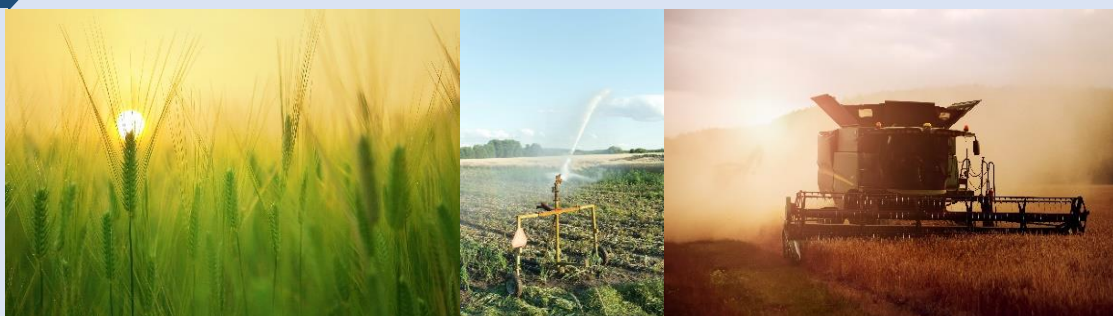


## KEY POINTS

- Contracts with farmers should be incentive-compatible to allow the farmer to get the best possible price for both inputs and outputs
- There is need for the establishment of an agricultural revolving fund with appropriate structured lines of credit. Formal Financial Institution must build a relationship first with farmers first before they engage them in business.
- Other sector players should contribute information on value chain financing to a central repository housed by government
- The government should promote bundling of insurance products with farm credit to increase uptake as well as linking these to regional insurance schemes.



## Unblocking supply of Agricultural finance in Zimbabwe: Reviewing cases involving risk-mitigating mechanism

### 1. Introduction

A vibrant agricultural sector is key to drive pro-poor economic growth and development, as well as ensure food and nutrition security in Zimbabwe. However, to achieve the sectors' potential in the country, significant increase in productivity is needed as is the case in many African countries (Jayne, 2017). This may appear to be a daunting task because growth in productivity remains low, negative or stagnant and agricultural intensification is proceeding at rates that are less than desirable (Binswanger-Mkhize and Savastano, 2017).

COVID-19 crisis on food systems to support policy response strategies that resonate well with the local realities cannot be overemphasised. Therefore, IAPRI conducted this study to better understand the scope of COVID-19 necessitated disruptions and impacts on food systems in both rural and urban areas in Zimbabwe. Thus, generating evidence to support implementation of evidence based policy response strategies to mitigate its effects and strengthen resilient of food systems in the country. One reason for this is the limited access to finance for agricultural investments among the millions of smallholder farmers who dominate agricultural production in the developing world including Zimbabwe. Global evidence suggests that only 1% of commercial loans are allocated to the agricultural sector. In Zimbabwe, commercial supply of loans to agriculture marginally increased from 19% of the loan portfolio of banks in 2012 to 19.3% in June 2019 (RBZ 2013, 2019).

The problem of under-supply of finance to agricultural value chain players is a direct consequence of the perception by formal financial institutions (FFIs) that the sector is highly risky. Indeed, various risks plague the sector including natural risks such as the vagaries of weather, which have been accentuated by climate change, and outbreaks of crop and livestock diseases and pests. At the postharvest level, farmers often have uncertain access to markets and are also exposed to considerable intra-seasonal variability in prices as well as inter-year price volatility.

Disabling policy actions, often ad hoc in nature, tend to further compound risks and uncertainty in a sector where information asymmetry is a fairly common phenomenon (World Bank, 2005). Most farmers also lack suitable collateral.

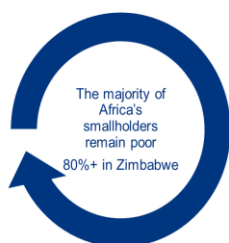
Livestock is a potential asset for use as collateral by farmers, as many of them including small-scale communal farmers own livestock. However, there is no collateral registry system to allow smooth and easy transfer of ownership. The Reserve Bank of Zimbabwe (RBZ) is working on a movable asset registry which includes livestock and other movable assets which can be used as collateral. But this needs to be comprehensive, including small livestock that are usually owned by women and youths.

