Global Food Security Strategy Technical Guidance
Finance: Unlocking Capital Flows

This is one of 18 technical guidance documents for implementing the U.S. Government's Global Food Security Strategy. The entire set of documents can be found at www.feedthefuture.gov and www.agrilinks.org.

This guidance addresses strategies for catalyzing private capital flows and how these activities impact all areas of Feed the Future programming under the U.S. Government's Global Food Security Strategy (GFSS). Designing activities that incorporate financial components not only help an activity succeed, but they also amplify development impact and enhance sustainability after the activity concludes. Indeed, in many cases, the question is not whether a financial component fits into an activity, but what types of financial interventions can make relationships between market actors more efficient. While exploring which financial components to build into an activity is a key first step, it is by no means sufficient for a truly integrated activity to focus only on the financial sector. There are many complementary activities that are necessary to increase investment in food security, and financial interventions are one element underlying a comprehensive development activity.

This supplemental technical guidance will inform partner decisions on effectively programming finance into planned interventions. It provides an overview of the strategies and best practices for successfully incorporating finance into programming, and it walks through key steps and analyses that design teams should conduct when deciding which financial tools best fit an activity. Sometimes it can be difficult to figure out where to begin, so for further advice, see the contact information at the end of this document.

Context[1]

The GFSS places special emphasis on increased investment in agriculture and food systems through Cross-Cutting Intermediate Result 1 (Strengthened Global Commitment to Investing in Food Security), which supports the strategy's goal of sustainably reducing global hunger, malnutrition, and poverty. The strategy further calls for the USG to help facilitate increased public and private investment in and access to tools and technologies that correct market failures, decrease risk, and bring financial returns more in line with the market. Increasing access to finance is a core component of the GFSS's sustainability approach given the essential role that a vibrant financial sector plays in self-sustaining food and agriculture systems. The USG is in a unique position to leverage the GFSS to catalyze private sector investment in a wide range of solutions that directly or indirectly address food security, nutrition, and water and sanitation health (WASH) issues. Feed the Future's actions and investments in accordance with the GFSS can lead to the "crowding in" of additional funding from complementary actors to help the intervention reach a scale beyond what donor-funded programming could achieve on its own.

The **agriculture finance ecosystem** is made up of a web of private and public actors, most notably farmers, processors, consumers, capital providers, and policy makers, all of whom are highly dependent on market forces. Given the diversity of players, there are many entry points for interventions that can contribute to sustainably financing food security, including domestic resource mobilization, expanded trade finance, access to reliable data, and enabling environment reform. With an estimated $210 billion[2] needed for small-scale producer finance alone, tailored financial services, products, and systems, as well as agriculture-focused capacity building for financial actors, will be a key component for achieving a food-secure future.

The GFSS focuses in part on increasing access to finance for small-scale producers and agricultural small- and medium-sized enterprises (SMEs). Today, less than one-sixth of the financing needs of the world's 270 million smallholder farmers in emerging markets are met by formal financial institutions.[3] Thus, smallholder farmers frequently rely on informal, and usually more expensive, financing sources. Financial institutions are reluctant to invest in agriculture SMEs and smallholder farmers because the agricultural sector is seen as having higher risk, smaller transaction sizes, and a higher cost to service. As a result, many capital providers have not made the investment in agriculture programs and products that are appropriate for the needs of agricultural producers and enterprises.[4] In addition, the constraints facing women and other excluded groups (i.e. youth, marginalized ethnic groups, and castes) compound the effects of an already difficult financing environment.[5] The USG can support local and international finance providers (banks, investment funds, impact investors, etc.) in the design of more adequate financial instruments (including credit, digital payment systems, savings, and insurance); brokering of relationships between finance providers and intermediaries to ease the delivery of financial products and services; segmentation of smallholder farmers based on their agricultural activities, financial needs, and societal constraints; and strategic de-risking (i.e., cost-sharing their entry into agriculture related finance).

This guidance will focus principally on the important role that the USG can play in partnering with financing actors and/or spurring private investment and bolstering market system growth through value chain and firm-level assistance. More specifically, this guidance document focuses on options for supporting smallholder farmers and agricultural SMEs with both innovative and traditional financing instruments that support and grow operations. These strategic investments will lead to a more vibrant and sustainable landscape of actors, as well as more modern and competitive productive sectors.

Designing Interventions

To identify the appropriateness of developing a financing activity, a comprehensive value chain analysis and mapping exercise will help identify which financing interventions are likely to have the most catalytic effect on enhancing value chain performance, as well as identify the degree to which a lack of finance hinders activities within the value chain. Figure 1 illustrates when in the project cycle these analyses should take place.

