

# EFSE DEVELOPMENT IMPACT STUDY 2009: AGRICULTURAL FINANCE

## Executive Summary



May  
2010

Berne, June 2010



in association with



*The research and findings in this report reflect the work of the authors, and do not necessarily reflect the opinion of EFSE.*

## Objectives and research method

The European Fund for Southeast Europe (EFSE) was created in 2005 as a public-private investment fund to provide long-term finance to micro and small businesses and households through local Partner Lending Institutions (PLIs) in Southeast Europe. The EFSE Agricultural Finance Impact Study 2009 analyses the development impact of agricultural lending of EFSE's PLIs on end-borrowers (clients of banks and microfinance institutions), namely farmers, agro-processors and agro-traders, as well as EFSE's role in promoting agricultural lending among PLIs. The study also assesses adherence to environmentally and socially responsible lending practices as well as client satisfaction.

To analyse the impact of agricultural loans on end-borrowers, a **survey** was conducted among a total of 480 end-borrowers of two PLIs in each of the three countries, Albania, Kosovo and Moldova, and among a control group of 180 farmers (60 per country) who did not borrow from a PLI nor from any other formal financial institution between 2006 and 2008. The end-borrowers were randomly selected from a list of clients who had received credit between 2006 and 2008 (not more than 100,000 € in total), employed less than 50 staff and used the loan for agriculture and related purposes. The **control group** was selected by asking interviewed end-borrowers for similar farms/enterprises but who were non-borrowers. The interviews were conducted by local survey teams, at the houses/businesses of respondents, and based on a structured questionnaire.

The six **sample PLIs** consisted of one bank, two microfinance banks, two microfinance institutions (MFIs) that are structured to refinance individual clients as well as savings and credit associations, and one MFI that provides individual loans. In each country, one bank and one MFI were selected.

**At the level of end-borrowers** this study focuses on changes in the economic activity in which farmers and entrepreneurs have most invested in and explores the links between these changes and access or lack of access to credit. The changes in activity were measured using proxy indicators such as perceived profit, number of employees, number of clients, quality and diversity of products and diversification of income sources. In addition, improved social well-being was measured through perceived changes in access to education, basic food consumption and health services. Since the impact of credit was measured during a period of economic crisis, the end-borrower survey also addressed questions concerning the effect of the economic crisis on the economic performance and social well-being of end-borrowers. Finally, the importance of access to agricultural extension services for the economic performance of farms and enterprises is assessed.

**At the level of banks and MFIs**, impact was measured through indicators such as change in the volume of agricultural lending, the term of agricultural loans, development of new products and lending methodologies by PLIs, number of rural branches opened, and other efforts to increase outreach in rural areas.

## Background information of the study countries

All three countries in the study, Albania, Kosovo and Moldova, have witnessed a constant **growth of their GDP per capita** between 2005 and 2008, reaching respectively € 2,708, € 1,760 and € 1,158 (see table below). Nevertheless, due to historical reasons, poor infrastructure, and fragile political processes, these economies remain weak compared to European standards. Rural poverty is pervasive: unemployment and lack of opportunities have led to massive migration from rural to urban areas, as well as abroad. One third of the population in rural areas substantially depends on remittances.

### Socio Economic Indicators of Moldova, Kosovo and Albania

Data for 2008	Moldova	Kosovo	Albania
Population (millions)	3.6	2.2	3.2
GDP / capita (€)	€1'158	€1'759	€2'708
Rural population	57%	60%	53%
Agricultural employment	33%	40%	58%
Life expectancy at birth (yr)	68	65	75
Unemployment (official)	5%	24%	14%
Poverty (national poverty level)	40%	45%	12%
GDP sectoral breakdown			
Agriculture	19%	20%	21%
Industry	20%	20%	19%
Construction	n/a	n/a	14%
Services	61%	60%	46%
Exports / GDP	27.2%	5.2%	10.6%
Imports / GDP	80.5%	48.2%	38.4%
Trade balance / GDP	-53.3%	-43.0%	-27.9%

Sources: National Banks, Stat. Offices, World Bank, US State Dep, UNDP, EC

**Agriculture** is hampered by lack of technology and training, weak value chains, as well as poor logistics and distribution. Nevertheless, in all three countries an ongoing transition will eventually lead to the agricultural sector being increasingly composed of commercially oriented farms. Indeed, good climatic conditions offer opportunities for a diversity of agricultural products, from continental to Mediterranean crops, meat and milk as well as forestry and herbal products. Conditions mostly favour small-scale labour intensive farms rather than large-scale mechanised production.

