

# The Effect of Central Bank Policies on Lending to Agricultural SMEs in East Africa

LEARNING BRIEF



## BACKGROUND

**Aceli Africa** (Aceli) is a market incentive facility that utilizes grant funding from international donors to unlock lending by commercial banks and impact investors to agricultural small- and medium-sized enterprises (agri-SMEs) in East Africa. Drawing upon Aceli's original dataset<sup>1</sup> on the economics of lending to agri-SMEs, Aceli offers two types of incentives to lenders: 1) a portfolio first-loss cover to increase lender risk appetite, and 2) an origination incentive to defray the high transaction costs of serving these businesses. Aceli aims to mobilize \$600M+ and improve livelihoods for 1 million farmers and workers by 2025.

Aceli is set up as a demonstration model to establish an evidence base for using "smart subsidy" to mobilize private capital for agricultural SMEs. The end goal is twofold: first, to catalyze a more competitive financial market where lenders require less subsidy to serve high-impact agri-SMEs; and second, to partner with African governments and other stakeholders to strengthen the enabling environment for agri-SME finance. Regarding the latter, we believe there is need for: i) an entity at the country level to coordinate agricultural finance policies; ii) country-level budget allocations that replace donor funding for financial

incentives as part of national economic policies; and iii) central bank regulations aligned with these financial incentives to promote agricultural lending while maintaining appropriate risk controls in the financial sector.

Aceli developed this working paper as part of a broader effort to contribute to policy dialogue that promotes a more vibrant finance market for agricultural SMEs in East Africa and across the continent. In seeking out literature on how Central Bank regulations affect lending in African agriculture and particularly to agri-SMEs, we kept hearing from stakeholders that such analysis is lacking. To advance our own thinking, we began reading what we could find on this topic and gathering inputs from our networks of lending and development finance practitioners. This document incorporates our initial research findings and feedback from roundtable discussions with stakeholders in Kenya, Rwanda, Tanzania, and Uganda over the past year. We share these findings in the spirit of a working paper – to generate dialogue that can lead to more refined proposals and ultimately contribute to a stronger enabling environment for agricultural finance in Africa.

## ACKNOWLEDGMENTS

*Andrew Ahiaku, Aceli's Head of Financial Sector, is the lead author for this publication. Aceli CEO Brian Milder is a supporting author. Numerous Aceli team members have contributed to the research, writing, and ideas. We would particularly like to thank Aceli partners who have served as external reviewers and/or participated in two rounds of stakeholder workshops held in Kenya, Rwanda, Tanzania and Uganda from November 2021 – April 2022. Participating institutions include several of Aceli's partner lending banks, FSD Kenya, Access to Finance Rwanda, AGRA, AFRACA, representatives of the Bankers Associations of Kenya, Rwanda, Tanzania and Uganda, representatives from the Central Banks in Rwanda and Uganda, and several independent reviewers. In all, 70 individuals provided feedback that has been incorporated into this piece. We look forward to continuing this dialogue with a broader group of stakeholders going forward.*

<sup>1</sup> This dataset at the time of publishing compiles information from 35 lenders on 14,000 loans ranging from USD 10k to 2M to agricultural SMEs. In aggregate, loans in the dataset total \$4 billion.

**“Regulations have to strike a balance between providing a safe environment for banking while ensuring adequate credit growth.”<sup>2</sup>**

National-level financial policies have the dual objectives of promoting economic growth and ensuring economic and financial sector stability. In the ideal scenario, growth and stability are fully compatible and reinforcing; the reality is far more complicated. Fiscal conservatism and an emphasis on protecting consumer deposits – an important responsibility of any Central Bank – may have the unintended consequence of constraining commercial bank lending. For developing economies, such as those across Sub-Saharan Africa, applying a one-size-fits-all approach to financial regulation across all sectors may not be optimal. This is particularly true in the agricultural sector where factors such as seasonal production cycles, natural hazards such as climate and pests, governments’ concern with food security and related interventions in market policies, and communal land titling do not align well with conventional banking practices and the regulatory environment in which these practices have developed. For these reasons, along with other factors that contribute to elevated risk, higher transactions costs, and variable returns, the agricultural sector has been chronically underserved by lenders in the region.

