholder Finance**, a multi-donor effort designed to demonstrate how specific products and services can expand the reach of financing for smallholder farmers. Initiative activities include targeted market research, product development and testing, and investment facilitation in the smallholder finance market.*

Previous research from the Initiative for Smallholder Finance has explored local lending to smallholders, smallholder impact and risk metrics, the role of government in developing agricultural finance, and the social lending sector.

Introduction: Direct-to-Farmer Finance

The vast majority of smallholder farmers have difficulty obtaining appropriately structured credit and other financial services. Smallholders who operate in tight value chains – characterized by strong, consistent relationships with buyers – often have access to finance, inputs, agronomic training, and other support from the buyers they work with. However, an estimated 90% of smallholders lack these strong buyer relationships and the support that accompanies them.¹ Typically, these smallholders grow primarily staple crops, operate on land sizes of two hectares or less, and consume the majority of their harvest within their households; when they grow cash crops and/or have surplus production, they typically sell crops through local markets that operate on a relatively informal basis.² These smallholders' lack of strong buyer relationships, as well as their relatively small landholdings and limited commercial activity, often translates to constrained access to credit and other financial services.

More than 150 finance providers offer finance directly to these smallholder farmers.³ These “direct-to-farmer finance providers” include public policy lenders, niche poverty lenders, diversified branch banks,⁴ non-bank microfinance institutions (MFIs),⁵ and informal financial institutions such as savings-and-loan groups⁶. Some of these providers – public policy lenders and diversified branch banks, in particular – also provide finance to farmers via cooperatives, buyers, or other aggregation points, in addition to their direct-to-farmer finance activities.

The identified direct-to-farmer finance providers are concentrated in Sub-Saharan Africa. While there are fewer identified providers in Asia, several of the providers in Asia have a particularly large reach, exceeding five million smallholders in some cases.⁷ These providers include agricultural development banks that have grown with significant government support and microfinance institutions with a long track-record of serving smallholder and other rural populations.

However, the scale of these providers' current lending activities significantly trails demand. The total amount of formal debt financing supplied by local lenders to smallholders in the developing world is approximately \$9 billion,⁸ meeting less than 3% of the total smallholder financing demand (\$300 billion excluding China).⁹ The

TYPES OF DIRECT-TO-FARMER FINANCE PROVIDERS^{4, 5, 6}

Public Policy Lenders: State and agricultural development banks that local governments originally established but later fully or partially privatized

Niche Poverty Banks: Microfinance (MFI) banks and banks focused on lending to the poor that have moved into customer segments adjacent to their urban lending base (typically including poor farmers)

Diversified Bank Branches: Commercial banks that have come “down market” to offer products to smallholders

Non-bank Microfinance Institutions (MFIs): Microfinance institutions that are not licensed to mobilize deposits

Informal Financial Institutions: Deposit-taking institutions collectively owned and managed by members

scale of formal direct-to-farmer lending is even smaller than \$9 billion, as that figure includes smallholder lending via intermediaries such as cooperatives. While non-bank MFIs and informal financial institutions like savings-and-loan groups meet some of the remaining demand, a significant gap remains; for example, Finscope estimates suggest that 30% to 60% of the rural population in Sub-Saharan Africa has no access to financial services, whether formal or informal.¹⁰

Common Challenges and Practices

The approximately 90% of smallholders who operate outside of tight value chains are some of the most difficult clients for finance providers to reach given three key challenges associated with direct-to-farmer lending:

- Smallholders have unique financial needs.** Smallholder household cash flows are often cyclical. Many smallholders require cash for inputs and other farming needs (such as labor) during the planting season. However, they often do not earn the income required to repay these loans until several months later, after the harvest. Smallholders also might need to pay other relatively large household expenses, such as school fees, at points in the year when household liquidity is particularly low. This cyclical nature of financing needs and repayment abilities conflicts with traditional microfinance and group saving and loan models that are structured around regular repayment schedules.
- Smallholder lending carries additional risks.** It can be challenging for direct-to-farmer finance providers to make well-informed credit decisions, because most smallholders lack the credit history and collateral that traditionally inform loan assessments. In addition, agronomic factors create significant risks for both smallholders and finance providers. Many smallholders have limited knowledge of agronomic best practices and some lack access to high quality inputs – both of these factors can contribute to low yields and revenue. Smallholders are also vulnerable to weather events (e.g., flooding, drought) and other agronomic risks (e.g., crop or livestock disease) which can drastically decrease their income and ability to repay loans. Finally, most smallholders’ lack of strong and consistent buyer relationships contributes to price risk when selling their surplus, which can further jeopardize their repayment ability.
- Delivering financial products and services to smallholders is difficult.** It typically costs more to provide finance to smallholder clients than to clients who live in urban and peri-urban areas. Many smallholders live in rural areas characterized by relatively low population density, which increases the time providers must spend to reach these clients and also contributes to additional operating risks, such as those associated with loan officers transporting cash over long distances. Infrastructure constraints to reaching and serving smallholders, such as poor road conditions and lack of reliable electricity and connectivity, further contribute to higher operating costs. Human resources requirements also make delivery challenging for direct-to-farmer finance providers. As providers expand into rural areas, they often find it difficult to recruit appropriately skilled staff, particularly at mid-management levels, given the relatively low education levels of many rural populations. When a provider’s staff lack the necessary combination of both finance and agricultural expertise, it is more difficult for the provider to develop appropriate products and make informed lending decisions.

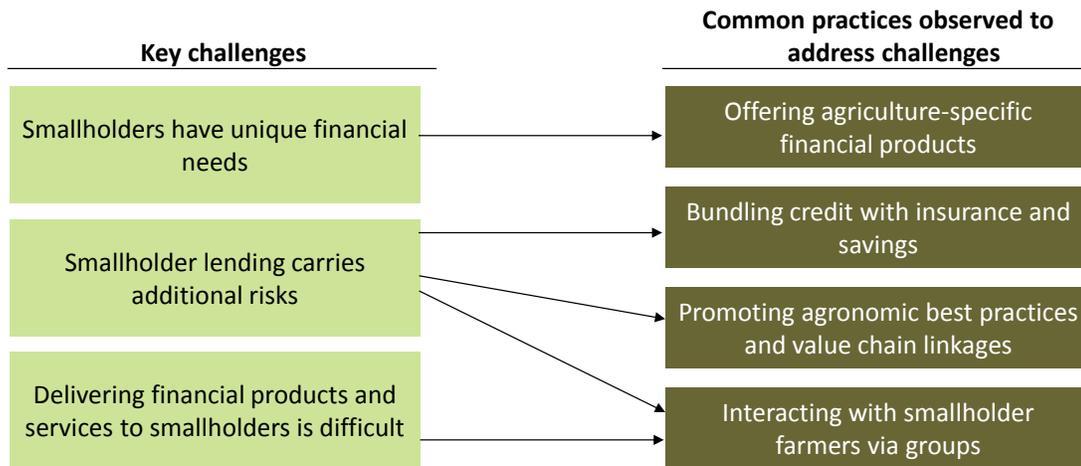


Figure 1: Key challenges and common practices

Financial providers apply four common practices to overcome these challenges. Within each of these common practice areas, there are more prevalent approaches as well as some that are less frequently observed.

1. Offering agriculture-specific financial products
2. Bundling credit with insurance and savings
3. Promoting agronomic best practices and value chain linkages
4. Interacting with smallholders via groups

Offering agriculture-specific financial products

Financial providers have changed their product portfolios to include offerings that better meet smallholders' unique financial needs. The most common agriculture-specific offering is a seasonal loan, in which the disbursement happens during planting season, to cover the costs of inputs and other planting needs, and all or most of the repayment is due after harvest in the form of a bullet payment. These credit offerings allow providers to better meet smallholders' agricultural finance needs by aligning repayment requirements with harvest cycles. However, when compared to traditional microfinance loan products with regular repayment schedules, seasonal loans with bullet repayments increase the length of financial providers' cash turnover cycles.

Less frequently observed agriculture-specific offerings include asset-based financing and commitment savings

products. Asset-based financing helps smallholders access more expensive productive assets such as livestock, irrigation systems, and vehicles. These assets serve as collateral for the finance provider, while also helping smallholders increase their productivity and/or household income. With agriculture-focused commitment savings products, smallholders contribute savings when income is generated and later – during the next planting season – apply these funds to purchase inputs. These savings products help smallholders better manage the cyclical nature of their agricultural cash flows without taking on the risk associated with credit products. For providers, these savings products are an opportunity to expand their client base and begin serving smallholders who may not yet be eligible for loan products. As these clients increase their production and income, providers may then be able to offer them a wider range of financial products.