Figure 1: Project Cycle for a Value Chain Development Program

The value chain analysis process illustrates the broader constraints that inhibit competitiveness, as well as specific bottlenecks. Enhanced value chain analysis examines drivers, including financial services, and how they affect transactions within the value chain. Finance frequently is a critical input, allowing firms at all levels in a value chain to upgrade or expand their operations to better serve an end market. Therefore, it is important for programmers and implementers to examine finance as a driver during the analysis phase and to begin by examining the policy levers and the broader financial enabling environment to identify constraints. Programmers can then prioritize appropriate interventions to address specific supply and demand issues. Value chain finance (VCF) encompasses a wide range of products, services, and arrangements that provide businesses in the value chain the capital they need to operate, upgrade, and expand. These products, services, and arrangements should be evaluated during VCF analysis.[6]

When designing an intervention, program sustainability is a key desired outcome. The following questions provide a rough guide to help understand how financial interventions could be valuable components of future programming, given the program objectives:

If the objective of the program is primarily to increase farm-level productivity:

- What national and local policies impact the financial sector (e.g., interest rate caps, land tenure, collateral registries, existence of credit bureaus, etc.)?[7]
- Who are the suppliers of finance, and are any of them willing to partner at a reasonable cost/benefit to scale/enhance the intervention?
- How can the intervention incentivize increased flows of private capital to the target beneficiaries?[8]
- How can marginalized groups or demographics who are traditionally left out of the business sector or ignored by financiers be included (especially examining by sex, size, and degree of formality)?
- How can the intervention help level the playing field so that women and other marginalized groups who participate in the value chain in production, processing, and trade have better access to finance for their SME?
- Which financing methods or channels are being ignored or failed by traditional financing schemes (e.g., mobile banking, collateral-free loans, flexible repayment options, etc.)?
- Are there new financial providers that could be encouraged to enter the market and provide cost-effective financial products to underserved segments of the agricultural sector, and who are they?
- How can private sector expertise be utilized to create the conditions for a more sustainable commercial solution in the long term?
- What are the national development objectives and strategies for financial inclusion that can be achieved through increased access to finance for SMEs in the agribusiness sector?
- Are there any complementary tools or services that can enhance the impact of access to financing, such as insurance, business training, etc.?

If the objective of the program is primarily to promote agribusiness firm-level growth:

- What are the policy or market failures, or other barriers (whether real or perceived) that are currently prohibiting private sector involvement? How can Feed the Future programming overcome/reduce the barriers or correct the market failures?
- Can Feed the Future programming de-risk investment in a strategic area to attract private sector financing?
- Is there an insertion point later in the agricultural value chain that will enhance or undermine the effectiveness of the proposed intervention (i.e., if the intervention gives farmers access to credit to increase their production, do they have access to markets to sell their product or storage facilities)?
- Could Feed the Future resources be programmed more strategically to crowd-in private capital?
- What informal constraints (e.g., business culture, technical skills, enforcement of prevailing laws, market actor landscape, etc.) may inhibit the free flow of finance?
- What are the key risks that prevent those new entrants or existing actors from increasing their financing or offering better terms, and can they be mitigated through development assistance?

If the objective is to enhance the resilience and risk management strategies of farmers and firms:

- What risk management and coping strategies do smallholder farmers and agribusinesses currently use? Is there a role for finance providers to facilitate improvements or innovations in risk management?
- Does the political environment support or promote private sector involvement in the program or intervention in question? Are there significant conflicts of interest or competing political objectives that need to be addressed? How do these issues affect access to financial services?
- Does the proposed financial intervention require the approval or involvement of any regulatory authority? If so, how supportive are the local regulatory authorities?

So, what financial activities could be a part of your program? Looking at financial instruments (or constraints to finance) for producer productivity, firm growth, and risk management/resilience is the first step. Under each of these categories, there are a number of debt, equity, and other types of instruments that can either be the target of a program (e.g., technical assistance and capacity building to a financial institution), a catalyst for a program (e.g., a portfolio guarantee at a financial institution), or both.[9] Bear in mind that understanding the constraints in the broader financial system (both formal and informal) is an essential element when identifying the best intervention strategy(-ies), especially in high corruption or low-capacity contexts.