Innovative finance models with in-built mechanisms to reduce and/or mitigate the risks identified above, and therefore lower default risk for lenders, have been demonstrated to increase the appetite of FFIs to make finance more available to players in agricultural value chains. Examples include value chain financing arrangements for Sesame, groundnuts and Cattle pen-fattening under FAO's Livelihoods and Food Security Programme (LFSP), and contract farming arrangements by Tabasco chillies. Typically, these are structured in such a way that an off-taker minimises the lender's risk exposure. However, some issues still remain unresolved.

This policy brief summarises for policymakers, evidence-based choices of appropriately structured financial innovations which are compatible with risk mitigation policy strategies and instruments being implemented in Zimbabwe. It explores the potential to align some of the identified innovations to the operations of Microfinance Institutions (MFIs) and banks in order to enhance their ability to service smallholder farmers without being too dependent on donor funds or government subsidies.

## 2. Data and Methods

Qualitative methods were used to collect data for the study. This was done through extensive literature review, key informant interviews drawn from implementing partners under the LFSP, non-LFSP aligned practitioners of value chain financing, and the Reserve Bank of Zimbabwe. Focus group discussions were also conducted with farmers involved in value chain financing both from LFSP- and non-LFSP aligned value chain financing arrangements. Study areas included Gokwe, Mutare, Mutasa, Guruve, and Kwekwe districts.



**Inadequate access to financial services is a key constraint to economic growth and poverty reduction**

- Land constrained
- Low productivity
- High post harvest losses
- Limited input and output markets
- Unpredictable weather
- **Liquidity constraints and limited access to credit**
- High transport costs
- Unpredictable agricultural policies etc.



### 3. Results and findings

Figure 1: A typical smallholder farmers' challenges

**Box 1: Why do financial institutions lend so little to agriculture?**

- Risks in agriculture are high (policy, market, production and environmental risks)
- Farmers lack formally recognized collateral
- High costs and risks in lending to smallholder farmers
- Micro-finance institutions lack sufficient funds for lending and repayment structures may not suit agriculture
- Lack of affordable weather indexed micro insurance products to cushion farmers/FIs against the impact of persistent droughts

One innovation which has been piloted in Zimbabwe is value chain financing (VCF). VCF refers to any or all of the financial services, products, and support services flowing to 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). This is expected to yield a win-win situation for chain actors; however, it requires the banker to see and understand the business in its entirety (Shwedel, 2007).

The structure of value chain financing arrangements in Zimbabwe is such that farmers are only funded when there is an off-taker. Inputs on the other hand are disbursed through an agro-dealer, and disbursements are often staggered, and other service providers also play a role in the VCF arrangements (e.g. extension service providers and government). This design is assumed to reduce risks to the lender (Figure 3.1). Typically, financing is mainly for operational expenses, without consideration for other expenditure such as capital.

VCF models were piloted under LFSP. The model took account lessons from pilots elsewhere in the world, including what has emerged from efforts by the Government through the RBZ in efforts to promote financial inclusion and ensure increase in agricultural finance.

In piloting VCF in Zimbabwe efforts were made to address identified old challenges in rural finance, operational constraints such as the high cost of borrowing faced by smallholder farmers, low assets base for most of rural population, inappropriate financing instruments and unstable/slow returns to investments and production as well as marketing risks (see Miller 2017; Mudyazvivi and Mutamba 2017)