This working paper examines how Central Bank policies in four East African countries (Kenya, Rwanda, Tanzania, and Uganda) affect lending to agricultural SMEs. Recent developments across the region are promising indications that agricultural finance, which has long been a policy orphan, is garnering more attention at the national level. Our aim is to generate further discussion among policy actors

across the region and the continent to promote increased lending to the sector while also maintaining appropriate safeguards to national financial systems.

## Agricultural Missing Middle

In the four East African countries that are the subject of this analysis, the agriculture sector contributes 25–30% of the Gross Domestic Product and employs 60–65% of the population.<sup>3</sup> The World Bank estimates that growth in the agricultural sector in Africa is 2–3x times more effective in reducing poverty than growth in any other sector. Yet less than 10% of commercial credit goes to agriculture, with even less going to agricultural SMEs despite the important role they play in sustaining both rural livelihoods and regional food systems.<sup>4</sup>

A 2018 Dalberg and KfW report estimates that there is a **\$100 billion annual gap** in access to finance by agri-SMEs across sub-Saharan Africa.<sup>5</sup> This gap stems from various factors, including higher risk associated with agriculture; poor bankability of SMEs; and the lack of conducive legal and regulatory frameworks.<sup>6</sup> The World Bank has highlighted regulatory constraints as a particular challenge, noting: “Basel III raised the minimum capital ratios and liquidity ratios of banks, which do not favour SME lending, especially long term lending. These issues can be exacerbated by unstable, often uncertain policies, as well as policies that are not market friendly for the agriculture sector.”<sup>7</sup>

### IN EAST AFRICA

**25–30%**

OF GDP IN  
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**60–65%**

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AGRICULTURE

<sup>2</sup> Capgemini Financial Services, *Impact of Regulations on Bank Lending*, 2014.

<sup>3</sup> OECD; World Bank, *Agriculture sector as a share of GDP in Africa by Country*, 2020.

<sup>4</sup> AGRA, *Africa Agriculture Status Report*, 2019.

<sup>5</sup> Ibid.

<sup>6</sup> Dalberg and KfW, *Africa Agricultural Finance Market Landscape*, 2018.

<sup>7</sup> Coffey E, *Agricultural Finance: Getting the Policies Right*, 1998.



## Policy Limitations

There are two inter-related drivers of the weak enabling environment for agricultural finance in countries across the continent:

### 01 Agricultural finance is a policy orphan.

Inadequate coordination at the national level between policy actors stems from the lack of a single, empowered entity to develop and implement enabling policies for agricultural finance. As a report by the International Finance Corporation (IFC) finds: “too often responsibility for policies impacting agricultural finance falls into a void among several government ministries, such as finance, agriculture, planning, trade, and commerce... inhibiting a coordinated legal environment that promotes the cohesive development of strong, sustainable, and socially-responsible agricultural finance policies and supportive underlying legal and regulatory systems.”<sup>8</sup>

To solve for this single entity gap, the African Development Bank (AfDB) and other African policymakers issued the Kampala Principles for Agricultural Finance in Africa in 2011, calling on national governments to strengthen agricultural finance policy by establishing a high-level coordination body to promote agricultural finance. Unfortunately, a decade after the IFC report<sup>9</sup> and the adoption of the Kampala Principles, there is still no single agency advocating for agricultural finance in any of the four countries. Central Banks and Ministries of Finance tend to focus on other parts of the economy while Ministries of Agriculture focus on improving the availability of seed and fertilizer or managing lucrative export crops. Of the four countries, Uganda has made the most headway with the Ministry of Finance spearheading a draft policy under discussion supported by technical assistance from AGRA.

### 02 One size fits all approach to financial regulatory policy constrains agricultural finance.

Legal and regulatory policies tend to be undifferentiated by sector and ill-suited to the particularities of agriculture. Commerce, manufacturing, and agriculture are typically treated the same. We know, however, that the seasonality and peculiarities of agriculture calls for a separate, sector-specific regulatory guidelines. Thus, the African Development Bank (AfDB) finds that “legal and regulatory frameworks do not take adequately into account the specificity of agriculture finance, resulting in overregulation, inflexibility, and an unwillingness to entertain innovative product ideas.”<sup>10</sup>

Consistent with the findings above, we found that Central Banks in Kenya, Rwanda, Tanzania, and Uganda have historically not had specific policies or regulations for agricultural finance (although there are preliminary indications that this may be changing with recent reforms announced by the Central Bank of Tanzania). The non-sector-specific financial policies that do exist may preserve the overall health of the financial system at a national level, but they also constrain lending to agri-SMEs and hinder the associated economic development benefits.

