POLICY BRIEF
ON AGRICULTURAL FINANCE IN AFRICA

African Union

giz Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH

On behalf of
BMZ Federal Ministry for Economic Cooperation and Development
# Table of Contents

Abbreviations ii
Acknowledgments iii
Foreword v

## Introduction

1

## Background and Rationale

3

## Setting the Stage: The Challenges of Agricultural Finance

5

## Recommendations

8

## Going Forward

19

Principle references 20

Annex 1 - Members of the MFW4A Task Force on Agricultural Finance in Africa 21

Annex 2 - Members of the Kampala Principles’ Drafting Committee 21
# ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFRACA</td>
<td>African Rural and Agricultural Credit Association</td>
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<td>AGRA</td>
<td>Alliance for a Green Revolution in Africa</td>
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<td>AUC</td>
<td>African Union Commission</td>
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<td>ASGF</td>
<td>African Smallholder Farmers Group</td>
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<td>BMZ</td>
<td>Ministry for Economic Cooperation and Development (Germany)</td>
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<tr>
<td>BNDA</td>
<td>Banque Nationale de Développement Agricole</td>
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<td>CAADP</td>
<td>Comprehensive African Agriculture Development Programme</td>
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<td>FAO</td>
<td>Food and Agricultural Organization</td>
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<td>GIZ</td>
<td>Deutsche Gesellschaft für Internationale Zusammenarbeit</td>
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<tr>
<td>IFAD</td>
<td>International Fund for Agricultural Development</td>
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<td>IRR</td>
<td>Internal rate of return</td>
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<td>KfW</td>
<td>Kreditanstalt für Wiederaufbau</td>
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<td>MDG</td>
<td>Millennium Development Goals</td>
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<td>MFW4A</td>
<td>Making Finance Work for Africa</td>
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<td>NEPAD</td>
<td>New Partnership for Africa's Development</td>
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<td>OHADA</td>
<td>Organisation pour l'Harmonisation en Afrique du Droit des Affaires</td>
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<td>PPP</td>
<td>Public-private-partnerships</td>
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<td>SADC</td>
<td>Southern African Development Community</td>
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<td>SME</td>
<td>Small and Medium Enterprise</td>
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<td>UNCDF</td>
<td>United National Capital Development Fund</td>
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<td>WRS</td>
<td>Warehouse receipt systems</td>
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ACKNOWLEDGMENTS

This Policy Brief is a joint undertaking of the members of the Making Finance Work for Africa (MFW4A) Task Force on Agricultural Finance. The Task Force was established in March 2011 to discuss and draft policy recommendations on agricultural finance in Africa. Its members are ABI Trust, AFRACA, AU/CAADP, Bank of Uganda, Centenary Bank, KfW, FAO, FinMark Trust, GIZ, IFAD, UNCDF and the World Bank. All MFW4A Task Force members were involved in providing technical feedback and reviewing the full text at different stages. The following members deserve special mention: Richard Roberts (consultant), Boaz B. Keizire (AUC/CAADP) and Michael Rothe (GIZ), who laid the groundwork for this Policy Brief when preparing the paper ‘Policy Support to Agricultural Finance in Africa’ for the conference ‘Zipping Finance and Farming in Africa – Harnessing the Continent’s Potential’ held on 29 and 30 June 2011. The substance of the Policy Brief is drawn from this document. Its core policy messages together with the main outcome of the conference – the Kampala Principles – and the valuable comments received from the participants are published herewith.

We would also like to thank the following for their insights and helpful feedback: Gerhard Coetzee (Centre for Inclusive Banking in Africa), Michael Hamp (IFAD), Enid Kiiza (Bank of Uganda), Muragu Kinandu (Central Bank of Kenya / Kenya School of Monetary Studies), Ajai Nair (World Bank), Fodé Ndiaye (UNCDF), Stephen Makanga (AFRACA), Maya Makanjee (FinMark Trust), Stefan Nalletamby (MFW4A), Robert Ocaya (GIZ Uganda), Camille Severac (AFD), Claudia Schmerler (KfW), Matthew Troniak (USAID), Saleh Usman Gashua (AFRACA) and Richard Wangwe (Stanbic Bank Uganda). And we are especially grateful to Kathryn Imboden (consultant), who had the challenging task of summarising the main messages of the conference paper, the Kampala Principles and all the comments and feedback received.

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Management support was ably provided by the Secretariat of the Making Finance Work for Africa Partnership, led by Stefan Nalletamby (Coordinator) and his team: Habib Attia, Alessandro Girola, Hugues Kamewe and Olivier Vidal.
FOREWORD

The global food price crisis has moved agricultural finance on top of the African and international development agendas. Agricultural production needs to increase by 70 percent by 2050 to feed the world, while climate change and urbanization will heavily reduce the area of cultivable land. One key solution lies in the agricultural production of the African continent. Agriculture is, and will continue to be, a major building block in the economic success and the achievement of the Millennium Development Goals in most of Africa.

This policy paper is the final result of a joint effort between key stakeholders and development partners and culminates in the “Kampala Principles”, which were adopted at the “Making Finance Work for Africa” (MFW4A) conference “Zipping Finance and Farming in Africa”, in Kampala, attended by more than 300 participants. The Kampala Principles will form a major building block within the Comprehensive African Agricultural Development Program (CAADP) national agriculture and food security investment plans, signed by half of the African Union Member States. At the same time, the subgroup on SME-Finance of the G20 Global Partnership for Financial Inclusion (GPFI) welcomed the Kampala Principles and integrated them as substantial input into its Report »Scaling-Up Access to Finance for Agricultural SMEs - Policy Review and Recommendations«, which was prepared for the November 2011 G20 summit in Cannes, France.

More recently, the MFW4A Partnership brought together the African Union Commission and NEPAD Planning and Coordinating Agency, as drivers of the CAADP, to team up with the “African Rural and Agricultural Credit Association” (AFRACA), African governments, and private institutions, to form the “African Agricultural Finance Stakeholder Working Group”, in order to boost finance for agriculture in Africa.

