microNOTE #27

Rural and Agricultural Finance: Emerging Practices from Peruvian Financial Institutions

A. Introduction

The formal financial system[1] in Peru provides very limited rural and agricultural finance (RAF) services and most financial institutions focus uniquely on serving urban clients. If financial institutions lend to agriculture at all, it is primarily to large agro-processors or input suppliers, rather than to farmers directly. Only 3.2% of all formal loans are for agriculture, for a total amount of US$388.8 million.[2] Even microfinance providers, which are more inclined to serve the needs of the rural poor, focus on the urban areas of Peru. Given the Peruvian microfinance industry's 20% growth last year, microfinance providers are likely to continue to focus on unserved urban markets, which are easier to serve than rural markets.

Several financial institutions in Peru are making efforts to serve poor clients with a variety of RAF product and process innovations that reduce transaction costs and manage risks. This microNOTE captures some of the emerging products and processes of four Peruvian financial institutions, whose RAF portfolios are summarized in Table 1. While not all of these innovations are specific to Peru, their positive results suggest that they may be applicable in other countries.

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[1] In this case, "formal financial system" refers to all entities regulated by the Superintendency of Banks and Insurance in Peru.
[2] Data from Carolina Trivelli, *Instituto de Estudios Peruanos,* Oct. 2005.

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Table 1: Peru RAF Portfolios, Interest Rates and Gross Margins as of Nov. 30, 2005

RAF Provider	Loan Product Type	RAF Portfolio US$	No. of RAF Clients	Annualized Savings Interest Rates	Annualized RAF Lending Interest Rates	Annualized Gross Margin
Caja Rural de Sr. de Luren	agricultural micro rural	$7.7 mil $0.5 mil	3,500 2,000	5% (US$) 7-15% (soles)	18-20% (US$) 36-48%	13-15% 21-41%
Caja Municipal Huancayo	agricultural	$4.8 mil	1,780	5% (soles)	48-55% (soles)	42-50%
EDPYME Confianza	agricultural	$3.0 mil	3,300	Doesn't mobilize deposits	37.2-50.4% (soles)	27.2-40.4%
Mibanco (Dec. 31, 2005)	working capital fixed asset	$2.5 mil $0.1 mil	7,246 116	4.5-8.5% (soles)	38-70%(soles) 34-40%(soles)	29.5-65.5% 25.5-35.5%

RAF PRODUCT INNOVATIONS

Some Peruvian financial institutions have adapted their products to better respond to the needs and risks of rural and agricultural borrowers, as described below.

Adapting disbursal and repayment to agricultural cash flows

The financial institutions experiencing some success with agricultural lending in Peru linked loan disbursals and repayments to the specific cash flow cycle of the agricultural crop. The most common schedule included three loan disbursements, which were primarily linked to purchase of inputs, such as seeds, fertilizer and pesticides. Only one final, full loan repayment (principle and interest) was made post-harvest, allowing enough time for the farmer to sell the majority of the crop. In most cases, the financial institution financed 100% of the direct investment, excluding land and labor costs.

The Caja Rural de Sr. de Luren in Ica adds an additional risk management measure by requiring farmers to bring invoices for needed inputs. The rural bank then uses the invoice to pay the input provider directly to avoid the risk of false receipts and the potential for farmers to use the loan funds for purposes other than the agricultural investment.

BOX 1: MIBANCO'S PONY EXPRESS

Mibanco's 'Chasqui Efectivo' product was designed specifically to transition rural, group microloan clients to individual loans. Loan sizes are small (from $85 to $300) with a maximum term of 12 months. Interest rates begin as high as 80% per year, but are reduced after the first year of successful repayment.

Allowing agricultural income to be considered in microlending

Mibanco does not offer traditional agricultural loans, however it recently started a pilot test to allow agricultural income to be factored into the cash flow analysis of its microloans. The microloan income can come 100% from agricultural revenues and Mibanco designs the loan disbursals and repayment schedule to the cash flow. Mibanco has created another rural loan product 'Chasqui Efectivo,' which refers to Peru's former Pony Express (see Box 1).

Given the success of its RAF portfolio, Mibanco plans to increase its RAF lending threefold, from 6.4 million Peruvian soles ($1.9 million) in 2005 to 20 million soles ($6.0 million) in 2006. However, with the rapid growth of Mibanco's urban portfolio, RAF will only increase from 1% in 2005 to 2% in 2006 of its total loan portfolio.