	Productivity Enhancing	Growth Enhancing	Resilience Enhancing
Debt-Based Instruments	• Formal lending (including digital credit) • Lease agreements • Alternative collateral-based loans (e.g., factoring, warehouse receipts, etc.) • Buyer credit • Agrodealer-to-farmer (business-to-consumer, B2C) • Input supplier-to-agrodealer (business-to-business, B2B)	• Formal lending (including digital credit) • Longer-term loans (enabling capital expenditure) • Lease agreements • Convertible debt • Debt instruments – linked to revenues/dividends for prepayment • Quasi-debt instruments (subordinated debt)	• Formal lending (e.g., to finance the purchase / construction of climate resistant farm inputs or risk-mitigation tools) • Informal lending from a village savings and loan association • Emergency loans • Informal lending/support from social network (reciprocal obligation)
Non Debt-Based Instruments	• Input selling mechanisms (e.g., pre-paid and layaways) • Buyer non-credit • Remittances (as capital/investment) • Mobile payments	• Paid-in capital • Private investor/joint ventures • Venture capital • Private equity (including search funds)	• Formal and informal savings • Index-insurance (e.g., weather) • Personal insurance (e.g., life, health, property, personal accident savings products) • SME insurance (e.g., property, accident, life) • Remittances (as social support)

Key Lessons Learned

Programming under Feed the Future has revealed several key lessons learned when it comes to designing and implementing financial interventions.

<u>**Lesson 1:**</u> ***Integrating finance into broader, more comprehensive programming works better than creating a stand-alone finance program.***[10] When financial interventions are implemented in isolation, the development results are frequently not as significant as when complemented by supporting activities. Therefore, the best practice is to structure financial interventions intentionally as part of a larger program and to use financial aspects to help amplify impact. Frequently, there are aspects of the broader enabling environment that make it difficult for finance providers to invest in agriculture, such as collateral requirements, etc. Systemic issues should be addressed in a way that incorporates financial interventions as a way to impact the broader ecosystem. Take financial guarantees, for instance. A guarantee by itself, in many cases, may not be the complete answer.[11] Several agencies offer loans, loan guarantees, and other finance tools. Financial guarantees through USAID's Development Credit Authority (DCA) or Overseas Private Investment Corporation (OPIC) can be very powerful tools, but ensuring high levels of utilization of a guarantee with a finance provider often requires additional support. Capacity building, financial

product development, technical assistance to beneficiaries (i.e., end users of the guaranteed loan(s)), and strategy enhancement are examples of activities which are complementary to guarantees. Aligning technical assistance or capacity building grants alongside (or in advance of) a loan guarantee have proven to yield more successful development results than guarantees implemented without these complementary activities.

<u>**Lesson 2:**</u> ***The key elements to focus on when incorporating a financial component into an activity are risk, transaction costs, and yield.***[12] The three related elements of risk, transaction costs, and yield cannot be ignored when designing an intervention in the financial sector. First, finance providers seek to avoid sectors where risks are higher, such as agriculture. To overcome this challenge, activities can focus on reducing risk either at a systemic level (e.g., through enabling environment reform at the Ministry of Finance) or at a transactional level (e.g., through the development and adoption of innovative insurance products). Second, finance providers seek to minimize transaction costs when servicing a client. Here, activities can focus on technical assistance for business advisory service provision to make investments more attractive and can help steer investors to the resulting more attractive markets. Or an activity could foster the development of new digital tools that decrease some of the physical barriers to accessing finance, such as the time it takes to travel a long distance to a financial institution.[13] And third, activities seek to maximize their yields. An example activity could be using performance-based incentives to entice business advisory service provision to address management capacity or bookkeeping skills, which would in turn decrease the risk associated with the investment, and thereby make it more attractive for lenders.

<u>**Lesson 3:**</u> ***Focus on inclusive investing to build a sector, not just a project.***[14] It is easy to focus technical assistance and training programs on those finance providers or organizations that are most vocal and come to you for assistance. But in order to achieve systemic change, it may make more sense to work with the broader industry and offer services to the whole sector. However, especially when it comes to agricultural financing, it is important to identify those institutions and organizations that are most likely to be catalytic, viable, and capable of effectively using new sources of capital. Not every organization will have the necessary elements for long-term success.

<u>**Lesson 4:**</u> ***Focus on interventions that create a "demonstration effect" and that encourage pulling other actors into the space.***[15] Market disruptions and distortions are not necessarily a bad thing, as long as interventions are designed to amplify market-correcting behaviors around which actors should reorient. Avoid long-term market distortions and think hard about the policy elements for which the program advocates. For instance, cost-sharing can help cover the cost of entry into agriculture-related lending or investing, create a demonstration effect to local financial institutions, and set an example that lending to difficult sectors is actually possible and could be profitable! However, always keep in mind that any intervention requires an exit strategy, so once the methodology has been demonstrated, project support must be phased out.