<sup>8</sup> World Bank, *Assessment of Long-term Finance Providers for Small and Medium Agribusinesses Stocktaking, Lessons, and Case Studies*, 2021.

<sup>9</sup> GPF/IFC, “Scaling Up Access to Finance for Agricultural SMEs: Policy Review and Recommendations,” 2011.

<sup>10</sup> MFW4A/AU/GLZ/BMZ, “Policy Brief on Agricultural Finance in Africa.” and GPF/IFC, 2011, “Scaling Up Access to Finance for Agricultural SMEs: Policy Review and Recommendations,” 2012.

## Policies that Impede Agricultural Finance

In particular, we identified five policies that impede agricultural finance:

*Note: Each of the five policy areas identified is rooted in well-founded objectives of ensuring fiscal responsibility at the country level and solvency of financial institutions. However, these policies have detrimental effects at a macro level and could potentially be counter-balanced to achieve development objectives without imperiling national economies or individual financial institutions.*

### I. International Financial Reporting Standards (IFRS) 9

IFRS 9 is an International Accounting Standard that guides Central Banks in setting national-level policies. Under IFRS 9, which emerged from reforms following the 2008-2009 financial crisis in the United States and Europe, banks are required to anticipate the Expected Credit Loss (ECL) associated with a loan and make the necessary provisions. This policy change replaced International Accounting Standards 39, which required banks to account for losses when they occurred. Under the new regime, banks are structurally disincentivized from lending to risky sectors like agriculture because IFRS 9 requires them to provision for losses more conservatively. The opportunity cost of tying up their capital deters lenders from making agricultural loans.

### II. Capital adequacy ratios (CAR)

Banks are required to set aside a percentage of their capital in relation to their risk-weighted assets. The CAR requirements imposed by Central Banks in East Africa are significantly higher (ranging from 10-15%) than the International Standards under Basel III (8.5%). A significant factor in these higher CAR levels in East Africa are the 'convergence criteria' set by the East African Economic Community to manage inflation and reduce budget deficits. Combined with IFRS 9, the CAR levels further deter banks from financing riskier

assets, such as agri-SMEs, that would erode their capital and prevent it from being deployed in more lucrative ways. It is likely not a coincidence that, of the four countries analyzed, Rwanda has both the strictest CAR requirements (15%) and the lowest allocation of its commercial bank lending to the agriculture sector (2%).

### III. Loan classifications and provisions

Banks are required to classify their loans based on delays in meeting loan repayments. However, in the agricultural sector, delays in loan repayment may not necessarily indicate that the loan is non-performing. For example, seasonal harvest fluctuations may cause repayment delays but do not necessarily indicate an underlying weakness of the borrower. Despite this, Central Banks in the four East African countries do not currently provide special classification guidelines for agriculture. A differentiated approach by sector that is informed by data on loan performance may be worth considering. Countries such as Pakistan have introduced a differentiated policy in agriculture and more research is required to determine how this approach has affected credit volumes and quality in the sector.