Caja Rural de Sr. de Luren has been piloting a micro rural loan product over the past year with good results. Micro rural loans now represent 10% of its total loan portfolio. These loans factor in agricultural income, as well as non-agricultural income, and are available to small land holders (farmers with less than five hectares) and to those who do not own land. Most loans are small, ranging from $300 to $900. The rural bank charges 3%-4% interest per month on these loans, which is higher than the interest on traditional agricultural loans.

Offering longer-term loans for fixed asset lending

Longer-term fixed asset loans for investments, such as in irrigation and tractors, are important to increase agricultural productivity. In fact, having access to water for irrigation is a requirement of EDPYME Confianza's agricultural lending, because of the higher chance for a successful harvest. Most of the RAF providers interviewed offered only working capital loans, except Mibanco. In one of Mibanco's RAF pilot branches in Huancayo, 40% of its rural microloans are for longer-term (up to five years) fixed asset loans. Depending on the size of the loan and the client's history with Mibanco, interest rates range from 34% - 40% per year.

Using technology to lower transaction costs of serving rural areas

The comprehensive nature of Peru's central credit bureau, which includes microfinance clients, is one way in which technology facilitates risk management. Financial institutions are able to perform client checks through the credit bureau and refuse to lend to anyone with repayment problems in the past five years, regardless of other guarantees or agreements.

The Caja Municipal in Huancayo uses two other technologies to reduce RAF transaction costs and risks. The bank began a pilot test in May 2005, providing personal digital assistants (PDAs) to loan officers to collect information from clients in rural areas. PDA technology has already demonstrated its ability to reduce transaction costs by cutting the time loan officers have to spend with each client in half, down from 30 minutes to just 15 minutes per client on average. The results have been so positive that the Caja Municipal plans to offer PDAs to all loan officers in the future. In addition, the bank began pilot testing a credit scoring system in February 2005. While the potential impact of the credit scoring system is still unclear, the Caja Municipal hopes that it will streamline costs and reduce risks associated with its lending decisions.

RAF POLICY AND PROCESS INNOVATIONS

Some Peruvian RAF providers have integrated their policies and processes to minimize the risks involved with rural and agricultural lending as demonstrated in the techniques below.

Diversifying loan portfolio – not just rural and not just agricultural

One way that financial institutions use to reduce risk involved with rural and agricultural finance is to diversify their portfolios to include non-agricultural loans in rural areas as well as urban loans. Some of the financial institutions had target maximums for their agricultural loan portfolios. For example, the Caja Rural de Sr. de Luren has a policy to try to keep the value of its agricultural loans to no more than 30% of its total loan portfolio. The Caja Municipal in Huancayo makes efforts to diversify the types of crops it finances to reduce systemic and weather-related risks of RAF.

EDPYME Confianza learned the importance of portfolio diversification the hard way. In 1998, a non-governmental organization, SEPAR, transformed into EDPYME Confianza, transferring its portfolio of primarily "unsecured solidarity loans to groups of women, 95% of whom depended on agriculture – largely potato farming – for their livelihoods."[3] A year later, more than half of Confianza's loan portfolio was at risk of default due largely to a significant drop in potato prices. As a result, Confianza set a

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[3] CGAP Agricultural Microfinance: Case Study No. 1, "Confianza in Peru Overcomes Adversity by Diversifying Loan Portfolio," August 2005. Available at www.cgap.org/docs/AMCaseStudy_01b.html

target limiting its agricultural loan portfolio to no more than 30% of its total loan portfolio.[4]

Hiring loan officers experienced in rural and agricultural markets

Both the Caja Rural de Sr. de Luren in Ica and the Caja Municipal in Huancayo hire agricultural engineers and train them as loan officers to ensure that they have a strong understanding of the agricultural markets they serve. These financial institutions prefer to train agricultural specialists on best practices in finance, rather than hire financial specialists or economists and train them to understand agriculture. The Caja Rural de Sr. de Luren does not distinguish its loan officers by loan product, but by rural versus urban geographical targets. This client-focused approach enables them to offer a full range of products to clients depending on their needs, and has been so successful that the bank plans to double its rural loan officers next year.