<u>**Lesson 5:**</u> ***Identify constraints to and demands for inclusive financial services that are informed, flexible, and client-centered.***[16] Many workers and entrepreneurs along the agribusiness value chain, particularly women, tend to have insufficient access to and control over credit and other financial services, an issue that has been cited as one of the top three limiting constraints to women's empowerment across Feed the Future’s zones of influence. This is partly due to women’s lower membership in agriculture and business associations, smaller farms, and more limited land ownership, as well as cultural and legal factors. Women and men also have different risk tolerances and preferences that influence their demand for and uptake of financial services.

Programming in Practice[17]

Feed the Future has a number of recent and current programs taking a holistic approach to increasing investment in food security. Below is one example of an innovative program which features financial components:

Financing Ghanaian Agriculture Project (FinGAP): FinGAP has been using pay-for-results incentives (a form of blended capital) to build out supply chain infrastructure, as needed, to support increased production of targeted crops. The project has facilitated over $100 million in primarily additional financing for agribusinesses in Northern Ghana in return for just over $3 million in incentive payments to business advisory services providers (to identify and package agribusiness proposals for financing) and to Ghanaian banks and other finance providers (to extend financing to the agribusinesses).

Additional Resources and Tools

Rural and Agricultural Finance Learning Lab (https://www.raflearning.org/)

Global Impact Investing Network (https://thegiin.org/)

Enabling the Business of Agriculture Indicators (http://eba.worldbank.org/data/exploretopics/finance)

Guide to the Use of Digital Financial Services in Agriculture (USAID, 2016)

For further assistance related to topics discussed in this Technical Guidance, please contact ftfguidance@usaid.gov.

References

[1] For some helpful terminology, the Nonprofit Finance Fund has a comprehensive glossary of key financial terms. Feed the Future also maintains a glossary of some helpful terminology on its website.
[2] For more context on the ability of small-scale producers to access finance and their needs, see the Initiative for Smallholder Finance (ISF) report Inflection Point: Unlocking growth in the era of farmer finance (April 2016).
[3] Ibid.
[4] For a deeper discussion of the challenges facing small-scale producers, see USAID's Legacy in Agricultural Development: 50 Years of Progress (2013, 2016).
[5] Additional information on the unique needs of women and other marginalized groups, please see the IFAD Rural Development Report's chapter on Rural Finance.
[6] For more information on designing your financial activity, see USAID's FS Series #5: Value Chain Finance: Primer, Diagnostic Checklist, and Model Scope of Work (2009).
[7] For a deeper discussion of policy issues facing the financial sector, see IFC's Scaling Up Access to Finance for Agricultural SMEs: Policy Review and Recommendations (October 2011).
[8] To learn more about unique approaches to agricultural SME financing, see IFC's Innovative Agricultural SME Finance Models (2012).
[9] For a deeper discussion on designing creative financial instruments, see USAID's The Firm to Farm Finance Toolkit: Hearing, Creating & Delivering Human-Centered Solutions for Inclusive Access to Finance (September 2014).
[10] For more information on the critical role of technical assistance in finance provision, see the Initiative for Smallholder Finance (ISF) report Inflection Point: Unlocking growth in the era of farmer finance, pp. 9, 15, (April 2016).
[11] For more information on the ideal ways DCA guarantees operate, see the one-pager on DCA's website.
[12] For more information on the key barriers to providing agricultural finance, see the Initiative for Smallholder Finance (ISF) report Inflection Point: Unlocking growth in the era of farmer finance, pp. 24-36, (April 2016). Information on how to manage risks associated with agriculture microfinance products see Managing Risks and Designing Products for Agricultural Microfinance (CGAP, 2005).
[13] For more information on the many ways digital tools can also complement your programming, see USAID's Guide to the Use of Digital Financial Services in Agriculture (USAID, February 2016).

[14] For more information on technical assistance and capacity building for financial institutions, see the International Finance Corporation's (IFC) Agricultural Lending: A How-To Guide (October 2015), and USAID's Lending to the Agricultural Sector: A Toolkit (January 2013).

[15] To learn more about some programs resulting in positive demonstration effects, see USAID's report on The Enterprise Funds in Europe and Eurasia: Successes and Lessons Learned (September 2013).

[16] For more information on gender and financial inclusion, see USAID's Women's Empowerment in Agriculture Index Report (2014), the Food and Agriculture Organization's (FAO) The State of Food & Agriculture: Women in Agriculture (2011), and the IFC's Study on mapping the market potential and accelerating finance for women entrepreneurs in Bangladesh

[17] For additional examples of increasing access to finance for smallholders, see IFC's Access to Finance for Smallholder Farmers: Learning from the Experiences of Microfinance Institutions in Latin America (2014).