Looking forward, we believe that the collaborative work of the “African Stakeholder Working Group on Agricultural Finance” together with the G20 effort on agricultural finance will enhance the CAADP agenda and will bring forward concrete actions in agricultural finance. This will increase the opportunity for millions of people, to lift themselves out of poverty through asset building, increased agricultural production and enhanced food security.

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Making Finance Work for Africa
MFW4A

Tumusiime Rhoda Peace
Commissioner for Rural Economy and Agriculture
African Union Commission
INTRODUCTION

This Policy Brief provides a set of policy recommendations designed to help promote the expansion of agricultural finance in Africa. It is addressed to African policy makers from the broad range of ministries, from central banks and regulatory authorities involved in agricultural finance. It concerns also donors, financial institutions and farmers’ organizations engaging in policy dialogue and advocacy.

This brief focuses on specific agricultural finance policy measures that can make the biggest difference in expanding access to financial services for producers, agribusinesses and other agricultural value chain participants within the African context. It builds upon the analysis of policy issues and the formulation of recommendations emanating from the Making Finance Work for Africa (MFW4A) Zipping Finance and Farming in Africa Conference held in Kampala, Uganda in June 2011. The Conference produced the Kampala Principles (see Box 2), which recognize that the financial services needs of agriculture sectors in Africa are pressing and demand special attention; the Principles are the cornerstone of this brief.¹

This work provides the opportunity to reinforce the efforts of the Comprehensive Africa Agriculture Development Program (CAADP) endorsed by the African Heads of State and Government in Maputo in 2003, which aims to support African countries in reaching a higher path of economic growth through agriculture-led development. (See Box 1.)

BOX 1 The Comprehensive African Agriculture Development Programme (CAADP) principles

- Agriculture-led growth as a main strategy to achieve MDG-1
- The pursuit of a 6% annual sector growth rate at the national level
- The allocation of at least 10% of national budgets to the sector
- The exploitation of regional complementarities and cooperation to boost growth
- Policy efficiency, dialogue, review, and accountability
- Partnerships and alliances to include farmers, agribusiness, and civil society communities

This Policy Brief leverages also the momentum of the G20 commitment to put more emphasis on both financial inclusion (notably via the Principles for Innovative Financial Inclusion) and food security/sustainable agricultural development as pillars of the G20 Seoul Action Plan for Development.

¹ The policy recommendations draw from the policy related dimensions of the Principles, the unpublished Kampala conference policy paper (Policy Support to Agricultural Finance in Africa), the deliberations of the MFW4A Task Force on Agricultural Finance in Africa (See Annex 1 for the list of Task Force members); the March 2011 Round Table discussions preceding the Kampala Conference and the outcomes of the conference discussions.
INTRODUCTION

See Annex 2 for the list of members of the drafting group.

The MFW4A Conference held in Uganda in June 2011 recognised that while agricultural finance is a part of the overall financial system of a country, the financial services needs of agriculture sectors in Africa are pressing and demand special attention. The Principles set out below are intended to suggest actions to give effect to this objective.

1. Address Agricultural Finance policy strengthening through establishing a specific high-level coordination body and by recognising a single entity as the advocate for Agricultural Finance.

2. Strengthen farmers’ organizations so that the production end of agricultural value chains becomes an effective influence on agricultural finance policy making.

3. Focus public sector policy on a value chain/commodity approach, with clustering of smaller farmers to facilitate economies of scale in input purchase, value addition, marketing and advisory services.

4. Ensure legislation is in place and is implemented to foster innovation and to remove barriers to financing the business of agriculture, through measures such as, but not limited to: asset-backed products, warehouse receipts, contract farming, credit reference bureaux (and better client identification), consolidation of small but viable rural financial institutions and other support to the informal financial sector.

5. In accordance with CAADP Principles, and in encouragement of private sector investment, increase public sector expenditure in areas such as, but not limited to: crop and livestock research and extension, water for irrigated crop production and livestock farming, infrastructure for crop insurance, rural energy supply, communications and roads.

6. Support transformation of the agricultural sector through encouragement of longer-term productivity enhancing, on-farm investments such as water supply/irrigation, fencing and farm buildings, through consensual approaches to land tenure issues.

7. Enable financial institutions to meet the demand for longer term financing by developing financial markets so that lenders can gain access to the term liabilities required.

8. Encourage the commercialisation of agriculture and of farming as a business, whether by consolidation of small holdings or through involvement of the private sector (domestic and foreign); in both cases ensure that social, cultural and environmental concerns are met and, in the latter case, that appropriate controls are in place to prevent undesirable exploitation.

9. Develop and implement concrete actions to improve financial literacy, consumer protection and farmer business education, with a special focus on gender and youth issues.

10. Drive research, training and dissemination of knowledge to foster private sector investment in developing and marketing added-value agricultural products and services.

11. Ensure a sustainable flow of information is available in areas such as, but not limited to: markets, output prices, costs of inputs and cost and conditions of financial products and services.

BOX 2 Kampala principles

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BACKGROUND AND RATIONALE

With Africa's unprecedented population growth, agriculture remains an essential component of Africa's economic development. At present, Africa still depends considerably on food imports to nourish its population. Massive increases in productivity and production are required to turn Africa into both a food producer for its own needs and a food exporter.

On the African continent, with 70 per cent of the population employed in the sector, agriculture is a catalyst for broad-based economic development, with its huge potential to create employment and reduce poverty. Africa's vast amounts of cultivable land offer significant scope for increases in productivity.

More than half a billion Africans, or some 65 per cent of the population (more than 80 per cent in some countries), depend on small or micro-scale farming as their primary source of livelihood. While this number includes pastoralists and the landless, the great majority of them are smallholder farmers, 80 per cent of whom farm less than two hectares (ASGF, 2010). Smallholders face particularly acute constraints in accessing the full range of crucial financial services.