Bundling credit with insurance and savings

Many direct-to-farmer finance providers bundle credit with insurance and/or savings products to manage some of the key risks associated with lending to smallholders. As is common among non-agricultural microcredit offerings, providers often include mandatory personal life and/or funeral insurance as part of their agricultural credit offerings. These products protect both the finance provider and the smallholder family against default and indebtedness, respectively, in case of the borrower's death. While this model is currently less prevalent, some providers bundle their credit products with agricultural insurance (including both index crop and weather

insurance and, in the case of asset-based financing, asset insurance) to protect against losses due to major agricultural risks. However, the limited availability and high cost of these products have thus far kept adoption of this model low.

Some providers also require smallholders to contribute savings before receiving a loan. These mandatory savings accounts typically range from 10-25% of the loan value¹¹ and serve as a form of partial collateral for providers in case of smallholder default.

Promoting agricultural best practices and value chain linkages

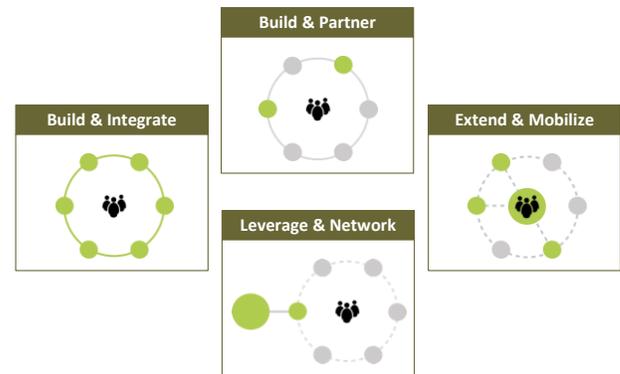
Direct-to-farmer finance providers broadly recognize the importance of effective agronomic support services for smallholder borrowers to mitigate production and price risks. These services most often include training to promote agricultural best practice and improve yields. In some cases, these services also encompass market access support to connect smallholders to buyers and improve the prices realized.

Finance providers' approach to delivering these agronomic support services varies. Some providers deploy support services directly via dedicated field staff or loan officers. These providers typically charge smallholders for these services, either through a mandatory service fee bundled with the loan or a separate fixed charge for these services. However, these providers often report that the price smallholders are willing to pay for agronomic training does not fully cover the costs of provision.

Other providers outsource supporting services delivery to partners. In these cases, the partner is responsible for covering the costs associated with these support services, through fees charged to smallholders, philanthropic capital, and/or other revenue sources.

While a less prevalent form of agronomic support, some providers also offer clients in-kind loans, delivering high-quality seed and fertilizer to the farmer on credit rather than disbursing cash. This approach is particularly valuable for smallholders who lack access to high-quality inputs near their homes. For providers, however, this practice increases operational complexity and exposes them to additional risks associated with input price fluctuations.

Figure 2: Business Model Archetypes



Interacting with smallholders via groups

Many direct-to-farmer providers interact with smallholders via group structures to decrease the costs of reaching smallholders and lower the risk of default. This type of lending differs from social lenders' loans to producer organizations in that the groups involved in direct-to-farmer finance are smaller (typically fewer than 100 members), less formal in nature, and often formed by the finance providers themselves. In some cases, particularly when working with non-commercial smallholders, providers extend one loan to the group, which then disburses the loans to its members and manages repayment. In other cases, providers offer individual loans with group guarantees, allowing smallholders to access loans with more flexible terms and sizes relative to group loans. In both models, groups serve as a point of interaction for disbursement, monitoring, and repayment, which lowers providers' lending costs. In addition, group guarantees can replace the need for collateral, as peer pressure encourages loan repayment and decrease lenders' risk.

Alongside the benefits, there are limitations associated with group lending approaches. Smallholder willingness to participate in group lending varies, given some individuals' aversion to guaranteeing others' loans and/or difficulty obtaining larger loans within the group structure. Furthermore, the often informal nature of group guarantees can make enforcement difficult for finance providers.

Business Model Archetypes

Providers' specific approaches to direct-to-farmer finance cluster around four business model archetypes.

While each of the business model archetypes have strengths and merit, each also faces limitations to scale. Understanding these archetypes can help funders, investors, and finance providers better align models across smallholder farmer segments and identify opportunities to address scaling challenges.