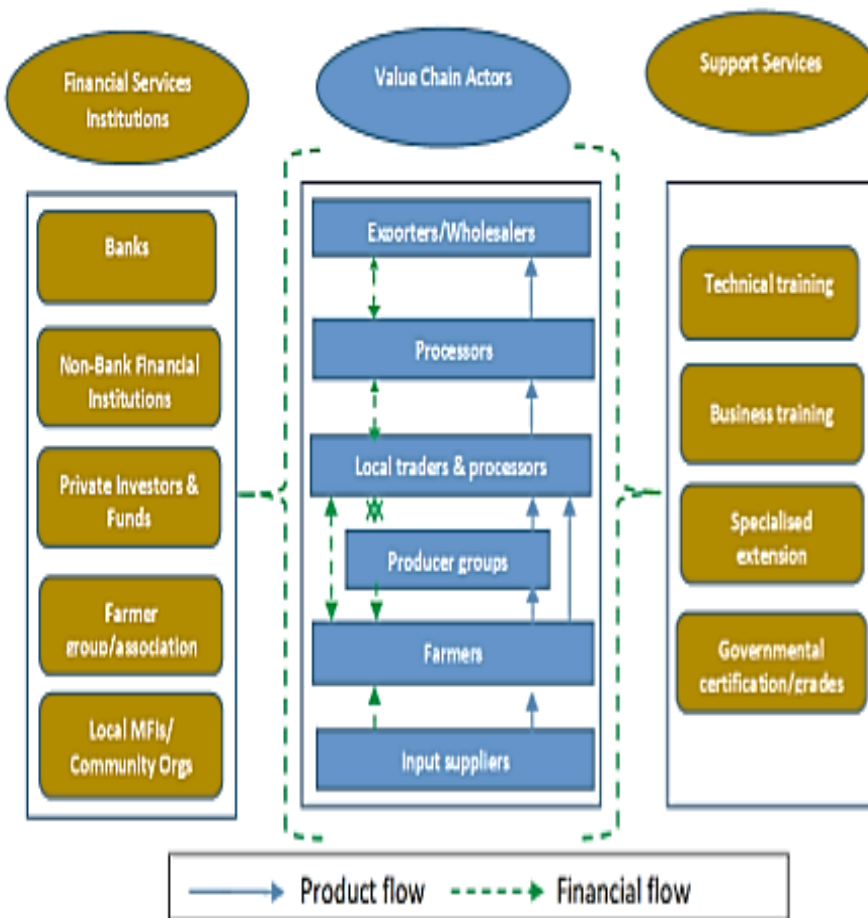


Figure 2: The Concept of Value Chain Financing: Source: LFSP (2017)

**Supply-side innovations** under VCF pilots included specific mechanisms to reduce the cost of loanable funds, increasing the supply of appropriately structured lines of credit, increasing competition among FFIs lending to the target farmers and reducing information asymmetries among FFIs, as well as lowering access barriers.

**On the demand side** LFSP identified commercially bankable smallholder agricultural value chains in the project areas for financing by participating FFIs. Furthermore, financially viable farmers were identified based on objective productivity criteria and records of these maintained on a database accessible to the participating FFIs for purposes of assessing loan applications from potential borrowers.

**On the product side**, various loan products were designed, focusing on Input Loans rather than packages to finance entire farming operations. The success of these innovations is reflected in the high loan recovery rates, ranging between 90-100%. The evidence further shows that with good facilitation and training, farmers are bankable.

#### *Emerging issues in value chain financing*

However, some critical issues affecting VCF in the country that need to be resolved are discussed below.

- Existence of unequal power relations between smallholders and other players within financed value chains (e.g. off-takers and input providers). Quite often, the more powerful off-takers dictate the terms of trade, creating a perception among farmers that they are being cheated and as a consequence, encourages side-selling which can threaten the sustainability of VCF initiatives. This issue may reflect a design failure in the system.

### 3.1 Innovative Finance Models for Smallholder Financing

3.1.1 *Contract farming*: It is a specific form of VCF which has a long history in Zimbabwe and other countries in the Eastern and Southern Africa regions. Current cases include initiatives for the production of Mung beans, Tabasco chillies, and Sesame. These crops are mainly for export and involve few exporters who are well-connected enough to minimise side-selling to non-financing buyers. The off-takers may also be involved in provision of inputs and extension services.

Quite often, these large-scale players provide finance which is internally-generated or sourced offshore at very competitive interest rates. However, involvement of local FFIs can catalyse expansion of such schemes but this requires addressing some inherent constraints. These include:

- *Delays in input supply by contracted agro-dealers and/or in loan disbursement* making it difficult for farmers to acquire inputs on time. Where these affect output, the participating farmers may struggle to repay their loans, especially when finance is provided by FFIs rather than the off-taker/out-grower.
- *Lack of effectively enforced standards on weights and grading* sometimes leads to disputes which can disrupt or impede this system. Setting future prices and complying with them, however, tends to be a more common source of dispute among contracting parties.