**Agricultural extension services are available in all three countries.** In Moldova, the extension services are well organised and funded through municipalities. In addition, professional associations offer advisory and training services. In Kosovo, by contrast, extension services are barely available. In Albania, extension services are available from government, NGOs and donors, but farmers rarely use them.

The **financial sectors** in Moldova, Kosovo, and Albania have matured after two decades of dramatic political and economic changes. Foreign capital has driven modernisation, and banks now offer a full spectrum of financial products. Two thirds of the loans have a maturity of over one year. Agriculture, however, is neglected by banks in all three countries: the share of bank credit to agriculture is much lower (1 to 5% of gross loan portfolio) than the contribution of agriculture to GDP (19 to 21%). MFIs play an important role in agricultural lending: while their share in the financial markets is small, they are much more focussed on rural areas than banks.

The 2008/09 global **financial and economic crisis** has affected all three countries. The main effects of the crisis are reduced remittances, a decline in demand for their mineral and agricultural export commodities (particularly in Moldova), as well as reduced access to international capital and investments. A comparison of the three countries shows that Moldova is by far the most affected. This is confirmed by the farm and enterprise survey, national accounts (GDP, remittances), and by the PLIs which have been frantically adjusting their operations and balance sheets.

## Impact of agricultural lending on farms and agricultural enterprises

The randomly selected sample of end-borrowers and non-borrowers was classified by interviewees into **five types of farms and enterprises**. These types were defined by the study team according to national statistics collected before the survey. The five types are:

1. Subsistence farmers who consume 80-90% of their production. Operations are based on mixed farms with less than 1 ha of land, one cow and some small animals; farm income is often supplemented by non-farm income such as remittances or employment. Most subsistence farmers do not actively try to develop their farm.
2. Small farmers with semi-commercial orientation, mixed operations such as crops, animals, orchards, and less than 5 ha of land. Such farmers often try to develop their farm in small steps.
3. Small and medium commercial farmers who have specialised their dairy, vegetable or orchard production, and who sell a substantial part of the products. They own between 5 to 20 ha of land, have around 20 cows (if any), greenhouses and/or orchards.
4. Agro-processors with less than 50 employees, often active in dairy or vegetable processing, most of which manage a farm.
5. Agro-traders with less than 50 employees, mostly farmers who have started trading in farm inputs or products.

The sample was also divided into **four types of borrowers**: clients of banks, clients of MFIs, clients of MFIs and banks, and non-borrowers (control group).

**Survey sample by type of farm and enterprise and by type of PLI borrower**

Respondents in sample			Subsistence farmers	Small farmers	Medium farmers	Agro-processors	Agro-traders	Total
Respondents served by	MFIs	Count	42	86	74	10	5	217
		%	19%	40%	34%	5%	2%	100%
	Banks	Count	32	79	103	20	2	236
		%	14%	33%	44%	8%	1%	100%
Both MFIs and Banks	Count	2	10	13	0	1	26	
	%	8%	38%	50%	0%	4%	100%	
None (Control group)	Count	60	69	40	2	0	171	
	%	35%	40%	23%	1%	0%	100%	
<b>Total</b>		Count	136	244	230	32	8	650
		%	21%	38%	35%	5%	1%	100%

The cross-tabulation of the sample between types of enterprise and of end-borrower shows that subsistence farmers are overrepresented in the control group (35% versus 21% of the total sample). While this has to be taken into consideration throughout the analysis of the statistical results, the authors consider that this **somewhat “biased” sample of end-borrowers** corresponds to the reality: both banks and MFIs tend to have an underrepresentation of subsistence farmers in their clientele compared to national realities.