Build & Integrate archetype

“Build & Integrate” financial providers aim to fill a market gap by serving primarily non-commercial smallholders with little to no access to finance and farming related services. Field-based staff deliver financial products, typically developed specifically to support smallholders' agricultural needs, as well as agronomic training and other support services. The hands-on and field-based nature of Build & Integrate providers' approach helps them build strong relationships with smallholders and a deep understanding of their financial and non-financial needs. However, this approach also translates to a low farmer to field officer ratio of approximately 100-200 farmers per field officer – the lowest observed across archetypes.

Given their approach to serving smallholders, Build & Integrate providers' key challenges to scale are most often delivery and cost related. In particular, as providers grow, they often face recruitment and training challenges, particularly at the middle management level. In addition, providers report that the price farmers are willing to pay for agronomic training often does not cover the cost of provision. Therefore, most Build & Integrate archetypes are partially reliant on short-term philanthropic capital, which creates a need for continuous fundraising as they grow.

Build & Partner archetype

“Build & Partner” financial providers also aim to fill a market gap by serving rural populations, including both non-commercial smallholders and commercial smallholders in loose value chains. Similar to the Build & Integrate model, these providers operate in close proximity to clients, delivering financial products through field-based staff. However, Build & Partner providers

typically outsource the development and delivery of agronomic training and other support services to formal partners. As providers' staff operate in the field but are primarily responsible for financial activities only, Build & Partner providers typically have farmer to field officer ratios of approximately 300-500 farmers per field officer, higher than those of Build & Integrate providers. A focus on financial product and service provision and greater emphasis on commercial smallholders allows Build & Partner providers to rely more exclusively on investment capital to fund lending and operations. Some Build & Partner providers also seek out philanthropic capital to support higher risk activities such as new product development or extension of services to non-commercial smallholders.

For Build & Partner providers, key challenges to scale are typically delivery and risk related. Similar to Build & Integrate providers, they often face recruitment and training challenges, particularly at the middle management levels, as they grow and need to recruit additional field-based staff. Build & Partner providers also face important risk-related challenges given their dependence on partnerships for delivery of agronomic support services. Specifically, when these providers pursue growth, they are limited by their agronomic support service partners' reach, quality of offerings, and operational sustainability.

Leverage & Network archetype

“Leverage & Network” financial providers use existing infrastructure to broaden their client base by serving commercial smallholders, including some in loose value chains. To do so, providers typically deploy existing capital sources (including revenue, client savings, and investment capital) and staff to deliver a full set of financial products to smallholders. Most Leverage & Network providers serve smallholders from branches and seek out informal partnerships with other organizations who can provide training and other agronomic support to their clients. Given these factors, Leverage & Network providers typically have the highest farmer to field officer ratios: more than 1,000 farmers per field officer. However, when compared to other providers, Leverage & Network providers usually operate farther away from smallholders, which can affect the depth of their client relationships and knowledge of smallholder needs. These factors may limit these providers' ability to customize products and manage smallholder-specific risks.