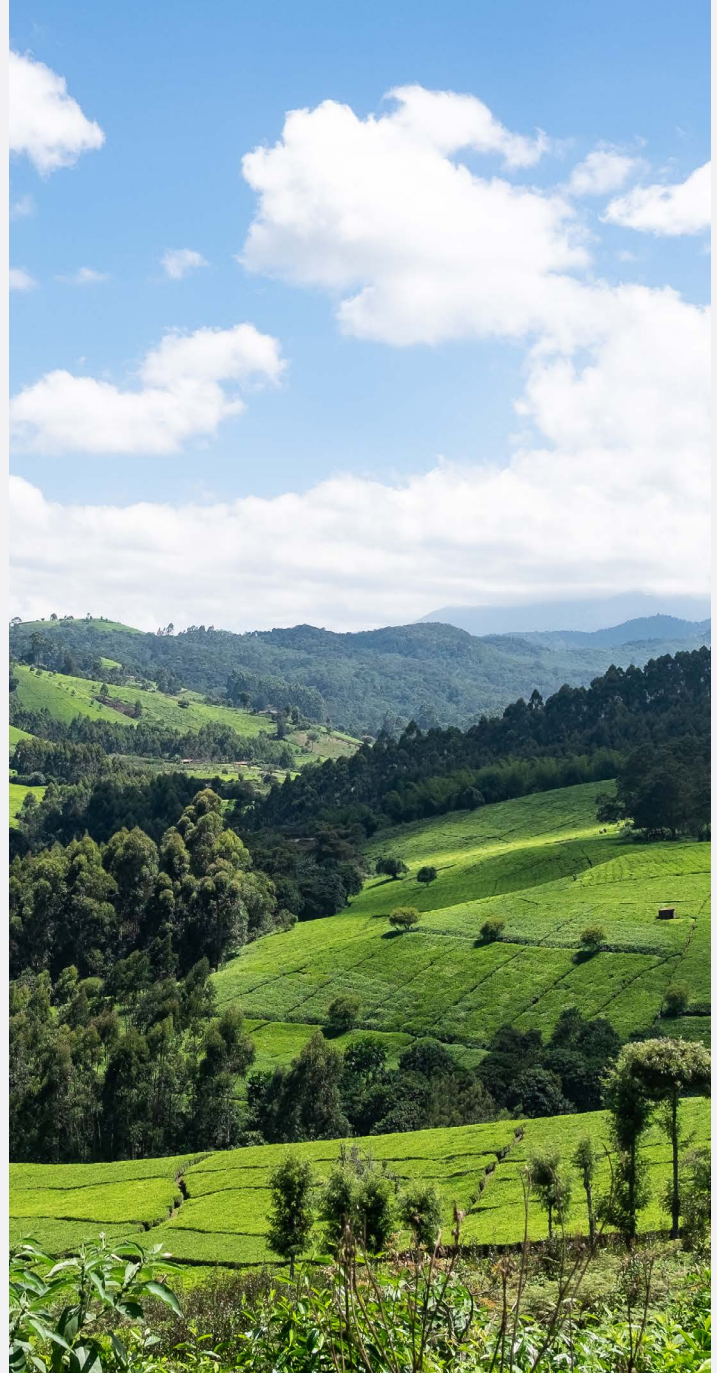


#### **IV. Collateral requirements for agri-SMEs.**

Banks are required by the Central Banks to discount the level of collateral held at loan write-off. In order to match the loan to value of collateral, financial institutions lending to agri-SMEs often require collateral valued at 120-150% of the loan amount. However, banks typically discount the collateral value of rural assets that may have limited resale value. In many cases, an agri-SME may be required to provide collateral valued at 200% of the loan amount (e.g., \$200k in collateral for a loan of \$100k). While some cushion above 100% may be appropriate, our review of bank policies suggests that many lenders err on the side of being overly conservative. This affects the loan size available to agri SMEs, widening the existing finance gap. We recognize the importance of other financing types like factoring, equipment leasing, and warehouse receipt financing; these approaches are usually more flexible around collateral but remain in infant stages of development in each of the focus countries, in part because of the lack of an empowered agricultural finance entity (as noted above) to develop appropriate guidelines.

#### **V. Treatment of credit guarantees.**

Central Banks do not treat credit guarantees as de-risking instruments, but rather as insurance against credit loss. Most credit guarantees, including those that are cash backed, are not zero-rated by the Central Banks. This makes it difficult for banks to use guarantees to stimulate lending through third-party assumption of risk. There may be room for increased coordination between Central Banks and guarantee providers to appropriately factor in the risk coverage offered by guarantees, thereby enhancing their ability to increase the lender's risk appetite.



## Recommendations for Discussion

Given the challenges outlined above, we identified the following areas for further review:

**1. Implement Kampala Principle 1** at the national level by recognizing a single entity as the high-level coordination body responsible for promoting agricultural finance.