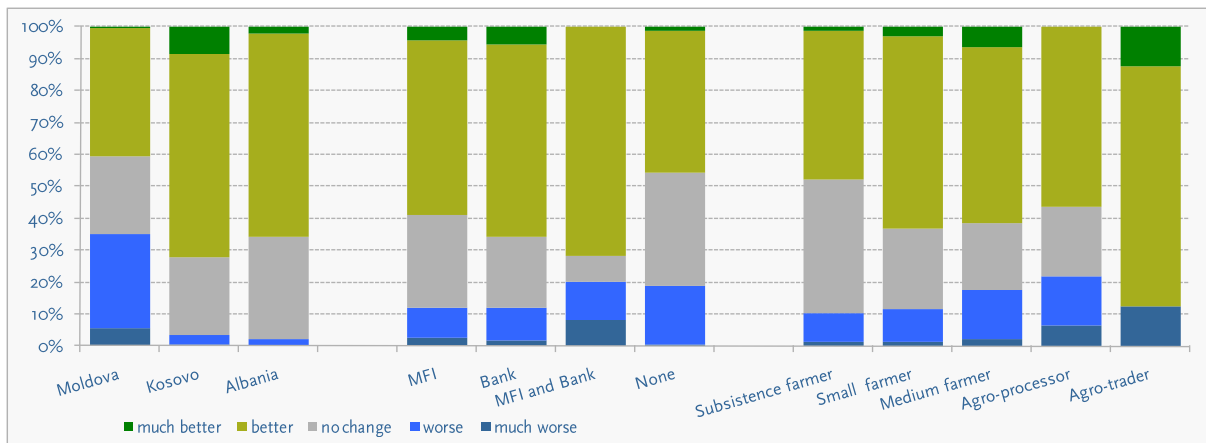
**Impact on investments.** The statistical analysis of the enterprise survey shows that since 01/2006 80% of respondents invested money in their most important income generating activity, in particular production of vegetables, potatoes, cereals, production from dairy cows and production from orchards. The other 20% invested in their second or third most important activity. What differentiates end-borrowers from non-borrowers is the type of investment in their enterprise: end-borrowers tend to invest more in fixed assets (over 80% of them) than non-

borrowers (60%). The remaining respondents invest exclusively into operational expenses (seeds, input, fertilizers, animal feed, and labour). Access to credit is a trigger for investments: almost 90% of PLI end-borrowers express that they could not have made the investment without the credit.

**Access to agricultural credit.** 45% of respondents say that access to credit has improved since January 2006, while 20% say that it has decreased. Respondents in Moldova are the most pessimistic, probably due to a stronger negative impact of the financial crisis, and Kosovars the most optimistic. This is confirmed by central bank data in these countries. Other important sources of funding besides banks and MFIs are people's savings and remittances. Almost one third of the respondents receive remittances from abroad, the proportion being highest in Kosovo and lowest in Albania.

**Impact on business profit.** Access to credit has a significant positive impact on increased enterprise profits: 60 to 70% of end-borrowers perceive that their profit has increased (thanks to the investment) while 46% of non-borrowers perceive increased profit (see graph below).

#### Perceived change in profit after investment, according to country and to type of borrower and enterprise



Number of observations: respectively 642 by country, 635 by type of borrower, 641 by type of enterprise

Access to credit is judged as being the most important reason for increased profits (40% of respondents), followed by increase in product demand and by know-how/skills (see table below). Statistical regressions also confirm that the higher the credit, the bigger the perceived positive impact on profit increases. Besides access to credit, other important factors contributing to improved profits are the level of education of the entrepreneur and access to agricultural extension services. Finally, investing in fixed assets (purchase of livestock, land, equipment, and building) has a significant positive effect on profits, while investing in operational expenses (purchase of seeds, inputs, fertilizer, animal feed, and salaries) does not have a significant impact on perceived change in profits. The graph also shows that Moldova has a lower percentage of persons whose profit has increased, compared to the other two countries, most probably due to the stronger negative impact of the economic crisis in this country.



### Reasons for profit being worse, much worse, better or much better

Reasons for profits being worse or much worse				Reasons for profits being better or much better			
n=93	1st reason	2nd reason	3rd reason	n=369	1st reason	2nd reason	3rd reason
Climate	33.3%	9.3%	15.5%	Credit	39.8%	17.1%	17.5%
Decreased demand	28.0%	22.1%	20.7%	Increased demand	20.1%	28.1%	16.9%
Decreased prices	19.4%	39.5%	20.7%	Know how / skills	16.8%	19.4%	12.3%
Economic crisis	8.6%	7.0%	15.5%	Climate	8.4%	9.0%	8.4%
Lack of money	0.0%	7.0%	12.1%	Increased prices	4.9%	15.2%	14.9%
Family illness	2.2%	0.0%	0.0%	Remittances	4.3%	6.1%	13.6%
Lack of advice	1.1%	0.0%	0.0%	External advice	0.8%	3.5%	3.9%
Other	7.5%	15.1%	15.5%	Other	4.9%	1.6%	12.3%

**Impact on other business indicators.** At the level of the farms and businesses, the number of full-time, part-time and family labour as well as diversification of income sources were analysed in order to assess whether access to credit has an effect on these indicators. Since 01/2006, 10% of respondents increased the number of full time employees, 23% increased the number of part-time employees and 10% increased the number of family labour. These percentages are only slightly higher for end-borrowers than for non-borrowers, making it delicate to conclude that improved profit leads to an increase in employment, at least in the short term. Finally, regarding the change in the number of income generating activities, 22% of respondents adopted one or two new activities and 5.2% abandoned one or two activities. There is little difference in these results according to the type of PLI or to the type of enterprise. Nevertheless, the most important reason mentioned for entering a new activity is access to credit, followed by the need for more income and the existence of good business opportunities.