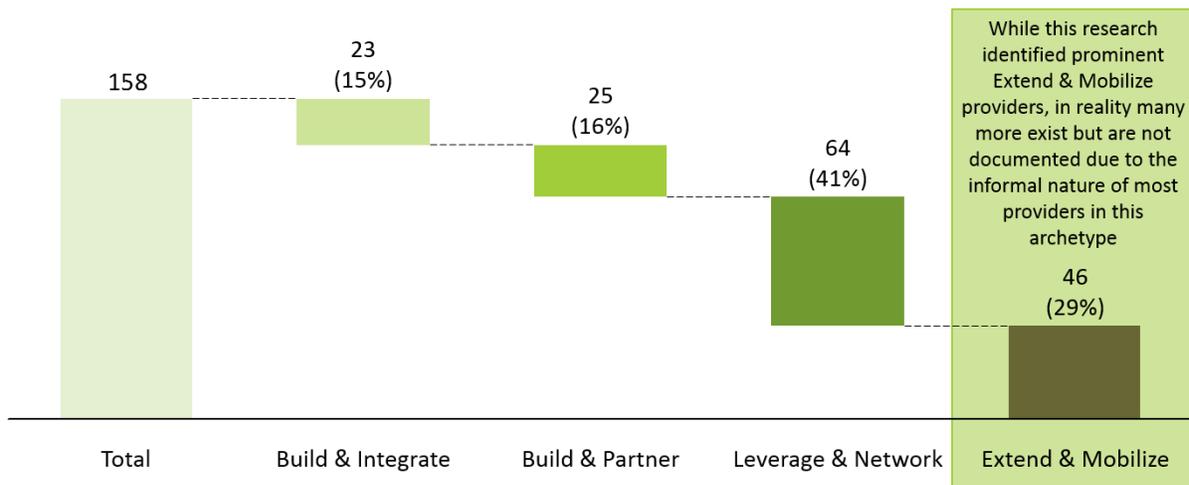


Figure 3: Archetype prevalence among models identified in research

Leverage & Network providers' key challenges to scale are primarily driven by risk-related challenges. Similar to the Build & Partner archetype, Leverage & Network providers seeking to scale are also limited by agronomic support service partners' reach, quality and sustainability. Internally, Leverage & Network providers' commercial pressures, paired with staff's more limited agricultural knowledge, can hinder scaling potential as firm leadership seeks to minimize perceived risk.

Extend & Mobilize archetype

"Extend & Mobilize" financial providers are typically member-run organizations set up to meet the needs of the rural communities in which they operate. Thousands of these providers exist, and some have extended their financial product offerings to include agricultural focused products for non-commercial smallholders. Most Extend & Mobilize providers depend on their existing staff and capital base (typically member savings) to support their agricultural finance activities. Agronomic supporting services are typically member driven and provided more informally on a volunteer basis.

When scaling direct-to-farmer finance activities, Extend & Mobilize providers are limited by internal challenges. Providers often struggle to meet smallholders' unique financial needs; the seasonal nature of agriculture means that all borrowers require credit at the same time, and this syncing places pressure on the providers' savings-based capital pool that is often lent out on a rotating basis. In

addition, Extend & Mobilize providers' institutional capacity constraints related to staff and management ability, internal processes, and infrastructure further limit their ability to scale.

Most of the providers identified in ISF's research are concentrated in the Leverage & Network archetype. Given the typically informal nature of Extend & Mobilize providers, however, thousands of small institutions in this archetype are informally documented and were not captured in this research.

The different approaches taken across archetypes translate into differences in key drivers of per-client revenue and costs. While additional research is required to more accurately detail providers' specific cost and revenue structures, both quantitative and qualitative proxies can help us understand relative values across key drivers.

Looking Ahead to Achieve Greater Scale

Overcoming archetypes' key challenges to scale and increasing the amount of finance deployed directly to smallholders will require further learning, knowledge-sharing, and innovation across the sector.

		BUILD & INTEGRATE	BUILD & PARTNER	LEVERAGE & NETWORK	EXTEND & MOBILIZE
Revenue per client	From agricultural credit products	Lower average loan size (~\$50-\$300) given focus on serving non-commercial smallholders	Medium average loan size (~\$50-\$500) given focus on both non-commercial and commercial smallholders	Larger average loan size (~\$300-\$5,000) given focus on serving commercial smallholders	Lower average loan size (~\$50-\$300) given focus on serving non-commercial smallholders
	From other financial products*	Limited additional products given focus on agricultural finance	May offer some additional credit products (i.e., household loans)	Typically offer widest variety of additional financial products	Typically offer some additional credit products (i.e., household loans)
	From support services*	Clients typically pay for support services via service fee and/or separate fixed charge	Not applicable as support services are outsourced to partners	Not applicable as support services are outsourced to partners	Limited revenue as support services are typically informally provided
Cost per client	From staff costs	Lowest farmer to field officer ratio (~100-200:1)	Mid-range farmer to field officer ratio (~300-500:1)	Highest farmer to field officer ratio (~1,000+:1)	Farmer to field officer ratios vary widely
	From other operating costs*	Providers take a field-based approach and are typically developing systems	Providers take a field-based approach and are typically developing systems	Providers take a branch-based approach and have the relatively most sophisticated systems	Providers take a field-based approach and have the relatively least developed systems

Typical per client revenue/ cost from driver (relative across archetypes)



*Qualitative proxies

Note: Quantitative and qualitative proxies assessed based on both primary and secondary research and are approximations to characterize key differences across archetypes

Figure 4: Key per-client revenue and cost drivers for direct-to-farmer finance providers

Funders can support additional learning to deepen the sector’s understanding of each business model archetype. In particular, it is important for funders, investors, and finance providers themselves to further understand the specific revenue and cost drivers for direct-to-farmer finance provision to identify the most significant opportunities for revenue growth and cost reduction going forward. Additional research is also required to understand more specifically which smallholder segments are reached by each business model archetype to help providers optimize their finance activities across segments and to help funders and investors better align investments with their own priorities.