The challenges of agricultural development are multiple and complex, beginning with the fundamental challenge of ensuring food security. At the forefront of the challenges are high systemic risks: from the environment (drought, flood and disease) and from markets (price volatility, trade policy and trade practices affecting exports and market access). Other key challenges are the lack of adequate rural infrastructure, socio-economic conditions at the farmer level, the lack of access to the range of inputs required by farmers, knowledge gaps, including financial literacy, and the lack of data. Last but not least, agricultural development is hindered by the negative effect on developing country economies of agricultural subsidies in developed countries, which reduce world prices and undermine the incomes of African farmers.

Access to financial services for all types of agricultural producers and agribusinesses is key to unleashing Africa's agricultural potential and funding the growth of the sector. Credit, savings, payments and insurance products are all important; the latter three are very important by themselves and can also provide opportunities to improve the viability of agricultural credit products.

As agriculture is subject to high systemic risks, engaging with the sector has traditionally been challenging for financial institutions, which are often unable to adequately conceptualize and assess risk and therefore are unable, or reluctant, to develop sustainable financial products for actors in the agricultural value chain. Consequently, agricultural clients, notably smallholders, lack access to adequate financial services and therefore face severe growth constraints.

Agriculture continues to receive only a small share of total credit, leaving farmers, particularly smallholder farmers, to rely on meagre savings and informal sources of credit. In Africa, only about 10 per cent of the total portfolio of commercial banks goes to agriculture, including agro-industries, and loans are rarely extended to smallholders (World Bank, 2009).
Improving access to agricultural finance for both women and youth deserves specific emphasis. Women’s contributions to agricultural production and family food security are invaluable and the role of women smallholders in agriculture self-employment is important in Sub-Saharan Africa. Yet the share of female smallholders who can access credit is 5 – 10 percentage points lower than for male smallholders (World Bank, 2007). For youth, agriculture, including on-farm entrepreneurial activities, remains a major opportunity for employment and for family household income.

An effective policy framework, the focus of this brief, is the major building block to creating a conducive environment for financial institutions to develop and offer appropriate financial products for agricultural sector clients, leading to benefits for the clients and for the financial institutions themselves.
SETTING THE STAGE: THE CHALLENGES OF AGRICULTURAL FINANCE

The recommendations set forth below focus on what policy makers can do to create favourable conditions to significantly expand access to finance by farmers and other actors in agricultural value chains. As the agriculture sector in Africa is dominated by smallholder farmers and because of the greater challenges they face in relation to other producers and agribusinesses, they are at the core of the analysis of challenges preceding the recommendations as well as of the recommendations themselves.

Definitions: the market and the market players

- **Agricultural finance** refers to financial services, including savings, transfers, insurance and loans, potentially needed by the agricultural sector, meaning farming and farm-related activities including input supply, processing, wholesaling, and marketing. Most of these activities are conducted in rural areas, but large processing facilities and agribusinesses, as well as largely subsistence-level smallholders, are also located in urban and peri-urban areas (Meyer, 2011).

- Agricultural finance as used in this brief includes agricultural value chain finance (finance for its individual elements as well as finance throughout a value chain), with emphasis placed on the needs of smallholder farmers. The concept of agricultural value chain finance covers financial services, products and support services, flowing to individual actors and/or through a value chain to address the needs and constraints of those involved in that chain, be it a need to access finance, secure sales, procure products, reduce risk and/or improve efficiency within the chain (Miller and Jones, 2010).

- **Smallholder farmers** represent the backbone of African agriculture and food security. Their importance derives from their numbers, their role in agricultural and economic development and the concentration of poverty in rural areas. The term ‘smallholder’ refers to their limited resource endowments relative to other larger scale and more commercial farmers; the actual definition differs among countries and among agro-ecological zones (based on soil, landform and climatic characteristics), with variations in farm size, allocation of resources, use of external inputs and proportion of food crops that are marketed (Dixon, Aysen Tanyeri-Abur and Wattenbach, 2004). Characteristics of smallholder farmers include low monetization and limited business skills, low financial literacy and financial management skills, little knowledge management and risk aversion.²

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² Framing of the concept and the needs of the smallholder farmer were advanced through the discussions held at the March 2011 Kampala Round Table prior to the Conference.
The concepts of agricultural finance, rural finance and microfinance are characterized by important distinctions as well as overlap, as framed in Box 3.

**BOX 3 The financial market**

- **Microfinance**: Financial services for poor and low-income people
- **Rural finance**: Financial services used in rural areas by people of all income levels
- **Agricultural finance**: Financing of agriculture-related activities, from production to marketing in rural and urban areas


On the **demand side**, the analysis of challenges and opportunities underpinning the set of recommendations takes into consideration a range of market participants: smallholder farmers (commercial and semi-commercial), medium scale farmers (largely commercial), and large-scale commercial farm enterprises, as well as the range of agribusinesses. Emphasis is placed on the needs of smallholders for a range of financial services.

On the **supply side**, financial services providers cover a wide range of bank and non-bank financial institutions, insurers and payment service providers, plus other participants in the agricultural value chains offering financial services in cash or in kind within the value chain. In the context of the very limited outreach of commercial banks, other than to large market players, cooperative structures, informal grassroots (decentralized and community-owned savings and credit associations and self-help organizations) and semi-formal institutions play a particularly important role in Africa. Agricultural development banks continue to play a role.

The range of increasingly diversified financial institutions provide a variety of services: agricultural credit, savings, insurance, payments, leasing and financing within value chains (such as contract farming). While financial intermediaries face particularly difficult challenges to expansion of activities in the agricultural sector, increasing opportunities are present, leveraging technology and other innovations, which will not only increase outreach of financial services to the agricultural sector, but will strengthen results for the financial intermediaries themselves.

