

## **Expanding the Agricultural Finance Frontier: A Kenyan Case**

*Betty Kibaara and James Nyoro*

*Institute of Agricultural Policy and Development,*

*P.O Box 20498-00200 Nairobi, Kenya*

### **Abstract**

Agriculture is the mainstay of the Kenyan Economy. However, agriculture has experienced low productivity over the years. Poor access to agricultural finance has been identified as a contributing factor to low crop productivity. Kenyan agriculture has undergone some fundamental changes which have profoundly affected agricultural financial services. In addition, most financiers shy away from lending to the agricultural sector because of the covariant risks related to rain-fed agriculture. Given this background, we undertake a comparative analysis of emerging models of agricultural finance that have expanded the agricultural finance frontier to the smallholder farmers. Key findings indicate that demand for farming credit takes the highest proportion of the credit needs among the rural households, thus accentuating the importance of agricultural finance. The state run model of agricultural financing has the lowest financial sustainability. On the contrary, the community financing models are the most likely drivers of change in the rural finance landscape.

### **Introduction**

Agriculture contributes 23.9 percent of the Kenya's Gross Domestic Product (GDP) and 60 percent of the total export earnings. In addition, 80 percent of the population derives their livelihood from agriculture. In spite of the significant contribution, agriculture has experienced low productivity in the past decade. Improving access to agricultural finance is in line with the Millennium Development Goals, which aims at reducing the proportion of people who suffer from hunger by half. Key government documents have highlighted the importance of agricultural finance in agricultural and rural development. However, Kenya has not developed a comprehensive rural financial strategy. Lack of working capital and low liquidity limit the farmer's ability to purchase productivity enhancing inputs like seeds, fertilizers and pesticide (Nyoro, 2002). The average production efficiency levels are higher among producers who have access to formal credit (Awudu and Huffman, 2000; Kibaara, 2005). In the late 1990's, most mainstream commercial banks closed down some rural branches in order to cut costs and improve profits. The non-traditional financial institutions have emerged to fill the gap created by the mainstream banks which locked out low income and irregular earners. In spite of the importance of a savings account, only 27 percent of the Kenyan population has savings accounts in to formal banking institutions (Finaccess, 2007).

It is against this background that we carried out a study to examine demanders, suppliers of agricultural credit the emerging models of agricultural financing.

### **Data and Methodology**

The data on the emerging agricultural financing models were gathered from key stakeholders purposely selected from 15 districts within six agro-ecological zones. We used a structured checklist covering the history of the organization, operations, outreach, costs, performance indicators, financial services provided, socio-economic characteristic of the client, requirements, use of loans, transaction charges, default rates, sustainability, constraints, and opportunities. The study uses supplementary data from the Tegemeo Agricultural Monitoring Project Analysis (TAMPA) panel data. This is cross-sectional panel (2000 and 2004) household data comprising of 1540 rural households. The data is analyzed using descriptive statistics and comparative analysis.

### **Results and Discussions**

#### *Demand for Agricultural Credit*

Data from the 2004 Tegemeo survey shows that only 39% of the households sought credit. Figure 1 show that credit for farming purposes remains the most dominant need and has increased from 53.71% in 2000 to 71.15% in 2004.