**Impact on end-borrowers' well-being.** Over the whole sample, 44% of respondents saw their capacity to pay for the education of their children improve since 01/2006, 50% witnessed an improvement in the quality and quantity of food consumption and 32% saw their capacity to pay for health services improve. Surprisingly, these figures do not differ significantly between end-borrowers and non-borrowers, but differ significantly between countries, Moldova being the worst off and Kosovo the best. Statistical regressions show that increased profit leads to an improvement in all three well-being indicators. Access to credit thus has an indirect effect through improved profits.

**Impact of the global economic crisis.** 72% of respondents stated that they personally felt the negative effects of the economic crisis, mostly due to reduced demand for their products, increased input prices and decreased production prices. Access to credit did not make a difference in this respect. What made a difference was the national context, businesses in Moldova having been hit stronger by the crisis than those in Kosovo or Albania, as well as the size of the enterprise: larger businesses (agro-processors and agro-traders) felt stronger negative effects, since they are more dependent on export markets than subsistence and small farmers.

**Agricultural extension services.** These services have a significant and important impact on increased profits. Nevertheless, only 25% of respondents have used extension services since 01/2006, of which 84% did so voluntarily and 16% because it was required by the financial institution. 93% of extension services recipients judged these services as useful to very useful. While differences in access to extension services are small between type of end-borrowers, differences are important between countries and enterprise types. In Moldova, over 50% of respondents have used extension services, less than 20% in Kosovo and less than 5% in Albania. PLIs in Kosovo more often require their clients to seek advice in order to obtain credit. Finally, while 53% of agro-processors use

extension services, only 5% of subsistence farmers do so, the percentage of small farmers and small and medium commercial farmers being 21% and 36% respectively.

### Impact on partner lending institutions

Since 2005, the three PLIs which are banks have **increased loans to agriculture**, both absolutely and relatively to the total portfolio, and did so more than other banks in their respective countries. Loan sizes and terms have also increased. The three PLIs which are MFIs also increased lending since 2005, but the share of the portfolio lent to agriculture remained unchanged. The three MFIs are and were already strongly orientated towards agriculture.

EFSE has had a **positive impact on the rural and agricultural orientation of PLIs**, more so for MFIs than banks. For the latter, the main mechanism encouraging them to lend to agriculture is dialogue and technical assistance. The banks do not depend so much on EFSE funds because they have access to their own funds (saving deposits) and other credit lines. However, EFSE funds help banks to improve the maturity structure and solvency in the balance sheet, and to diversify their funding sources. The three MFIs, by contrast, cannot mobilise savings and depend on external funds such as EFSE. The absence of EFSE would probably have meant less credit for agriculture by MFIs.

All six PLIs have made **changes in the strategies and methodologies for agricultural lending**. This has involved up-scaling (serving larger clients) by MFIs, and up- and downscaling by banks. In one PLI, EFSE guided this process through targeted technical assistance. The others mainly implemented such changes on their own initiative, reflecting EFSE's selection criteria to work with those partners that show commitment in serving EFSE's target group – small and medium sized enterprises and low-income households.

Although banks often argue that agricultural lending is risky, the six PLIs in this impact study do not share this view. **Agricultural loans are not currently performing less well than loans to other sectors**, and rural clients are seen as committed and serious. PLIs have developed methods for agricultural loan analysis that can be applied in the absence of financial records. Furthermore, they rely on non-traditional collateral. The key challenge for PLIs is serving (small) farmers more efficiently since the transaction costs of reaching them are high.

**MFIs are more inclined to channel EFSE funds to agriculture than banks**. When comparing the present operations of banks and MFIs in financing small farms, MFIs are currently more present than banks. Although MFIs only represent 5-10% of the financial sector by value of credits, many MFIs have invested at least half of their portfolio in agriculture and related rural purposes, while such investments represent only a few percent for banks. Consequently, up to half of all agricultural financing in Moldova, Kosovo and Albania is provided by MFIs. The field survey shows that MFIs are close to farmers, have well-adapted services and products, use flexible guarantees, and are less bureaucratic than (most) banks. On the downside, MFI interest rates are higher than those of banks, enabling the latter to gain a greater market share among the more developed farms and agricultural enterprises. Indeed, the continued head start of MFIs in small farm financing is by no means ensured, and MFIs face increased competition from banks. Many MFIs try to become (micro) banks to reduce the cost of funding (savings collection) and offer a wider array of services (payments, insurance) to accompany the development of commercially orientated farmers.