**Challenges to the expansion of agricultural finance**

The reasons why agricultural finance has not been able to meet the needs and expectations of clients, in terms of both sustainable access and suitability of financial products and services, are many. The financial sector related issues sketched out here represent a formidable challenge:

- Financial institutions are reluctant to lend to the agricultural sector in Africa; this reluctance is based to a large degree on the real and perceived high risk. These risks can be grouped as follows:
a. Risks common to other financial market segments (principal credit risks, which are accentuated in the case of agriculture sector borrowers, notably smallholders, given informality, limited client capacity, lack of assets, poor legal frameworks and systems, poor physical infrastructure in rural areas);
b. Risks (often covariant) specific to agricultural production, such as normal weather patterns, climatic catastrophes and climate change, pests, diseases, seasonality (leading to variations in repayment capacity) and market and price risks that are more pronounced in agriculture (local price volatility, delivery to markets, introduction of innovation, variations due to lack of information, price swings in international agricultural markets, trade policy barriers); and
c. Political risks (excessive degree of government intervention and interference) (Maurer, 2010).

Agricultural finance market development is hindered by cost structures on both the demand and supply sides that make it difficult to offer agricultural credit at prices within the means of producers, while providing adequate returns for lenders:

a. The spatial characteristics of agriculture increase costs: land is a fixed asset, production is dispersed and communications and travel costs are high.
b. Costs faced by financial institutions to deliver agricultural financial services are high: cost of funds for on-lending (high costs of raising deposits, high cost of commercial refinancing), the cost of provisioning to cover for increased risk, high transaction and distribution costs in rural areas.
c. Costs faced by agricultural producers to access credit: interest rates, other charges and the costs to access these services, if available, are high. These costs affect directly their ability to take on credit. Producers are constrained in their ability to pay high interest rates by the limited returns from agricultural primary production.4

Farmers, notably smallholders, lack collateral.

Financial infrastructure serving this market segment is particularly weak (credit bureaus, payment systems, collateral registries).

Legal and regulatory frameworks do not take adequately into consideration the specificity of agriculture finance, resulting in overregulation and inflexibility.

The range of appropriate agricultural financial instruments is limited. Financial institutions lack reliable data and specialized knowledge about agricultural production, marketing and agribusiness, rendering them unable to assess properly the risks and potential of agricultural financial services and to design products suitable to the specific needs of agricultural producers.

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4 From the perspective of the producer (demand side), interest rates paid should not be higher than the internal rate of return (IRR) of agricultural production. Increasing the IRR requires multiple vectors to increase added-value (productivity) and to transform the value into revenue (costs structures and marketing). From the perspective of suppliers, lowering interest rates involves lowering the cost of supply of credit.
RECOMMENDATIONS

An adequate agricultural finance policy framework is the cornerstone of creating a conducive environment for financial institutions to develop and offer appropriate financial products for agricultural clients. Such a framework looks at all levels of policy intervention, support and enhancement: macro, meso and micro. The focus here is on policy measures, derived from the treatment of policy issues in the Kampala Principles, that are specific and of prime importance for increasing access to agricultural finance in Africa.

Important policy considerations that are not directly specific to agricultural finance in Africa are not included here, but it is essential to keep them in mind. These include, among others, the full set of banking regulations for deposit-taking institutions, implementation of international standards and guidance at the country level, the policy, legal and regulatory frameworks for branchless banking and for payments, client identification systems, financial literacy/capability of all actors, financial transparency, consumer protection, loan contract law and collateral enforcement.

Underlying the policy recommendations offered here is an essential understanding of the roles of government that are appropriate and helpful to promote, protect and, in exceptional circumstances, provide financial services and roles of government that may hinder the expansion of agricultural finance.

Adopt a strategy of strong policy advocacy in favour of expanding agricultural finance, anchored with a strong and dedicated institutional advocate.

Agricultural finance is a “policy orphan.”

Too often, responsibility for agricultural finance policies falls among several public sector entities (Ministry of Finance, Ministry of Agriculture, Ministry of Trade, other ministries and the Central Bank). Very few countries have a strong advocate for agricultural finance. This leads to a lack of focus on the challenges and the complexity of the interrelationship of the issues and the required policy responses, which results in a fragmentation of efforts (and uncertainty) in a critically important policy area.

There is high value in having a coherent strategy with an agricultural finance policy leader overseeing its development and implementation.

Policy champions are well placed to promote a better understanding of agricultural finance paradigms and to encourage adoption of the most effective policy measures, without excessive government intervention and interference.

I Muster the necessary support for expanding access and usage of agricultural finance, starting with the identification of a country-level policy champion. The agricultural finance policy leader should have the competency to lead and promote change by engaging with the various stakeholders. Leadership can come from the Central Bank, the Ministry of Finance, the Ministry of Economic Development or other entities, with the institutional base varying in function of the country context.

I Establish a specific high-level coordination body led by the policy champion, which anchors and deepens the advocacy effort. The option of an agricultural finance commission headed by the policy
champion and based on a clear mandate from the government could be considered.

- Base policy advocacy efforts upon a comprehensive set of financial sector policy measures, adopting a holistic and synergistic approach. This set of policies should also fit in well with a general agricultural development policy, as access to finance cannot solve all problems.

- Incorporate strategies for agricultural finance development within a financial inclusion strategy or roadmap, where such a framework exists. This heightens the importance of the agricultural finance policy agenda at the national level.

**Eliminate counterproductive political interference in agricultural finance markets by ensuring that the appropriate role of government is well defined and respected.**

**Politically-based intervention and interference are most often counterproductive.**

Counterproductive and inappropriate political interference are distinct from constructive policy advocacy and moral suasion designed to support access to agricultural finance. Overly activist market-substituting approaches, often politically motivated, impede the development of sound agricultural finance. These practices include creating specialized rural finance institutions, introducing compulsory lending targets, supporting financing ineffective schemes for cooperatives, debt forgiveness, interference in lending decisions or loan collection operations and interest rate caps.

