CONCEPT NOTE

Design Workshop on Establishing an African Agriculture Risk Sharing and Financing Mechanism

12 – 13 July 2016
Safari Park Hotel
Nairobi, Kenya
I. BACKGROUND

1. The High Level Conference (HLC) on Agricultural Transformation held in October 2015 in Dakar, Senegal discussed amongst other major issues, approaches for the transformation of African agriculture sector. Innovative mechanisms for financing the entire value chain, prominently featured, as part of the critical success factors, needed for the transformation of Africa’s agriculture sector. One of the 18-action point declaration at the HLC was to “Significantly increase commercial financing to the agriculture sector by establishing an African Agricultural Risk Sharing and Financing Facility to de-risk agricultural value chains across the continent and allow commercial banks and financial institutions to lend at scale to agricultural value chains”.

2. Considering the current context of the slump in commodity prices, diversification of African economies has become imperative now more than ever. Investments in the agriculture sector presents a ready opportunity to generate incomes, improve the livelihoods of millions of Africa and deliver returns to investors. At present, the share of commercial banks’ lending to agriculture in Africa remains very low, ranging from 3% in Sierra Leone, 4% in Ghana and Kenya, 6% in Uganda, 8% in Mozambique to 12% in Tanzania. On average, only about 5% of domestic resources are being allocated to the agricultural sector. In part, a perceived combination of high risk and modest returns – as well as the costs of extending traditional banking infrastructures in rural areas – has deterred many financial service providers. The G-20 Global Partnership for Financial Inclusion’s (GPFI) SME Finance Sub-Group reported that neither commercial banks nor the emerging microfinance industry are willing or able to sufficiently meet the financial needs along agricultural value chains, leaving farmers and agricultural SMEs unserved in the “missing middle”.

3. Although there have been limited and varied attempts in the past to bridge the financing gap, results have been mixed. Through discussions around a risk sharing and financing mechanism, the AFDB through this workshop seeks to review best practice, and bring together an alliance of players to tackle this problem to significantly scale up financing for agriculture across the continent.

II. FINANCING AGRICULTURE IN AFRICA: THE CONTEXT

4. Across Africa, growth and opportunity in the agriculture sector is constrained by limited access to capital. Agriculture in Africa employs or provides livelihoods to 60 percent of the population1 while contributing 20-30 percent to Africa’s GDP2. And yet, it typically attracts less than 5 percent of lending from financial institutions on the continent, leaving farmers and agricultural enterprises starved of the capital they need to operate and grow their businesses. With Africa’s population expected to more than double to 2.5 billion by 2050, significant advances in

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1 The World Bank ‘Structural transformation and rural change revisited,’ Losch et. al., 2012.
2 AfDB, 2015-2019 Draft Agriculture & Agribusiness Strategy
agricultural production and productivity will be required to enable Africa to feed itself. Finance is what will make this possible.

5. **Finance matters because it is a catalyst for growth.** While there are a number of critical bottlenecks constraining the growth of a highly-productive and prosperous agriculture sector in Africa, finance is a cross-cutting catalyst for growth in the sector. By making possible investments in, e.g., productivity-enhancing farm inputs or agro-processing equipment, finance is an enabler of the positive outcomes that policymakers, development institutions, farmers and firms seek: increased productivity, higher value products, and broadened diversity of agricultural production that drives economic growth.

6. **There are a range of drivers to limited access to capital in the agriculture sector.** The causes include perceptions of higher risk in the agriculture sector, along with lower expected returns than what financial institutions can obtain elsewhere. But there are also real challenges in African agriculture that limit the economic opportunity that financial institutions see in the sector: low productivity, co-variant risk profiles, fragmented supply chains, inadequate infrastructure, and sub-optimal policies in areas as disparate as food safety, import regulations and land tenure. As a result of both perceived and real considerations, banks and other financial institutions tend to minimize exposure to agriculture in their portfolios. Even those banks that do serve agricultural enterprises or farmers tend to provide primarily short-term financing like revolving credit lines that only scratch the surface of financing needs.