*Traditional Suppliers of Agricultural Credit*

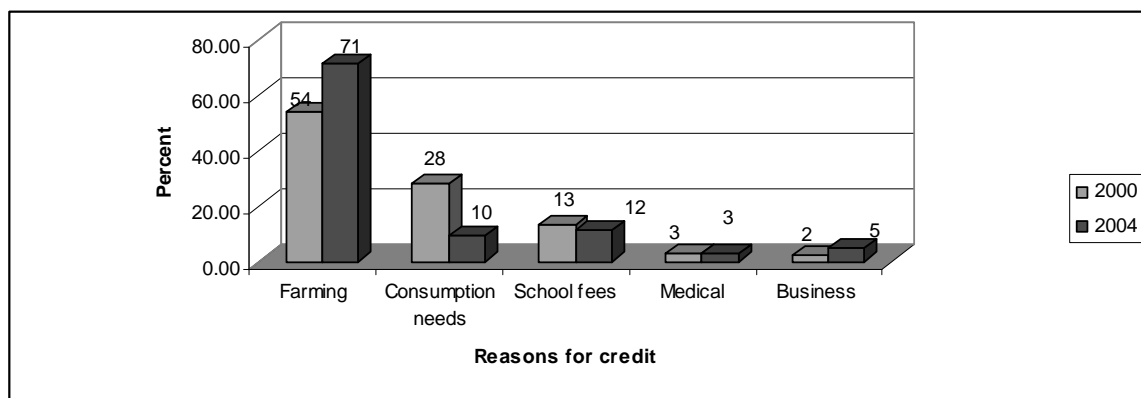
The supply of agricultural credit is dominated by commodity based credit providers/companies who promote tea, sugarcane and horticultural crops production. Provision of agricultural credit by the commodity based credit providers has increased from 53.5% in 2000 to 62.7% in 2004 (Table I). This shows that the role of contracted farming in provision of embedded services such as credit for agricultural inputs has become increasingly important. The savings and credit co-operatives (SACCOs) remain a significant supplier of agricultural credit. However, the SACCOs market share has slightly declined from 25% in 2000 to 20.6% in 2004 partly because of spillover

effect of wrangles and mismanagement of SACCOs. The informal money lenders and input stockists also play a vital role.

**Emerging Models of Agricultural Financing**

*State Owned Rural Finance Model*

This is a government owned, financed and managed model that provides agricultural credit mainly to large scale farmers with an objective of promoting food production in the country. In Kenya, the government implements agricultural financing through the Agricultural Finance Corporation (AFC). The corporation collapsed in early 1990s due to non-repayment of debts and political interferences.



**Figure 1:** Reasons for seeking any form of credit in 2000 and 2004

**Table I:** Source of agricultural credit in percent, 2000 and 2004

Source of credit	2000	2004
Commodity Based Credit Providers	53.5%	62.7%
SACCOs	26%	20.6%
Informal money lenders	12.1%	9.9%
Local trader/input stockists	6.8%	3.9%
AFC	0.4%	1.3%
Commercial banks	0.6%	1.0%
MFIs/ NGOs	0.6%	0.5%

Source: Tegemeo household survey, 2000 and 2004

In the past five years, the corporation has been resuscitated after receiving 1.3 Billion Kenya shilling

from the exchequer. The funding has enabled the corporation resume lending for seasonal and development loans. In addition, the corporation has expanded its lending frontier to cover value addition projects. In order to increase outreach the corporation is implementing the wholesaling group lending approach to organized farmer groups (AFC, 2005).

#### *Credit Voucher System*

This is a model of providing agricultural inputs on credit to rice farmers in Ahero Irrigation Scheme using a combination of a staggered credit voucher and cash, thus reducing the likelihood of credit diversion to other life cycle needs. The 75% of the credit is disbursed via the credit vouchers and 25% through cash vouchers. The following actors are involved; Savings and Credit Cooperative where farmers are members through purchase of shares; a micro finance institution which manages the SACCO; input stockists from where the farmers redeem vouchers; government which provides the irrigation water; the donor who guarantee to repay the loaned amount in case of default and buyer of the agricultural output. The credit voucher system is being piloted in Ahero rice scheme since March 2005. During the 2005 crop production year, the organization disbursed a total of Ksh. 6.7 million to 617 farmers in Ahero rice irrigation scheme.

#### *Beach Banking Model*

This model involves provision of agricultural finance services to the fishermen and fishmongers along Lake Victoria beaches. The motivation behind this innovation is to contribute towards poverty alleviation among the fisher folks. The participants are members of a SACCO managed by a micro finance institution known as SAGA at a fee recovered from paid up interest rates. The model operates eight service points otherwise referred to as 'Beach banks' along beaches in Kisumu and Bondo Districts. The 'beach banks' have front offices that operate like conventional banks, providing saving and credit products. It has a current membership of 3,000 clients with a total savings of Ksh. 15 million. Perhaps the most innovative loan product is the market day loan which is a very short-term loan which is processed within the same day and is payable within 5 days at a 2% interest rate. The market day loans account for 62% of the total beach 'bank' loans.