The risk of political intervention and interference is difficult to control and to manage and is particularly high with regard to agricultural finance, as expedient short-term solutions for such important and compelling issues as ensuring food security are tempting. Such intervention occurs easily and unpredictably. For example, interest rate ceilings, not specific to agricultural finance but still an important issue, discourage lenders from making small loans, due to their inability to cover high unit costs; interest rate ceilings limit outreach if financial institutions choose not to lend or they weaken financial institutions if they are forced to lend at non-viable rates. Similarly, debt repayment moratoriums thwart the sustainable development of financial institutions and deteriorate the repayment culture of clients.

**Change begins with building awareness of the risks of political intervention**

While it is difficult to counter political interference and to mitigate the negative effects when it occurs, the stakes are high and a number of steps can be taken.

- Deepen the understanding of the roles of government that are appropriate and helpful to promote, protect and, exceptionally, provide financial services and the roles of government that hinder the expansion of agricultural finance.

- Develop greater awareness of the risks of political intervention and the negative effects on the goal of promoting inclusive agricultural finance. This includes dialogue with ministries and parliaments.

- Build awareness of the positive impact of a sound agricultural finance policy and the value of making the case for taking a longer-term view of building agricultural finance systems articulating macro, meso and micro dimensions.

- Recognise that the still often adopted imposition of interest rate caps carries considerable risks for
RECOMMENDATIONS

the sustainable delivery of agricultural finance services and merits consideration only where abusive practices take place. Complement liberalized interest rate policies with consumer protection measures to ensure that financial institutions’ inefficiencies are not transferred to the clients.

Take a “smart subsidies” approach by providing only subsidies that support the expansion of agricultural finance without undesirable market distortion.

Subsidies, particularly those that subsidize private goods, often do not achieve intended goals.

Government and development partners’ subsidies (grants, matching grants, “non-reimbursable loans”) to farmers and other value chain participants are justified, when appropriately formulated, to improve economic efficiency or for long-term redistributive objectives. However, they often put the wrong incentives in place and encourage a culture of dependency on handouts.

Governments understandably face pressure to adopt short-term policies to support agricultural development and to maintain social stability, but the use of subsidies to meet short-term objectives is often suboptimal and entails potentially high opportunity costs in the form of insufficient allocation of resources and a lack of attention to long-term development needs.

A “smart subsidies” approach focuses on minimizing distortions and maximizing benefits.

Economic and social arguments can justify government and donor agency interventions into financial markets. However, there are no magic solutions and many well-intended subsidies turn out to be counterproductive and difficult to dismantle.

Adopt a “smart subsidies” approach. Carefully designed interventions can minimize distortions, mistargeting and inefficiencies while maximizing social benefits. Smart subsidies are (1) transparent; (2) rules-bound and (3) limited and time-bound with clearly upfront defined exit strategies. A number of subsidies can contribute to the development of agricultural finance without distorting its development:

1. Time-bound subsidies for financial intermediaries (technical assistance, innovation in products and delivery mechanisms (e.g. biometric identification systems) and branch expansion), where a demonstration/replication effect can be expected. They are designed to provide additionality by inducing through a demonstration effect other potential market participants to enter the market. Supporting and learning from research on the many innovations being tested needs to be widely disseminated;
2. Subsidies for financial infrastructure (public goods such as support for credit information agencies, collateral registries, special courts for credit defaulters), which generate higher returns than subsidies for specific institutions; and
3. Subsidies for economic and social infrastructure for building the capacity of smallholders and other agricultural value chain participants, such as financial literacy programs and training in production to help smallholder farmers participate effectively in value chains and increase incomes.

In the context of a financial systems approach, shift the basic focus of support from target groups (private goods) to public goods supporting financial systems, infrastructure and institutional development at the macro, meso and micro levels.

At the same time, recognize that subsidies for financial institutions can be helpful to provide necessary
technical assistance and introduce innovation, but that they usually provide fewer benefits than the subsidization of public goods and may create subsidy dependence.

- Avoid subsidies on inputs, interest-rate subsidies for clients and output market subsidies (e.g. stabilization funds).
- Conduct more robust evaluations to determine whether credit guarantees for agricultural lending provide the expected leverage (additional lending), to identify the best design and to assess the preconditions required for success. Support for guarantee funds is a subsidy that has engendered considerable debate, with the case for expecting a major impact from guarantee schemes supporting agricultural finance yet unclear.

Since 2009, the Alliance for Green Revolution in Africa’s (AGRA) Innovative Financing Initiative has served to unlock $160 million in affordable financing for smallholder-based agriculture. Through funding from Standard Bank, Equity Bank in Kenya and the National Microfinance Bank in Tanzania, AGRA works with national partners to establish loan guarantee funds. With an explicitly adopted “smart subsidies approach,” guarantees, put up by AGRA and their partners, leverage up to ten times their amount in low-interest loans. Smallholder farmers benefit from lower interest rates for loans backed by guarantee funds. Partners included the Kilimo Trust in Uganda, the Millennium Challenge Account Mozambique, the Mozambican Ministry of Agriculture, IFAD in Kenya and the Financial Sector Deepening Trust in Tanzania. It will be of great interest to study the further scale-up and impact of this ambitious program.

Foster a conducive legal and regulatory environment that takes into consideration the specificity of agricultural finance, removing barriers to financing agriculture and allowing for innovation.

Legal and regulatory frameworks may impede unnecessarily the development of agricultural financial services.

The legal and regulatory environment impacting agricultural finance encompasses prudential and non-prudential regulations for credit and savings services, insurance and payments regulation and a range of other legal and regulatory parameters. The focus here is on the dimensions of these frameworks of particular importance to agricultural finance in Africa.

Banking regulators and supervisors need to be as rigorous with regard to agricultural financial services as with other segments of the financial sector, i.e. in terms of risk-weighting of agricultural loan portfolio and imposing liquidity requirements. However, banking regulations may unnecessarily impede agricultural lending to smallholder farmers in particular. Loan collateral requirements may be established that cannot be met by farmers; overly strict provisioning requirements for non-collateralized loans or alternative forms of collateral (such as harvest) and strict rules-based systems for provisioning for longer-term or seasonal agricultural loans may unnecessarily add to the cost of lending; and branching regulations and reporting requirements may overburden rural finance institutions with unnecessary costs. Over-regulation may stem from lack of knowledge on the part of regulators and supervisors on the operations (actual risks and potential risks) of agricultural finance.
Opportunities do exist for introducing regulations that reflect a better understanding of actual and potential risks and that allow for innovation and for the development of new products and services.