Diversion of inputs to other crops is also a common problem and reflects the lack of consideration of the total financing needs of farm households (Figure 4.1). In fact, evidence emerging from this study shows that where farmers have flexibility in choosing the enterprises in which to invest loans, success rates in enterprises and in loan repayment tend to be high.

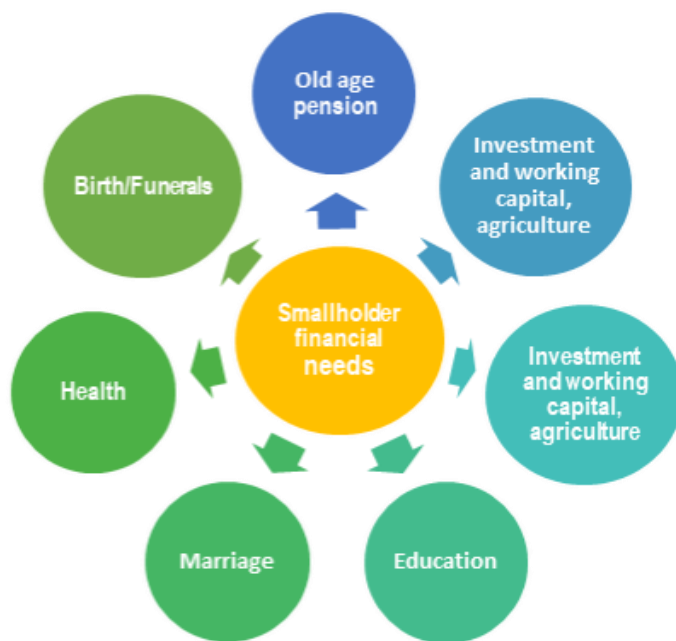


Figure 3: Understanding Farmer Needs: Source: LFSP (2017).

The 'diversion' problem reflects a strategy by some farmers to diversify, thereby spreading risks (production and marketing) across several enterprises. A better understanding of this situation may help financiers in better structuring input loans to farmers.

**3.1.2 Credit guarantee schemes:** These schemes are not really new and usually entail sharing of the risk of loan default between the financier and a guarantee fund that is usually funded by donors or governments. In Zimbabwe, efforts are currently being made by the RBZ to establish a credit guarantee scheme, with technical assistance from the World Bank. More recently, private sector also provides credit guarantees, for example LFSP through the Zimbabwe Microfinance Wholesale Facility. A recent success is that of the Credit Guarantee Scheme launched by the Alliance for a Green Revolution in Africa (AGRA) in 2006. With a fund of United States Dollars (US\$) 16 million, AGRA was able to leverage over US\$170m in Ghana, Kenya, Mozambique, Tanzania and Uganda by 2014. AGRA's experience demonstrated that such schemes work best when tied to other risk mitigating mechanisms and aim at encouraging "first movers" to gain confidence in financing value chains which are relatively new to them. For instance, the Nigerian Marketing Board (NMB) took advantage of the AGRA facility to initiate financing of out-growers involved in rice cultivation and marketing paddy to a well-run rice mill in Tanzania. After gaining experience, including a better appreciation of the inherent risks and the appropriate mitigation systems to adopt, NMB discontinued using the facility.

However, these schemes are often abused, especially when it encourages selection of high-risk portfolios by lenders and/or wilful default by borrowers, in particular the well-connected borrowers who are financed under public guarantee schemes. It is also not uncommon to find cases where uptake of the guarantees by FFIs is low, largely because the terms and conditions stress prudence in lending.

Recent variants of the guarantee schemes include farmer-based funded credit guarantee schemes. An example is that of a cooperative of cotton growers in Eastern Tanzania. They set up a fund based on member's contributions from the sale of cotton. The fund was kept in an interest-

earning account with the financier and was used to guarantee input loans for the members. Knowing that the fund represents their savings incentivises members to apply peer pressure to ensure repayment.

The model also minimises the cost of servicing debts of defaulters by “good borrowers” in groups and is sustainable. Another innovation in offering guarantees is the model in Nigeria which was developed with support from AGRA – the Nigeria Incentive-based Risk Sharing System for Agricultural Lending. This scheme bundles credit guarantee (up to 50%) with insurance and institutionalization of incentives such as interest drawback as well as provision of technical assistance to build capacity of banks and borrowers, the latter in financial literacy.