7. **Unmet demand for finance in the agriculture sector exists across the value chain.** This includes both smallholder and emerging commercial farmers, who are particularly under-served, as well as agro-processor Small and Medium Enterprises (SMEs), seed and input companies, agro-dealer networks, and others enterprises such as logistics and storage providers. The vast majority of Africa’s farmers are smallholders that operate, by and large, in fragmented markets with limited access to formal financial services that meet their unique needs. Many well-known constraints determine this outcome. On the supply side of the market for finance, banks face a steep cost to reach smallholders and have not develop the capability to serve their needs with appropriately-trained staff and tailored products, while lending margins to farmers are often no better than alternatives that banks can pursue. On the demand side, most smallholders are not organized into producer groups that can serve as a locus of productivity improvements, mechanization and connections to downstream markets, all of which increase their attractiveness to commercial banks. Farmers also often lack clear title deeds and other forms of collateral which help reduce risk for banks. Finally, agro-enterprises across the value chain can face significant barriers to accessing the capital they need to grow and operate at scale. Evaluating the credit risk of an agro-enterprise, as is the case with farmers, requires agriculture-specific expertise that financial institutions often simply lack, often due to a limited presence in rural areas where agriculture predominates. Banks that do finance small- and mid-sized agribusinesses often employ unique operating models, technologies or processes—all of which require upfront investments in staff and systems that cannot be recouped without reaching scale.
8. **Demand for finance in agriculture spans a range of different types of capital, from short-term trade finance to long-term debt and equity investment.** Farmers and agro-enterprises require an assortment of capital to thrive. This includes, for instance, short-term working capital that farmers use to purchase seeds and farm inputs on a seasonal basis, or that SMEs use to purchase offtake from farmers or operate an agro-processing facility. Demand for finance in agriculture also includes medium-term financing for farm or agro-processing equipment, as well as long-term debt and equity investments in capital equipment and land. Further, smallholder farmers often face limited access to the full gamut of formal financial services, including a dearth of savings and risk management products tailored to their unique circumstances. This situation creates an opportunity for different types of financial intermediaries and providers of capital—from commercial banks to private equity funds, state-run agricultural development banks, microfinance institutions, and non-banking financial institutions like merchant banks, credit unions, insurance companies and mobile money providers—to play different roles in addressing different unmet finance needs in the agriculture sector.

9. **Private sector-led innovative financing tools have great promise to improve access to capital in African agriculture by catalyzing private investment and addressing market failures.** Innovative financing instruments are designed to mobilize additional resources and address market failures or institutional barriers. They complement traditional resource flows such as foreign direct investment, remittances, government investment and development aid. And while public sector investment is important in agriculture, the private sector ultimately drives activity and growth in agricultural development. This makes private sector involvement central to public sector-initiated innovative financing efforts.

10. **Many innovative financing mechanisms can catalyze growth in the African agriculture sector, and several are being deployed today.** For example, efforts such as AGRA’s credit guarantee and risk-sharing facilities with Equity Bank and Standard Bank have leveraged ten times their commitments of risk-sharing public capital into private lending to farmers. Other innovative financing approaches gaining attention in agriculture include risk management tools like weather index-based insurance that helps farmers mitigate climatic risk; guarantee or guarantee-like products such as warehouse receipts programs that eliminate the need for external collateral; and private partnerships like equitable outgrower schemes that link agribusinesses and farmers, enabling bank financing of productivity-enhancing farm inputs.

11. **Innovative financing efforts are building momentum for African agricultural transformation.** Typically operating through partnerships between private investors, development finance institutions, technology companies, governments and/or agribusiness firms, innovative financing in African agriculture is mobilizing new resources, addressing institutional barriers or introducing new financing products into new markets. Innovative financing mechanisms address traditionally high costs to serve the agriculture sector among financial intermediaries, or reduce the risk of doing so. They are also helping to unlock large-scale investments by agribusinesses by coordinating public-private investments. Finally, innovative financing mechanisms are helping to
dispel misplaced perceptions of risk associated with agriculture by demonstrating commercially-attractive returns that crowd in more private capital over time.

12. **Innovative financing efforts often focus on the supply side of the market, while constraints to growth in agriculture are multi-dimensional.** Innovative financing typically seeks to increase the amount of capital available in a particular sector or market segment, through a variety of mechanisms that ultimately mitigate risk or enhance returns. Yet, growth-enabling investments in African agriculture can require interventions that address multiple dimensions of the situation on both the demand and supply sides of the market, as well as through technology solutions and complementary infrastructure investments. Supportive, enabling policies are required across each dimension as well. Innovative financing, in this view, creates an ecosystem of opportunity that isn’t just about the supply of capital.

13. **On the demand side of the market for finance, there are several well-known constraints that farmers face in particular.** Most smallholders are not organized into effective producer organizations that enhance banks’ ability to provide financing for working capital and equipment, nor do they tend to have reliable linkages to downstream markets that improve the consistency of their cash flows. Smallholders tend to live at the margin of subsistence where fluctuations in cash flow, as is common in agriculture, can be devastating to the household economy and reduce farmers’ ability to service traditional loans. Small- and mid-sized agro-enterprises also often face significant barriers to accessing the financing they need to grow, and tend to finance their operating and investment needs through a mix of retained earnings, other household income, and a variety of finance providers including commercial banks and informal money lenders. Some agro-enterprises can mitigate risk by operating flexibly across multiple crop value chains or regions of a country, but the co-variant risks in agriculture—and limited availability of insurance mechanisms to offset this risk—lead banks to reduce exposure to these businesses.

14. **On the supply side of the market for finance, there are a range of deterrents to increased participation in agriculture.** There are high costs associated with banks serving smallholder farmers or farmer groups in particular, requiring upfront investments in staff skills, systems and back-office processes that cannot be recouped without reaching scale. The seasonality and uncertain timing of cash flows inherent in agriculture also lead to unique liquidity management issues for banks; banks must reach significant scale to smooth anticipated cash flows and reduce the co-variance of risk across their agricultural portfolio. Banks also need specific agricultural expertise to properly assess credit risk among both farmers and agro-enterprises, as well as to design appropriate financial products that meet farmers’ needs. Further, while commercial banks across the developing world report that average default risk in agricultural lending is on par with the rest of their lending portfolios, the risk distribution is skewed towards occasional catastrophic negative “spikes” (e.g., during droughts) with risk that cannot be easily hedged or distributed to others through reinsurancemechanisms. Compounding the problem, agriculture poses particular challenges for risk management, as the higher likelihood of co-variant risks and thus large,
concentrated payouts against losses requires holding large financial reserves against losses unless significant scale and risk diversification can be achieved (e.g., at a regional or continental level).