Insurance legislation and regulation affect crop insurance and other insurance products important for the agricultural value chains. Issues include the inability to offer innovative products under existing legislation, such as weather-index insurance, and the lack of recognition and oversight of community-based and mutual/cooperative insurance schemes. In some jurisdictions, insurance oversight for entities in rural areas falls under ministries of agriculture, in which case the insurance supervisor may not be able to ensure that these entities are sufficiently regulated from an institutional and governance point of view.

Other legal and regulatory parameters, such as those that impact (a) land tenure, (b) land rights and registry; (c) collateral registry, (d) contracts/contract enforcement and (e) warehouse receipt systems are also critically important.

**A risk-based approach to regulation of agricultural finance needs to take into account its specificity.**

- Adopt a risk-based approach to the regulation and supervision of agricultural finance that takes into account the specificity of agricultural finance in terms of risk, but also in terms of opportunities for a range of institutional models, financial products and delivery channels.

- Allow room for innovation by having in place legislation that permits innovation in products and delivery channels and allow these tools to work effectively, as well as prudentially.

- Allow alternative forms of collateral in terms of provisioning and portfolio risk weighting (asset-backed securities, leasing, chattel mortgages (using moveable tangible personal assets as collateral), acceptance of warehouse receipts as collateral, future harvest, and other collateral substitutes). Affecting 17 countries in Sub-Saharan Africa, the OHADA Uniform Act on Secured Transactions was amended in December 2010 to allow borrowers to use a broader range of assets as collateral, such as warehouse receipts (recognition of titles).

- Focus supervisory capacity on understanding the risk profiles of agricultural lending and on insisting on the improvement of risk management systems within institutions offering agricultural finance. This implies a stronger role for on-site supervision and higher supervisory costs, but is an important measure to enhance the trust and confidence necessary to engage in this sector.

- Strengthen the often weak regulation and supervision of cooperative structures. Adopting a risk-based approach, take care not to overregulate and overstretch supervisory capacity with many small cooperatives structures. A tiered approach to regulation and supervision can be appropriate here. Regulation can facilitate the identification of market-based solutions to tying rural savings and loans associations more effectively to broader commercial banking systems to provide greater financial intermediation and diversification of risks.

**Insurance regulations**

- Revise insurance regulation to facilitate the development of crop insurance for smallholders, including the amendment of legislation and regulations to facilitate the development of weather-based index insurance and of public-private-partnerships (PPP) that ensure that natural catastrophe cover is funded. Other regulatory reforms may include the lowering of minimum capital for
insurance underwriters, adjustment of solvency ratios and modes of regulation for microinsurance schemes.

- Allow within the regulatory framework for insurance the integration of agricultural insurance with other financial services for farmers, taking into consideration the need for coordination between the different regulatory/supervisory authorities for banking and insurance. Ensure sound supervision across entities in rural areas offering insurance products.

**Other legal and regulatory issues**

- Complement prudential regulations with legal and regulatory reforms to better define and demarcate property rights, improvement and enforcement of security in rural assets and contracts.

- Enforce existing secured transactions legislation more rigorously to be able to realize collateral if necessary.

- Pay attention to the harmonization of regulations across financial institutions, telecommunications institutions, and other market participants.

- Resolve legal and regulatory issues around warehouse receipt systems (WRS) with regard to titles of underlying assets (movable or immovable), use of titles as legal documents that may be transferable and of negotiable instruments in financing schemes that comply with banking regulations. Regulations are required to ensure minimum quality of infrastructure, and minimum solvency and financial reporting. Legislation may vest regulatory powers in a public, private or arms-length public-private institution for the licensing and oversight of the operations of participating warehouse operators. The law then has to be clear on licensing requirements and sanctions for breach of those requirements as well as other relevant regulations.

Legal frameworks for warehouse receipt systems can support a greater use of this mechanism, but often have been introduced progressively. In some cases (silo receipt system in South Africa, WRS for grains in Zambia), schemes are not backed by specific warehouse legislation and formal regulatory structures. In Ghana, the Ghana Grains Council is striving to become the cornerstone of industry driven oversight mechanism. In the cases of Tanzania and Uganda, the laws backing warehouse receipt systems came in after the systems had already evolved. In Zambia there has been a push to amend legislation to accommodate WRS. In practice, success at the outset can galvanize support for the necessary legislation.

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**Address weaknesses in state-owned agricultural development banks by ensuring sound governance and management.**

Many African countries have poorly performing state-owned banks for agriculture.

In response to negative experience with once dominant government-managed or government-owned banks in Africa, donors and governments moved away from retail lending in agriculture. In light of the inability of other financial service providers to fill the gap, the question of state-owned banks has been revisited. A more optimistic, yet cautious, view has emerged about the possibility of successfully reforming, and even introducing, state-owned agricultural development banks.
Specialized state-owned agricultural development banks were created as part of the subsidized direct-credit paradigm. Overall, they have performed poorly, and continue to do so, although there have been some notable exceptions (such as the reformed Banque Nationale de Développement Agricole in Mali, operating as a second-tier institution offering refinancing facilities and offering savings products). Many state financial institutions have been characterized by political interference, lack of transparency, low accountability to stakeholders, inadequate prudential regulation and supervision and lack of managerial skills and proper incentives, with these weaknesses leading to credit misallocation, high losses and need for recapitalization. Many agricultural finance banks in Africa have been privatized (e.g. Tanzania’s National Bank of Commerce), reformed (e.g. Senegal’s Caisse National de Crédit Agricole) or closed (e.g. Lesotho’s Agricultural Bank and Building Society).