Alongside increased learning, there is also a need for additional knowledge sharing and blending of approaches in the space. While there are emerging examples of direct-to-farmer finance providers beginning to adopt practices from other archetypes and reflect more hybrid-models, this practice remains relatively uncommon in the space. Funders and investors can encourage this activity by supporting knowledge-sharing platforms and

activities among providers and working with individual direct-to-farmer finance providers to experiment with practices more commonly observed in other archetypes.

Finally, funders and investors can support both ongoing and future innovation in the space to help providers overcome challenges and scale more quickly. Direct-to-farmer finance providers are already experimenting in a range of innovation areas. The forthcoming briefing note, Direct to Farmer Finance: Innovation Spaces Playbook, describes these innovation areas in greater detail and suggests compelling new directions in which practitioners could build off of current activity.

Conclusion

Direct-to-farmer finance is an important pathway towards poverty alleviation and meeting the vast global demand for smallholder finance. More than 150 finance providers offer direct-to-farmer finance globally. While these providers’ business models reflect distinct approaches to reaching smallholders, several common

practices for addressing key challenges have emerged across models.

Yet there is limited evidence of models reaching sustainable scale and there remains a vast gap between current supply and smallholder demand. Closing this gap will require further evolution of the models observed today, both through additional research and knowledge-sharing across models, and continued innovation within the space.

SCOPE OF THIS STUDY

This study focuses on finance providers that provide financial products and services directly to smallholders, particularly noncommercial smallholders and commercial smallholders operating in loose value chains. While some of the providers identified in the research also provide finance to smallholders via cooperatives, buyers, or other aggregation points, the scope of this study excludes these intermediated lending activities. In addition, large input suppliers and buyers, who can also provide financing direct to smallholders, are also outside of the study's scope and will be investigated in further detail in forthcoming research from the Initiative for Smallholder Finance.

NOTES

¹ Source: CGAP, "Segmentation of Smallholder Households," April 2013.

² Ibid.

³ Various sources were used to identify direct-to-farmer providers, including; Initiative for Smallholder Finance local lending database; CGAP crowdsourcing submissions; major reports highlighting direct-to-farmer models; and key funders, networks, and technical assistance providers that support providers to deploy direct-to-farmer finance.

⁴ For definitions of public policy lenders, niche poverty lenders, and diversified branch banks see the prior briefing note from The Initiative for Smallholder Finance, "A Roadmap for Growth: Positioning Local Banks for Success in Smallholder Finance."

⁵ Defined as microfinance institutions that are not licensed to mobilize deposits.

⁶ Informal financial institutions are defined as deposit-taking institutions collectively owned and managed by members. Source: Technoserve, "A Guide to Working with Informal Financial Institutions," June 2014.

⁷ Direct-to-farmer finance providers in Asia with reach in excess of five million smallholders include Bank for Agriculture and Agricultural Cooperatives in Thailand and Vietnam Bank for Agriculture and Rural Development.

⁸ Source: The Initiative for Smallholder Finance, "Local Bank Financing for Smallholder Farmers: A \$9 Billion Drop in the Ocean," 24 October 2013.

⁹ Source: Dalberg, "Catalyzing Smallholder Agricultural Finance," September 2012.

¹⁰ Source. FinScope National Surveys, 2008-2012.

¹¹ Based on sample of 11 providers in the direct-to-farmer database with data available on mandatory savings levels required to receive a loan.

RESEARCH BY

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ABOUT THE INITIATIVE FOR SMALLHOLDER FINANCE

The Initiative for Smallholder Finance is a multi-donor initiative hosted by the Global Development Incubator to build research and development infrastructure in the smallholder finance industry and make progress toward filling the gap in financing through targeted product development, piloting, and partnerships.

For the original report that led to the creation of the Initiative for Smallholder Finance, see "[Catalyzing Smallholder Agricultural Finance](#)" (2012).

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