*3.1.3 Risk transfer via agricultural insurance:* There is a long history of using traditional indemnity-based insurance products in the agricultural sector in many African countries. In Zimbabwe, traditional insurance cover has been largely among commercial farmers for farm equipment and against hail, and insurance company's networks were thin and had limited uptake (Tsikarayi et al., 2013). This type requires that a loss assessment is undertaken prior to settlement of any claims. They are often considered quite expensive to run, especially when targeting smallholder farmers.

In many African countries, uptake of such products was linked to government-funded credit schemes and their sustainability was often undermined due to abuse. To minimize the apparent moral hazard and adverse selection problems associated with this product, the 1990s saw the emergence of index-linked products, the most popular being weather index insurance (e.g. Zimnat insurance has piloted this in Zimbabwe, since then, no progress has been made to date). These peg pay-outs to a particular trigger – level of precipitation required for normal plant growth and yield performance – and therefore minimizes monitoring costs as well as make redundant the need for loss adjustment prior to settlement. Though several pilots have been implemented in many countries, sustainable delivery is rare. A recent challenge for both products remains system capacity to survive incidence of risk such as drought on a catastrophic scale – i.e. affect large number of farmers over a wide geographic area.

*3.1.4 Inventory collateralization:* this entails transforming agricultural produce into secure and relatively liquid collateral by storing in designated warehouses run by reputable operators. This may be under a regulated Warehouse Receipt System (WRS) or under a collateral management agreement involving a reputable inspection company. Its demonstrated benefits include direct access by farmers to postharvest finance, not only for investment but also for household consumption smoothing purposes. It also allows depositors to secure inputs credit secured against the stored produce and, where it can serve as a credible delivery system, it can be the foundation of a viable commodity exchange. Exchanges reduce credit risk by facilitating liquidation of collateralized stocks and offer a means for transparent price discovery, thereby making valuation of pledged stocks as well as close monitoring of the value relatively easy for financiers.

Zimbabwe has the physical storage infrastructure (the bulk owned by Grain Marketing Board); required warehouse legislation (passed in 2007); and experience by grain producers and some coffee farmers in the use of WRS and the exchange. There has been renewed momentum to have the WRS operationalized. For example, the draft Agricultural Policy Framework 2012-2032 and National Development Strategy 1 spelled out the need for WRS in Zimbabwe. The implementation of WRS is also the foundational step towards operationalisation of agricultural commodity exchange to strengthen agricultural commodity trade and exchange which is critical for the realisation of Vision 2030 of upper middle-income economy.

Experience from Zambia and Tanzania demonstrate that smallholder farmers as groups can aggregate and access these platforms along with large-scale users. There is also experience from Burkina Faso which demonstrates that small-scale operations, exclusively targeting smallholder farmers, can be linked into commercial systems if appropriate commodity standards are instituted along with training.

Evidence from across the continent has also proved that it is not legislation which drives the development of these systems but rather trade-friendly policies which are predictable and do not discourage private stockholding. Actions such as administrative determination of commodity prices and restrictions on trade, including exports into regional markets, are among those which dampen incentives for depositors and therefore uptake of these systems.

### 3.2 RECENT KEY AGRICULTURAL FINANCE POLICY CHANGES

This section briefly discusses recent key agricultural policy changes aimed at improving access to agricultural finance among farmers particularly smallholder farmers who have not been supported by commercial banks due to lack of recognised collateral security.