Debate on the appropriate strategy for dealing with state-owned agricultural development banks continues. Rural banking outlets have been lost through the closure of state-owned banks and there are indeed some successful examples of reform, allowing the preservation of rural outreach. The need to kick-start lending to the agricultural sector has led some countries to again expand the role of existing state-owned financial institutions and create new agricultural development banks.

**Successful reforms require fundamental changes in ownership, governance, management, products and services and clientele.**

The question is ultimately not one of ownership, but rather of governance and management, i.e. the conditions under which state-owned agricultural development banks can be self-reliant and sound financial intermediaries.

- Insist upon a clear and sustainable mandate, high standards of corporate governance, professional management, strong prudential regulation and supervision and reliance on market discipline to provide the right signals to the main stakeholders.

- Be prepared to make fundamental changes in ownership, governance, products and services and even the clientele served, diversifying loan portfolios.

- Adopt more sophisticated risk management techniques and maintain a firewall between credit operations and political interference.

- Oblige banks that specialize in agriculture to apply appropriate tools to evaluate clients to determine the potential and the risks and implement sophisticated forms of risk management by different portfolio segments. A greater knowledge of use of value chain finance can help with the analysis of lending costs and risks.

- In the case of a start-up, develop a solid institutional design that solves ex-ante governance and management problems and maintains a successful firewall between credit operations and political interference.

- Require the same rigor in regulatory and supervisory regimes for state-owned banks as for commercial banks. Within the West Africa Economic and Monetary Union, all banks, including those with specific agricultural sector mandates, are universal banks and are subject to the Banking Acts.
Financial infrastructure in Africa is in its nascent stages of development and that which exists serves primarily large commercial financial institutions.

Financial infrastructure comprises the set of market institutions, networks and shared physical infrastructure that enable the effective operation of financial intermediaries, including credit bureaus, payment systems, collateral registries. In some African countries, credit bureaus, collateral registries and credit rating systems are only beginning to be developed. On a cross-regional comparative basis, sub-Saharan Africa has the least developed payment and settlement systems. In countries where payment systems and credit bureaus are available, they are considered insufficient and inefficient and serve primarily large commercial banks, which are the least active in providing agricultural finance.

The financial systems paradigm recognizes the importance of development of the meso level – creating the infrastructure needed for financial intermediation. The challenges to develop such infrastructure in support of financial institutions operating in rural Africa are significant.

**Investment in financial sector infrastructure as a public good is a high benefit policy.**

- Allocate public sector expenditures to establishing and strengthening financial infrastructure, such as credit information bureaus, collateral registries and training institutes for financial institutions. Expanding financial infrastructure into rural areas is viewed as a high benefit investment. Using subsidies to create such public goods generate higher returns than subsidies for specific institutions. This type of public expenditure fits well into the CAADP objective of 10% public financing for agriculture by 2015, which has not yet been implemented in the majority of countries.

- Leverage new technologies to enhance payments system development in rural areas. The e-zwich money transfer system in Ghana, serving smaller scale financial institutions, allows customers in rural areas to use biometric cards for payment operations.

- Intensify efforts to determine the feasibility of expanding credit information bureaus to rural areas.

- Examine the initial results of commodity exchanges that have been established in a number of African countries, analysing reasons for success in some cases (Ethiopia) and failure in others.

- Invest in infrastructure such as weather reporting stations required for weather index-based insurance. Scaling up pilot schemes will require public goods investment in better data infrastructure and in creating new products. Weather-index-based insurance still needs public goods investment in testing and analysing alternative designs and scaling up these experiments, as well as for renovating automated weather stations.

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Kilimo Salama ("Safe Agriculture") is an insurance designed for Kenyan farmers so they may insure their farm inputs against drought and excess rain. The project, a partnership between Syngenta Foundation for Sustainable Agriculture, UAP Insurance, and telecoms operator Safaricom, offers farmers who plant on as little as one acre insurance policies coverage to shield them from significant financial losses when drought or excess rain wreak havoc on their harvests. So far, over 11,000 small corn farmers have chosen to insure their inputs against drought and excess rain.
Smallholders, women in particular, are disadvantaged in terms of land tenure.

Land ownership and tenure are important issues for farmers for two fundamental reasons: (1) for investment security and the ability to show repayment capacity and (2) as collateral.

In many circumstances in Africa, private ownership of land, as understood in developed countries, does not exist. It is rare for a smallholder to be able to claim title to his or her land and dispose of it freely. Current land tenure systems, often based on usufruct, do not provide the necessary security, as it is not possible to realize land as a guarantee due to social pressures and lack of a secondary market. Cultural barriers to moving away from usufruct are an important consideration, as land tenure has been and still is a prerogative of traditional authorities. Even when land tenure systems do evolve, land registries are imperfect and procedures are onerous.

Rights, responsibilities and obligations of men and especially women concerning land vary according to region, ethnic group, age, social status, education, religion, economic power and phases in life-cycles. Overall, women often do not have the possibility to assert their rights through land registration systems.

Policy should promote pragmatically long-term forms of land tenure for agricultural use.

Support for legal reforms that enhance property rights and improve secured transactions encourage financial development by improving borrower creditworthiness, reducing lender risks and increasing demand for investment credit.

- Promote more permanent forms of land tenure, adjusting land tenure rights to facilitate the development of viable farming units without undermining traditional rights or creating conflicting formal and informal land tenure systems. Ideally, freehold or long leases provide the best basis to encourage productive term investments and to permit collateralization of land. In some contexts, recognizing and legalizing forms of traditional ownership of land may be the best approach.

- Recognize that land tenure issues cannot be solved easily or quickly. There is a need for more pragmatic approaches, e.g. registration of the security of use, rather than ownership.

The Southern African Development Community (SADC) countries are working to deal with land tenure issues in a manner that reflects reality, i.e. that change will come via a slow normalisation process. This implies that one cannot base current policy proposals on access to finance (solely) on something that will take a long time to bring about and therefore calls for policies that look at substitutes, or look at unsecured lending approaches, linking with savings and transactional products.

