Globalization presents enormous challenges and opportunities for small- and medium-scale farmers; some will respond by diversifying into non-farm activities or gradually leaving the farming sector, while the more entrepreneurial and commercially oriented will seize the new agricultural opportunities. A key element in farmers’ capabilities is their capacity to invest in productive assets that will allow them to intensify production, enhance productivity and/or diversify into new farm enterprises. This technical brief summarizes some of the key findings from a major FAO study conducted in collaboration with the World Bank.

Many investments in agriculture require larger amounts of capital that amortize over many years or long gestation periods. These investments are mostly beyond the self-financing capacity of farmers and require access to external finance, in particular, longer-term, which allows to spread the investment costs over several years.
Term finance instruments

Term finance - medium-term (from 1-5 years) and long-term (over 5 years) finance comprise various financial instruments, such as term loans, financial leasing, and equity finance.

Term loans: These loans are well known and easily understood by farmers and may be used to finance a range of agricultural activities by adjusting loan sizes, disbursement and repayment schedules. There are seldom restrictions on the type of financial institutions that can provide them; in principle, even non-financial institutions such as processing companies or equipment suppliers can do so. Since uncertainty increases over time, the main difficulty in using term loans is the need to fix the repayment schedule ex ante, based on assumptions that might change over the repayment period.

Financial leasing: Its advantage is that it reduces or even eliminates the need for additional collateral – the financier remains the owner of the assets financed while the loan is reimbursed. It may therefore be particularly suitable in countries where weak legal and institutional frameworks create severe constraints on the use of rural assets, such as land, for securing term loans.

In designing leasing products for clients in rural areas, several issues must be taken into account:

• The concept of financial leasing is often unfamiliar to farmers and financial institutions, and its introduction may thus require higher set-up costs for capacity building.

• Since the financed asset is the main security and source of lease payments, leasing requires more supervision, resulting in high transaction costs.

• Legal and regulatory provisions may restrict the use of leasing to certain financial institutions, or the tax treatment may discriminate against leasing.

Equity finance: Equity finance requires specific skills that may restrict its use to specialized equity and venture capital funds, and development finance institutions. Venture capital uses equity finance for capitalizing risky investments, such as start-ups; therefore, these equity investors become part owner of the venture in question. The advantage of this instrument is that it enables these initial owners to access funds from investors on a long-term basis and without fixed repayment schedules and costs. However, all future profits are partitioned according to the ownership shares. For this reason, this form of finance is expensive in the long-run but may be optimal for large investment ventures with significant growth potential. The participation of the financier as shareholder in the enterprise reduces moral hazard related to asymmetric information, and the enterprise in turn benefits from management expertise from new investors.

The main limitations of equity finance relate to high transaction costs for appraisal and monitoring, which limits its use for smaller investments. It may, however, be suitable for financing larger-scale investments in processing and marketing, which in turn enhance the profitability of farm-level investments.

Agricultural term finance in practice

Long-term finance largely depends on a stable environment, profitable investment opportunities, the availability of specific risk-management instruments and access to suitable refinance facilities.

Term finance requires specific skills to appraise the stability of the borrower’s...
cash flow over time, the risks and profitability of investments, and the quality of collateral. Furthermore, providers need a strong equity base and access to refinance facilities.

Although the scarcity of term finance might be partly attributable to the inherent difficulties of this particular sector and the often hostile environment, it may also point to a lack of dynamism, innovation or competition in the financial system. This is because lenders might be unable to resolve these constraints and restrict themselves to lending to the few well-established medium- and large-scale companies in the commercial, service and industrial sectors. In addition, microfinance institutions often concentrate their activities in urban or peri-urban areas, focusing more on non-agricultural activities with a quick turnover, such as commerce and services.

**Risks**

While risks increase with the length of loan terms, they vary considerably according to investment purpose, type of borrower and the legal, institutional and market environment. The feasibility of term finance and the suitability of different instruments must be assessed on a case-by-case basis.

**Production risks**: These risks include all factors that affect the productivity of crop and livestock activities and thus the profitability of related investments. Due to the high dependence of agriculture on biological processes, external events such as drought, flooding, pests and diseases are major sources of production risk.