Among the six PLIs, the **two Moldovan PLIs have been most adversely affected by the economic crisis**. Due to lower remittances and agricultural exports, as well as the crisis in construction, both PLIs have seen overdue loans rise to nearly 6% of the portfolio by the end of 2009. In **Kosovo**, by contrast, PLIs reported only a limited impact of



the crisis, although the growth of their balance sheets and loan portfolios has slowed. Small farmers in rural areas have repayment difficulties, because remittances – a key source of loan repayment – have reduced and many farmers have difficulties in selling their products. In **Albania**, the effect of the crisis has been badly felt by the financial sector. Just like other financial institutions in Albania, the two PLIs involved in this study have witnessed a decline in portfolio quality.

None of the PLIs offer **advisory or extension services**. PLIs sometimes request farmers to seek advice, referring the client to external service providers and organising joint information sessions with service providers.

### Responsible lending practices

The three banks in the sample have an **environmental risk assessment** in their loan application form. Discussions with loan officers in the field revealed that environmental impacts are mostly considered absent in agriculture. Although all three MFIs claim to be aware of environmental risks, the loan files did not reveal that environmental risk assessment processes are systematically integrated in loan appraisal. At the initiative of EFSE, two of the PLIs are now involved in a technical assistance project to develop social and environmental impact assessments.

The study analysed through interviews with PLI staff and end-borrowers whether the PLIs apply **responsible lending practices**. The data confirm that all six institutions perform well in terms of ethical staff behaviour, avoiding over indebtedness of clients, transparent pricing of products as well as confidentiality of client data, appropriate collection practices and adequate procedures for handling complaints. Banks, on the other hand, have more formal written codes and guidelines on these issues. Improvements are still possible on confidentiality of client data and transparent product pricing. For the latter, in particular, communication with the least educated farmers could be improved. 10 to 20% of clients remained unclear about elements of the loan contract, loan amount, loan repayment schedule, or reasons for having been declined a loan. However, data on portfolio at risk do not point to reckless lending by PLIs and the field survey does not provide evidence of harsh debt-collection practices. Although some 40% of clients in Moldova found repaying difficult, nothing indicates that PLIs behaviour was careless.

### Client satisfaction

The large majority of end-borrowers (around 90%) are **satisfied with the products and services of the PLIs**, across all enterprise types. However, there is substantial inter-country difference, with 20-25% of Moldovans dissatisfied with the PLIs' products and services, while among Kosovars and Albanians the proportion is just 5-10%. This may reflect the overall atmosphere of dissatisfaction in Moldova and the fact that the two PLIs in this country reduced their lending in 2009, while the PLIs in Kosovo and Albania did not.

Client satisfaction is also shown by the relatively high **usage of other financial products** by end-borrowers and non-borrowers: 31% of all respondents use other services from the PLI (Moldova 34%, Kosovo 43% and Albania 14%). A comparison among farm types shows that the use of other PLI services increases according to farm size. As to the services used, these are current account (76% of respondents who use other services than credit), money transfer (36%), automatic teller machine -ATM- (18%), savings account (17%), and deposit account (13%).

## Recommendations

Although access to loans for the agricultural sector has improved in recent years, the study shows that there is still much scope for increasing the outreach. To foster this improvement, EFSE could encourage its PLIs to lend to farmers and to gain experience in the process by offering a **special “package” for agriculture**: EFSE’s loan, combined with medium term technical assistance and dissemination of pilot test results.

Because the results of the study suggest that credit, when combined with advisory services, is an effective way to increase profits, EFSE could encourage PLIs to **establish and increase collaboration with business/agricultural service providers**.

The study reveals that loan officers do not systematically pay attention to social and environmental impacts in their loan appraisals. This suggests for a need of greater **EFSE involvement in technical assistance to develop social and environmental impact assessments**.

The study shows that an important part of the rural population, particularly in Kosovo and Moldova, uses other services from banks, such as current accounts, ATMs and money transfer. EFSE should **encourage the growth in outreach of these other services** in rural areas, with a particular focus on Albania, either by promoting transformation of MFIs into banks or an expansion of bank services.