- Place more emphasis on consensual approaches in land tenure reform efforts. Changes in land tenure systems need careful preparation to ensure that social, cultural and environmental concerns are met.
Streamline the formalities of land title acquisition, with updated systems of accurate recording and transfer of ownership documentation. Changes in ownership need to be able to be formalized without major hassle and long procedures.

Remove legal constraints to women’s ownership of land, which will lead to improvement in women farmers’ ability to invest more securely and to offer collateral. Even-handedness in land title procedures for women and men goes with this.

Encourage foreign investment in agriculture, but consider in this context the risk of marginalisation of smallholders from the best agricultural land. Land rights need to be carefully considered to ensure fair access to economic resources and to favour longer-term food security.

Close the information gap between agriculture and finance through knowledge generation and management.

There are huge information gaps between the financial and agricultural sectors in Africa and within each of these sectors.

For financial institutions, a willingness to lend depends on having sufficient information to evaluate the borrower’s reliability, capacity to repay and intention to use the borrowed funds wisely. Faced with insufficient information, lenders may simply choose to deny loans. Overall, there is an insufficient understanding of client risk profiles.

For farmers, market data as well as financial mechanisms and marketing channels are required to be able to sell under the best possible conditions, ensuring income and the ability to repay loans and maintain access to financial services (insurance included). This knowledge creation has a public goods dimension.

For policy makers, more information is required to understand the challenges, realities and opportunities of agricultural finance in order to develop the most effective policy measures and to evaluate the results of their implementation.

A broad range of data initiatives promise to increase the outreach of agricultural finance.

There are information needs for value chain participants, active and potential finance service providers and for policy makers.

Expand and improve data collection, research, training and the dissemination of knowledge in order to bridge the information gap. This includes more extensive research of client risk profiles to underpin decisions by financial institutions as well as policy makers.

Collect data and information for banks to better assess risk for agriculture value chain participants. This information is also important for policy makers, regulators and supervisors.

Collect market data and technical Information (including gender disaggregated data) on agricultural markets and agricultural finance. A sustainable flow of information in areas such as markets, output prices, costs of inputs and cost conditions and use of financial products and services represent part of the data needs.
RECOMMENDATIONS

I Market data so that farmers are able to sell when prices are the most attractive.
I Monitoring of data from the banking sector to check whether agricultural finance policies and regulation are effective and lead to expected outcomes.
I Connecting rural farmers instantaneously to the information they need. This has become a reality, with examples of systems from Tanzania to Ghana and Zambia to Côte d’Ivoire that allow farmers to increase their incomes. In Ethiopia, an automated data server providing real-time commodity prices received more than one million calls in October 2011.

I Embrace a value chain perspective in generating knowledge, with the dissemination of non-proprietary information constituting a public good.

I Support networks to facilitate the exchange of information between and within the agricultural finance sectors.

Foster a new dialogue among the financial sector, the agricultural sector and policy makers.

There is room for far better understanding on the part of financial institutions, agricultural value chain participants and policy makers of the challenges and opportunities of agricultural finance.

The gap between the supply and demand for financial services will remain large as long as concerted efforts are not made to create a policy environment that will help increase access to appropriate financial products at lower costs to clients and raise returns for financial institutions.

Closing the knowledge gap in the interest of better policy solutions requires communication, transparency and increased understanding among stakeholders.

I Seek opportunities for increased dialogue among all stakeholders. Introduce regular dialogue between government ministries, the central bank/regulatory authorities, financial institutions, representatives of the agriculture sector, development partners, researchers, academics, technology and communications players and other stakeholders. This leads to the development of commonly embraced policy solutions and creates buy-in and ownership from the various public and private sector stakeholders.

I Involve a wide range of stakeholders, including non-traditional players, ranging from policy makers and regulators to market players, intermediaries and different entities that can represent the market segments that are currently excluded. This serves to broaden the dialogue in the interest of better understanding and consensus building in favour of the most effective actions to increase dramatically the outreach of agricultural finance.

I Strengthen farmers’ organisations, putting them in a better position to represent the needs of farmers in outreach to the government and to the financial sector.

I Underpin dialogue with sound quantitative and qualitative diagnosis and analysis of constraints and opportunities in the realm of agricultural finance. Without thorough diagnosis and analysis of issues and problems, stakeholders will be unable to work together to conduct well-informed dialogue leading to the creation of a sound policy environment for inclusive agricultural finance.
GOING FORWARD

Despite the difficulties in expanding agricultural finance, progress has been achieved in Africa, with innovative financial services and improved risk management on both the client and institution sides. The challenge before us is to support the development of financial systems that provide sustainable access to financial services for the large numbers of smallholder farmers and larger loans to finance value chains resulting into greater output, employment and income. Heightening the challenge is the on-going need for governments to tackle issues related to food security and income generation for their populations.

While the growing interest in agriculture in Africa had led to a new vision after two decades of policy neglect, a key tenet of policy support to agriculture should be the recognition that policy measures are the most successful when long-term institutional development is at the heart of the policy reform effort.

It is therefore of extreme importance to mainstream these policy recommendations deliberated during the Kampala process into the CAADP. The incorporation of the Kampala Principles and important conclusions of the conference’s policy paper into the G20 Report is already an important milestone as this has been accepted as the African contribution to the international dialogue.

The Kampala Principles and the agenda of the G20 subgroup on SME and Agricultural finance in Africa, as well as the CAADP principles provide a solid framework for future engagement in the agricultural sector in Africa. In November 2011, the MFW4A Partnership in collaboration with AFRACA created an Agricultural Finance Stakeholder Working Group (AFSWG) to champion this effort. In this regard, the AFSWG will deepen the dialogue with the AUC and provide support to the implementation of national action plans to be elaborated in the framework of G20 SME Finance Compacts.
PRINCIPLE REFERENCES


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