**Market risks**: These risks may be due to factors affecting timely delivery of produce to markets or its quality. This may also be due to price and market fluctuations, whose market risk increases with time.

**Client risks**: These risks are related to the investor’s family and household. Illness or the death of a family member may lead to labour shortages or increased expenditures for medical expenses or funeral costs, etc. Due to the fungibility of money, client risks have an impact on the income generated by the investment and the client’s repayment capacity.

**Macroeconomic and policy risks**: Unstable macroeconomic conditions, such as high or fluctuating inflation and interest rates, limit the possibility for longer-term financial and investment planning, and increase the associated risks. The stability and predictability of key macroeconomic parameters significantly depend on a sound and prudent government macroeconomic policy.

**Asymmetric information and moral hazard risks**: Some risks faced by a financial institution are rooted in asymmetric information between the lender and borrower on the specific factors affecting the feasibility and profitability of the proposed investment, or the financial conditions of the farm household. Moreover, the lender does not know whether the borrower will use the funds for the stated purpose or whether he/she intends to repay. Asymmetric information combined with difficulties to monitor and enforce contracts increase moral hazard risk.

**Risks of political intervention and poorly designed credit programmes**: Rural financial markets are prone to government interventions such as loan waivers and debt forgiveness programmes, which may seriously undermine the repayment discipline of borrowers and the credit culture in rural areas. Ill-conceived government or donor programmes using targeted and subsidized credit are further sources of risk for the development of sustainable term finance arrangements.

**Collateral risks**: Many farmers and agribusinesses can only offer assets with low collateral value. In many developing countries, severe deficiencies in the legal and administrative framework constrain the expansion of secured lending in rural areas. There are risks related to high transaction costs and delays in foreclosing and selling.

**Asset/liability management risks**: Risks result from mismatches between the financing terms, such as the amounts, maturities and costs of the assets (e.g. loans), and the terms of the agribusiness in question, such as turn-over periods and cash flow dynamics.

**Portfolio risks**: These risks are caused by the concentration of single or correlated risks in the loan-asset portfolio of a lender.

**Risk management**

Farmers manage risk by using good agricultural practices, diversifying into different farm and non-farm activities, building savings in cash or in-kind, and acquiring insurance through formal and informal networks. They may also invest in low-risk/low-return activities in order to reduce exposure to risk at the expense of a reduction in profitability. Risk-coping strategies include reducing consumption, taking out loans (mostly from informal sources), selling assets, and taking children out of school and sending them to work, among others. For this reason, risk management has
important implications for the welfare of rural and agricultural households.

**Financial institutions manage risk** by carefully selecting and supervising clients and appraising investment opportunities, portfolio diversification, risk-based pricing, securing loans with collateral and appropriate loss provisions. Risk-coping strategies for these institutions include foreclosure on or sale of collateral. It also includes rescheduling or restructuring loans contracts and taking out loans from other financial institutions to offset liquidity shortages.

### Support to developing term finance

Measures aimed at enhancing the supply of term finance should be part of a broader and longer-term strategy, framed by coherent, enabling macro and sectoral policies, and closely coordinated with other policies and programmes to promote rural development, commercial agriculture and rural financial services.

Areas of particular importance for government action and donor support include the following:

1. Improving the legal and institutional framework for secured lending;
2. Providing conducive policies to facilitate financial leasing;
3. Improving rural infrastructure;
4. Supporting farm diversification and innovation; and
5. Improving access to market information.

**Technical assistance that government action and donor support can provide to financial institutions**

Financial institutions may be directly supported in the introduction of term finance products through technical assistance aimed at:

1. Building capacity for the design of term finance products and financing technologies;
2. Developing and pilot testing of prototypes of term loans or financial leases;
3. Training loan officers in the appraisal of agricultural loan or lease applications, and in accounting, financial management and in internal control to ensure professional management and efficient operations of rural financial institutions;
4. Building staff capacity on the legal, regulatory and tax issues in those rural financial institutions interested in leasing; and
5. Upgrading management information systems in order to improve individual loan/lease tracking and overall loan portfolio management.

### RECOMMENDED READINGS