#### 3.2.1 *Command agriculture programme and its administration:*

The Government of Zimbabwe initiated the Command Agriculture Programme (CAP) also known as Special Maize Programme for Import Substitution in 2016/17 farming season in order to reverse decline in agricultural production (World Bank, 2019). Specifically, CAP has been aimed at stimulating maize and wheat production to ensure food security and substitute imports (Mazwi et al., 2019; World Bank, 2019). Concurrently, CAP is also targeted at bridging the financial gap in the production of cereal crops since private contractors who mostly provide agricultural finance mainly support production of export-oriented crops such as tobacco (Mazwi et al., 2019). At its inception, CAP supported around 2000 farmers with 200 hectares or more and irrigation facilities to ensure high productivity hence ability of farmers to repay the credit (Scoones, 2019). Unlike direct provision of cash to farmers, CAP provide credit to farmers in form of fertilisers, fuel, equipment and other inputs and the farmer will pay back by delivering produce to Grain Marketing Board (GMB) and stop order will be used to deduct the cost of inputs provided (World Bank, 2019). CAP involves a number of stakeholders such as the Ministry of Lands, Agriculture, Water and Rural Resettlement (MLAWRR), GMB, commercial banks and other private sector players such as seed, fertiliser and agro-chemical companies.

Basically, the supply of inputs from private sector players is securitized by Treasury Bills. The inputs essentially are delivered to GMB depots across the country by private sector player contracted by the Government and further distributed to farmers. To strengthen repayment of credit and improve targeting of beneficiaries, farmers sign contracts with commercial banks such as through CBZ Agro-Yield scheme before getting the inputs. The farmer will be obligated to deliver the produce to GMB and the cost of inputs will be deducted and these funds collected by GMB will then be transferred to Treasury which then transfer the funds to private sector players and commercial banks to redeem the Treasury Bills. The figure 5.1 below provide a simplified summary command agriculture administration.



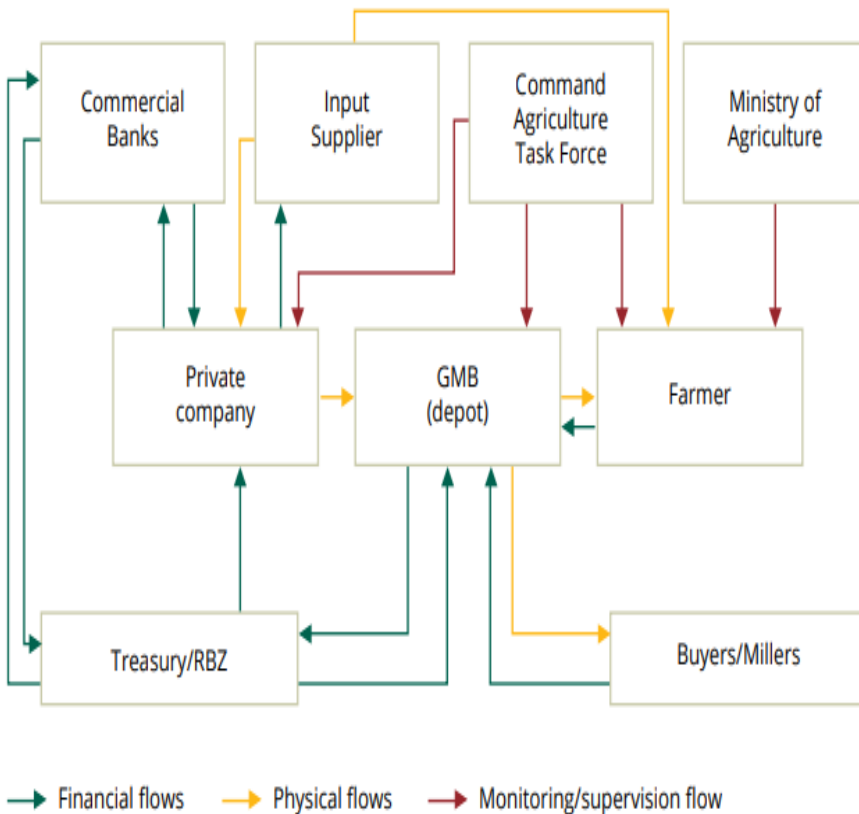


Figure 4: Administration and key stakeholders involved in Command Agriculture Program: Source: World Bank, 2019.

### 3.3 Transition of Agribank to Land Bank and its implication on access to credit:

In October 2020, Government approved the remodelling of Agribank into a Land Bank, a move aimed at improving access to agricultural finance through flexible borrowing terms. Specifically, the National Development Strategy 1 (NDS1) spelled out that, the restructuring of Agribank into a Land Bank is one of the key strategies to enhance productivity in the agriculture sector through improved access to finance. It is assumed that, the restructuring of Agribank will strengthen access to finance through offering short, medium- and long-term credit to smallholder farmers particularly communal, old resettlement, small-scale commercial and A1 farmers who owns up to 95% of the productive land and 90% of national herd. It is also anticipated that, the remodelling of Agribank as a dedicated Land Bank will help to diversify the existing agricultural financial services for sustainable agricultural transformation which is in line with the agriculture sector recovery plan.

