Financing Agriculture: Risks and Risk Management Strategies

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Risks that affect agricultural financing can be broadly grouped as systemic/correlated risks and idiosyncratic/independent risks. Major systemic risks include production risks (farming practice, weather, pests, etc), price risks, and political risks (export bans, price caps, debt write offs, etc). Both producers and lenders face the impact of these systemic risks. Idiosyncratic risks include risks that the borrower faces (life, health, asset, etc) as well as that the lender faces (willful default, wrong estimation of credit-worthiness, wrong pricing, etc).

Absence of or inadequate risk mitigation strategies leads to low private investments in farming and agribusiness, low availability of finance for farming and agribusiness, slow adoption of agricultural technology, and low bargaining power for producers in commodity markets. This, in turn, results in high volatility in household income and food security. The impact on low income households is higher because they have to reduce consumption and liquidate assets to cope with shocks caused by these risks. Both these coping strategies lead to reduction in future income, thereby keeping many of households in poverty.

Better management of risks in agricultural financing involves managing these risks at the level of the borrower, at the level of the lender, and at the level of the economy. At the borrower level, this means reducing and managing risks directly related to agriculture as well as those related to life, health, and productive assets. Use of improved seeds, farming practices and technology, and agricultural development services, and access to agricultural insurance help reduce direct agricultural risks. Access to life, health, and asset insurance reduces vulnerability to these risks. The risk from fluctuation of prices of agricultural commodities is better managed using physical tools such as forward sales and minimum price guarantee contracts, and financial tools such as options (typically through intermediaries).

Lenders can manage their risk better by facilitating access to risk management tools for borrowers, and by using processes and tools that allow them to assess and manage their own credit-risks better. The latter involves using improved credit-risk assessment techniques (such as use of credit scoring), using joint-liabilities and sale contracts, better monitoring of loans, and pricing loans according to credit-risk. Lenders can also use strategic alliances with other market players to reduce their credit risks.

Better management of risks at the level of the economy includes both indirect and direct measures by governments. Indirect measures such as increased investment in infrastructure and research, and creation of better legal and policy frameworks for agriculture and financial markets is as important or even more important than direct
measures such as facilitating pooling of risks among national intermediaries and their transfer to global reinsurance markets, and using futures market contracts to ensure availability and affordability of food to ensure food-security.

World Bank is currently supporting the development of new risk management products to enable improved risk management in major agricultural commodity sectors in its client countries. Ongoing work includes, among others, price risk management in Tanzania, Zambia, Mozambique, and Malawi; weather risk management in India, Malawi, Ethiopia, Thailand; and livestock mortality risk management in Mongolia. Users of these products have included governments, financial institutions, agribusiness companies, producer organizations, and producers. Services offered include policy advice and technical assistance in risk assessment, contract design, pricing, and program management.

The pilot project for price risk management in Tanzania has been implemented with CRDB, local bank in Tanzania as the partner. The bank helps its borrowers - coffee producer organizations and cotton ginning companies – access to price derivative contracts. Access to these contracts has helped these entities better manage their price risk, and offer higher purchase price to producers. However, demand for the contracts has varied with rise and fall in commodity prices.

The pilot project in Malawi has been implemented with NASFAM, the National Smallholder Farmer’s Association of Malawi. The project is in its 3rd year of program development. Rainfall index based insurance contracts have helped ground-nut farmers use improved varieties as these contracts enabled access to finance from Malawi Rural Finance Company and Opportunity International. The project is being expanded to cover tobacco and a contract farming operation in the coming season.

Lessons learned from these and other pilots include the following: need for robust historical data to design good contracts; need to develop local technical skills in risk assessment, contract design, pricing, accessing derivative and reinsurance markets, and program management; and, availability of institutions that can take risk, invest staff time and financial resources, and create outreach. Linkage to finance seems critical to increase product up-take.