Linking technical assistance providers to RAF clients

Caja Rural de Sr. de Luren's decision to hire agricultural engineers was attributed to their being able to provide technical advice to farmers. The rural bank's management believes that good technical assistance is needed to ensure positive results in agriculture, so bank helps farmers to access such assistance. For example, the Caja Rural offered 100% financing (using the land as collateral) to support a pilot project in which 40 hectares of asparagus were planted by groups of 4 to 6 farmers that worked together with an experienced project manager. The groups received additional technical assistance from ACTA, an agro-industrial firm that guaranteed a minimum price of $0.90 per kilo of asparagus. Caja Rural has also supported a similar project in paprika. These types of projects demonstrate to farmers the increased results they can achieve if they work together to leverage technical assistance.[5]

Linking RAF through processors within dynamic value chains

The Caja Municipal of Huancayo is more likely to lend to farmers if they are associated with a respected agricultural processor of a dynamic value chain (one that is export-oriented and/or growing). Caja Municipal Huancayo has an agreement with Agromantaro, an artichoke processor, to lend to the farmers that contractually supply its artichokes to Agromantaro. Each farmer must still satisfy all other requirements for the loan, including a good credit history and demonstrated ownership of the land. Agromantaro reduces the risk of lending to such farmers by guaranteeing the price of their product and facilitating their loan repayments. For each kilo of artichoke processed, Agromantaro pays 50% of the farmer's revenue directly to the bank to pay down their loan, until the loan is fully paid off. In this way, the Caja Municipal lends to farmers based more on their financial strength and the credibility of the processor, than the individual farmer. Agromantaro does not guarantee the loans, but simply facilitates loan repayment after processing farmers' artichokes.

EDPYME Confianza works with agricultural processors to lend to farmers. When the market price is clear, EDPYME Confianza offers interest rate discounts up to 1.9 % per month as a result of their reduced costs associated with the loan evaluation. Caja Municipal Huancayo does not offer such a discount for "political reasons," implying a concern for public perception of fairness.

CONCLUSIONS AND DONOR RECOMMENDATIONS

The results to date of these innovations suggest a number of recommendations that can be used to guide donors in their support of RAF.

Do not be discouraged by previous RAF failures, as RAF can be profitable, if well managed.

These RAF providers have found innovative ways to overcome some of the traditional barriers to rural and agricultural lending, including

[4] Ibid.

[5] While the initial results of these pilot projects have been positive, the sustainability of the financing is unclear, as it currently comes from COFIDE, a state-owned second tier development bank,.which is not currently able to cover all its costs with its earnings. COFIDE takes the lead role in these projects, assumes 100 % of the credit risk and caps the annualized interest rate to be charged to the farmers at 11-15 % in soles, far below the rates normally charged by the Caja Rural. Nonetheless, the Caja Rural's part is currently sustainable, as it plays a limited role and yet receives a 4 % fee for its intervention.

higher transaction costs and risks. As Table 1 shows, interest rates offered by RAF providers in Peru range from 13% to 65.5%. These RAF providers have also demonstrated that with effective risk mitigation, delinquency can be held to around 5% on average, which is line with microfinance best practices and substantially lower than the 13.5% average delinquency rates for agricultural lending in Peru.[6] Hence, there is a real need for donors to help financial institutions and governments to understand how RAF can be done in a cost-effective manner.

Support the expansion of RAF, because there remains significant unmet demand for RAF in Peru, as in other countries.

Given the limited involvement in RAF by the formal financial sector in Peru, it is not surprising that the few engaged in RAF are experiencing strong demand for their services. In fact, many have had to set limits on their agricultural lending to protect themselves from an over-concentrated portfolio. The situation in Peru is not unlike other countries; financial institutions around the world view rural and agricultural lending as high risk. Formal financial institutions tend to offer RAF as a last resort (when other markets are saturated) or in response to government mandates or subsidies.

Donors should support RAF pilot projects, new product development and capacity building, as well as more research and information dissemination, as there is still a lot to learn.

Disseminate lessons about Peruvian product and process adaptations

These Peruvian RAF providers have demonstrated their ability to serve an underserved population in a way that is not only sustainable, but profitable. Donors should disseminate the information about these innovations so that other countries or financial institutions can determine the feasibility of replicating or adapting these products and approaches to their markets.

Discourage negative interventions in RAF.

As Henri Cumayo Mantalva, EDPYME Confianza's Commercial Manager, explained, "There is always a political risk involved in agricultural lending. Governments always want to cancel debts to the agricultural sector." This reality can cause financial institutions to spurn agricultural lending, despite its profit potential. Hence, donors could encourage expanded access to RAF by working with governments and other donors to discourage them from intervening in ways that distort RAF markets (such as directly providing targeted or subsidized agricultural credit). Ideally, donors can work with governments to draft and issue policy directives, committing not to retail agricultural finance or introduce market-distorting policies or programs. Such commitment would increase financial institutions' interest in lending to the agricultural sector.

> *"The greatest limitation to Mibanco's ability to expand rural and agricultural finance is being able to find and train loan officers to understand rural and agricultural sectors."*
>
> *- Jesus Ferreyra, President of Mibanco*

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[6] June 2005 data from Carolina Trivelli interview, *Instituto de Estudios Peruanos*, Oct. 2005.