## 4. Conclusion and Policy Recommendations

Promoting the innovations discussed in this brief, which foster increased supply of agricultural finance through mitigating inherent risks, should include policy actions aimed at creating and maintaining an enabling environment. The actions required include:

- The RBZ ensuring that its regulatory role in the financial sector are complemented by sector development initiatives including Collateral and Credit Registries which cover smallholder farmers and assets available to them. The RBZ should facilitate establishment of collateral and credit registry for small holder farmers by development partners, which include credit

offered by Community-based lending institutions, with the RBZ playing a monitoring and facilitating role.

- IFFs should have incentives and support to structure credit products that increase access to credit by small holder farmers at the same time mitigating inherent risk of lending to the sector.
- Also Government could create a special purpose vehicle within Agri bank, that handles these structured facilities for small holder farmers. The window will then be exempted from stringent risk management and bank supervision regulation applicable to normal bank lending. The RBZ should incentivize banks to offer structured facilities targeted at small holder farmers. For example, with proper structuring, the RBZ could designate prescribed asset status for regulatory compliance, funds that are directed at small holder farmers as facilities by pension funds, asset management companies, fund managers, and insurance companies. Risk assessment will then be on the lending institution managing the facility, with Government giving a guarantee on the Fund to cover beneficiaries.
- Expand the current registry systems' framework to explore the inclusion of borrowers from non-banking institutions such as community-based microfinance institution (Savings and Credit Cooperative Societies, Internal Savings and Lending Schemes, and Village Savings and Lending Schemes) and contract farming. Community-based lending institutions and FFI could utilize the Collateral and Credit Registries established by development partners in their lending decision. The RBZ should assist by providing guiding mechanisms to enable creation of such registries.
- Promote bundling of insurance with farm credit to increase uptake as well as linking these to regional insurance schemes
- Expedite the establishment of the warehouse receipts system in order to collateralise assets that are common to smallholder farmers. Supportive actions can also include ensuring that public procurement for national food reserves as well as for relief operations are channelled through the WRS and a viable exchange, if it is incorporated in the country.
  - There is need for FFIs to harness the non-conventional assets possessed by smallholder farmers as collateral. In particular, there is need to collateralise small livestock in the movable asset registry currently being developed. For small holder farmers, collateralisation using livestock would work where beneficiaries are accessing funding as a group and they are able to co-guarantee and monitor each other.
  - Banks and MFIs must simplify the language and make contracts available in the local language. The banks should be encouraged to invest in trainings related to agricultural financing. Information gathering systems must be strengthened to form the basis for assessing credit-worthiness of potential borrowers.
  - Establishment of an agricultural revolving fund with appropriately structured lines of credit.
  - FFIs must include capacity building as part of the total package in their value proposition to the farmer.

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#### ABOUT LFSP:

- The Zimbabwe Livelihoods and Food Security Programme (LFSP), Agriculture Productivity and Nutrition Component (APN) is managed by the Food and Agriculture Organisation of the United Nations (FAO), with the aim of contribute to poverty reduction through increased incomes for a target 250,000 smallholder farming households. The programme is being implemented in four provinces covering 12 districts as follows: Mutasa, Mutare, and Makoni in Manicaland; Guruve, Bindura, Mazowe and Mt Darwin in Mashonaland Central; Kwekwe, Gokwe North, Gokwe South and Shurugwi in Midlands and Zvimba in Mashonaland West provinces. FAO is in partnership with three NGO consortia led by Practical Action, Welthungerhilfe and World Vision International, two Strategic Technical partners i.e. **IAPRI** for policy influence, HarvestPlus for biofortification, three Commercial Banks, 1 Wholesale Facility - the Zimbabwe Microfinance Fund (ZMF), 5 Microfinance Institutions (MFIs) and the USAID managed DCA Facility. To date the LFSP is funded for two phases to the tune of £72.4m.

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