#### *Community Owned Rural Finance Model*

The community owned rural finance model is a rural finance model that is owned and managed by the rural

community with assistance from the donor agency. The community forms registered associations. Membership is through purchase of shares in the associations. The objective of this model is to reduce poverty through improved access to financial services mainly in the low population density areas with high incidences of poverty and few alternatives to financial services. Examples of the community owned rural finance model are the Financial Service Associations or 'Village banks' and the church based Mbeu Savings and Credit Association. The community models provide savings, loan and money transfer services.

#### *Private Commercial Bank Led Model: a Case of Emerging Indigenous Bank*

In the early 1990's most mainstream banks restructured their operations such as closing branches in the rural areas to cut down on costs and improve profits. This left a gap in provision of rural financial services which has partly been filled by the emerging indigenous banks such as Equity bank. The emerging banks are mainly owned locally and work on the principle of taking banking services closer to the people. The bank financial services to rural clients make up 68 percent of clients in Equity (CGAP, 2004). The rural farming community can access supervised short term loans for horticulture, dairy, coffee and tea farmers. The bank has given incentives to its clients such as no ledger charges on saving accounts. The bank is also providing mobile banking services in the rural areas.

#### *Stockists Credit Guarantee System*

The credit guarantee system is a model that strengthens the lending and borrowing capacity of the commercial manufacturer of agricultural input and the capital constrained input stockists. The credit guarantee system involves; a local non-governmental organization (NGO) in this case Agricultural Market Development Trust which manages the project; agricultural input stockists/wholesaler who acquires training on business skills; an input manufacturing company which lends to the input stockists and the donor who guarantees to repay 50 percent of defaulted loans up to a maximum of US \$40,000. The NGO links the trained stockist to the input manufacturing company. The company then enters into agreement

**Table II:** A comparative analysis the agricultural financing models

Indicator	State Owned Model: AFC	Credit Voucher Model	Beach Banking Model	Community Owned Model	Commercial Bank Model
Objective	Food Production	Food security	Poverty reduction	Poverty reduction	Profit
Interest rates per annum	10%	24%	24%	20% to 34%	12% to 18%
Outreach ( no. of clients)	5,200	617	2,700	70,000	380,800
Annual HH income in Ksh	260,489	99,317	99,317	159,130	227,103
Per capital income in US \$	1.4	0.5	0.6	0.8	1.2
Average loans per client	320,000	10,000	18,153	7,215	42,942
Insurance on loans	No	Yes	Yes	Yes	Yes
% loaned members	N/A	N/A	30%	38%	21%
Unit cost of lending 1 Ksh	0.5	0.09	0.02	0.13	0.22
Savings per client-Ksh	N/A	3,635	5,797	19,000	16,071
Financial Sustainability	Low	Average	High	Average	High
Source of funds	Government	shareholders	shareholders	shareholders	shareholders

with the trained stockist to supply inputs (companies and wholesalers) on credit.

Since 2005, over 150 stockists had been trained in business skills thus improving their creditworthiness. Ten companies had received a revolving credit guarantee enabling them to extend credit valued at over one million Ksh to wholesalers. In return, the wholesalers have guaranteed over 100 new stockists who have received inputs worth four million Kenya shillings on credit. This project is being pilot in Western Kenya since 2005.

#### *Comparative analysis of the agricultural financing models*

The government led model charges the lowest interest rate but serves fewer but wealthier clients (Table II). It is also not financially sustainable in the long run. The credit voucher model, beach banking and the community owned models charges higher interest rates yet these are the models that are financing the poor rural income households who with per capita income below a dollar. The emerging indigenous banking model is reaching a higher proportion of the rural population who were previously unreached.

#### **Conclusion**

The study has shown a high proportion of farmers seeking credit for farming purposes than for other household purposes, thus emphasizing the importance of agricultural finance. Different models of agricultural financing have evolved over time and the proportion of households that seek credit for any

purpose is less than 40%. Therefore, rural finance is more than credit provision and policies that promote increased access to rural financial services should consider provision of a comprehensive financial package. The Kenyan government has continued to subsidize the wealthier farmers in the country. The government needs to focus agricultural finance on the group wholesaling approach in order to reach the low income farming households.

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