15. **Inadequate infrastructure is a cross-cutting barrier to agriculture sector growth that can be addressed through innovative financing.** Investments in irrigation, transport and market infrastructure are critical to improving returns and productivity in the agriculture sector, and necessary complements to private investment. Irrigated agriculture in much of Africa is a small proportion of overall production, and yet consistent access to water is one of the fundamental drivers of increasing yields. Access to irrigation can significantly decrease risk to financial institutions and off-takers or buyers of agricultural produce, enabling a “virtuous circle” of increasing productivity and incomes in agriculture. High transport costs are a significant constraint to growth in African agriculture, where production is dispersed in relatively under-connected rural communities and inadequate rural road infrastructure creates fragmented markets and increases post-harvest losses. Yet, the public good nature of this infrastructure, and the typically high initial cost of building it, leads to under-investment that dampens agriculture sector growth. Public-private partnership (PPP) models for agriculture-enabling infrastructure are promising but relatively unproven in Africa to-date.

16. **Finally, information and communications technology (ICT) offer significant potential to better enable the provision of financial services across the agricultural value chain.** The rapid adoption of mobile technology across the continent has been followed by solutions such as mobile-based electronic payment and money transfer services that create new distribution channels to reach previously unbanked populations, along with a host of mobile-based services that provide market information or enhance market linkages. Policies to create an enabling regulatory environment, however, have not always kept pace. Regulators are often understandably concerned by relaxing prudential regulations in the banking sector, but growth in the depth and breadth of non-bank mobile financial service providers is widely considered to be held back due to the absence of an effective regulatory framework in many countries. Creating enabling and competitive regulatory environments for digital financial inclusion will help to enhance agriculture sector growth.

**III. OBJECTIVES OF THE WORKSHOP**

17. The workshop has four objectives:
   i. Engage directly with the key stakeholders that will be involved in scaling up financing to agriculture on the continent.
   ii. Listen and learn about the specific country experiences, and identify common challenges and share the successes
   iii. Present AfDB’s initial thoughts on the Risk Sharing and Financing Mechanism, its preliminary design elements, and get feedback from the audience
   iv. Build consensus around an action plan leading to the establishment of the Risk Sharing and Financing Mechanism.
18. Through this workshop, the AfDB seeks to partner with African governments and financial institutions to design an innovative mechanism which will facilitate increase in financing to the agriculture sector, by de-risking agriculture value chains, reducing transaction costs and unlocking financial flows into the agriculture sector at scale across the continent. The workshop will be an opportunity for key stakeholders to contribute to the proposed facility’s modalities for sharing risks around financing agriculture value chains. The workshop will also present global and Africa-wide lessons learned and best practices for the design of a workable, context-based mechanism for the continent. By supporting this initiative, the AfDB working with the national governments and private sector institutions will be catalyzing the necessary finance for agriculture in Africa that is based on providing incentives to banks and other financial actors.

IV. EXPECTED OUTCOMES

19. At the end of the workshop, the main outcomes expected are:
   i. Lesson sharing from innovative financing and best practice risk-sharing models for agriculture finance in Africa and elsewhere, being implemented by governments, financial institutions, agribusiness companies, commodity traders, etc.;
   ii. A consensus built on common and agreeable understanding conceptual framework on risk sharing for financing Africa’s agricultural investments;
   iii. Buy-in and articulation of AfDB’s proposed roadmap and action plans towards establishing a continental agriculture Risk Sharing and Financing Mechanism;
   iv. Stakeholders’ inputs and contributions on the proposed financing mechanism, particularly on the articulation of the expected roles of public, private, institutional and government partners.

V. WORKSHOP PARTICIPANTS

20. The workshop will bring together participants drawn from the public, private and development sectors in Africa and will include among others; (i) Ministers of Finance, Ministers of Agriculture and Governors of Central Banks of Africa (ii) National sovereign wealth funds, pension funds, insurance companies (iv) Leading commercial banks, agricultural development banks, microfinance institutions, leasing companies and other financial institutions (v) Institutional investors, Private equity funds and Social impact funds (vi) National risk sharing initiatives (vii) Private sector companies with innovative inclusive financing initiatives (viii) Development finance institutions and agencies (ix) Representatives of farmers and farmer groups (x) Agricultural off-takers such as agro-processors and input suppliers (agro-dealers) (xi) Savings and Credit Organizations (SACCOS) and other farmers’ co-operative rural financing organizations (xi) Technical services’ providers and business development services’ (BDS) providers.

VI. VENUE AND DATES FOR THE WORKSHOP

21. The seminar will be held in Nairobi, Kenya from 12th to 13th July 2016 at Safari Park Hotel.