**2. Expand the Expected Credit Loss model for calculating IFRS 9 to include Expected Development Impact (EDI) for agriculture and other high-impact sectors.** To be clear, we recognize the real risks of lending in the agriculture sector and affirm the Central Bank's role in ensuring appropriate risk-weighted capitalization for lenders. However, we believe that policymakers should take a broader view that balances risk management with economic growth considerations. Specifically, we propose that "Expected Development Impact" (EDI) be incorporated into the Expected Credit Loss equation and recommend that national governments fund this EDI through stimulus incentives to lenders that would counteract the constricting effect of applying IFRS 9 to their loan portfolios. This proposal stems from our experience in agriculture, but we envision it being applied more holistically across other key sectors in the economy such as education, energy, health, and housing – i.e., national governments could set aside a pool of funds that would be channeled through the "EDI" mechanism to promote financing in priority sectors that advance human development of their population. To launch this process, donors might contribute matching funds for any government that creates such a mechanism (and some of these funds could be drawn from donor commitments related to climate). Integrating Expected Development Impact and accompanying stimulus incentives into

the regulatory environment would achieve the dual objective of maintaining prudent regulation and stimulating economic growth.

**3. Require banks to allocate a portion of their loan book (e.g., 10-15%) to agricultural finance.** Many countries have adopted Directed Credit Programs (DCP) as a tool to target financial resources toward select sectors of the economy that require a special boost. In the Indian Priority Sector Lending<sup>11</sup> example, banks are required to do 18% of loans in agriculture and 40% overall to the nine priority sectors. Any bank having a shortfall in lending to priority sectors pays the difference as a contribution to the Rural Infrastructure Development Fund (RIDF) or other funds as decided by the Reserve Bank. The result is 18% of total banking lending goes to the agricultural sector. Similarly, commercial banks in Nigeria are required by the Central Bank<sup>12</sup> to allocate a portion of their loan books to the real sector of the economy, including agriculture. Under Directed Credit Programs such as those in India and Nigeria, shortfalls in mandatory lending by commercial banks result in a penalty. To stimulate more agricultural lending, these penalties could include a mandatory subscription to low-interest bonds issued by a government agricultural finance entity (i.e., if banks opt not to finance agriculture directly then they would be required to contribute capital to a pool of affordable funds available for other lenders). The policy could be phased in over a few years to allow time for lenders to develop expertise in agriculture or opt to contribute indirectly through the penalty mechanism.

<sup>11</sup>Circular of the Reserve Bank of India, Master Directions – Priority Sector Lending (PSL) – Targets and Classification, 2020.

<sup>12</sup>Central Bank of Nigeria, CBN Update, ISSN No: 2695-2394 Vol. 3 No. 4, April 2021.

#### 4. Establish a Special Purpose Vehicle for Agricultural Finance Fund at the country level.

Such an entity (separate from the policy coordinating entity in recommendation 1 above) could pool capital at a wholesale level and distribute it to private sector lenders for on-lending to the sector and invest in innovations (pilot testing) that can reduce cost and risk of agricultural lending. Globally, many state-run agricultural banks that do direct lending have gone bankrupt from political mismanagement or borrowers defaulting on their loans. For this approach to work, we believe an indirect or mezzanine approach is advisable. Here, a public-supported fund can offer low-cost capital, longer tenor guarantees, or other incentives to private sector lenders for them to on-lend to and use for agricultural borrowers. As a non-

deposit taking entity, the fund would not be subject to the same regulatory and classification requirements by the Central Bank, although a close coordination between the Central Bank and the empowered agricultural finance entity would be important to ensure appropriate risk management policies at all levels.

**5. Implement tailored and flexible regulations for agricultural lending.** The higher development impact generated by agri-SMEs with access to finance may be a justification for tailored regulations that allow for some additional risk-taking within appropriate parameters to ensure financial stability. One specific area to consider are the standards for loan classifications and provisioning.

#### UGANDA EXAMPLE

*The Agricultural Credit Facility (ACF) of the Bank of Uganda, which blends 0% capital for banks to on-lend to agricultural borrowers, has contributed to a notable uptake in agricultural lending in Uganda over the past decade. Uganda now has the highest rate of bank lending to the agriculture sector (~13%) across the region. However, the ACF also slows down the turnaround time of participating banks as the ACF is required by statute to conduct its own due diligence on the end borrower but ACF lacks the staff and capacity to conduct this analysis efficiently. Feedback gathered from stakeholders in Uganda indicated that ACF could be improved by removing the independent credit assessment process for bank on-lending to borrowers (or, alternatively, staffing it appropriately to reduce turnaround times). It is also important that access to capital is de-coupled from political influence.*



## 6. Allow for alternative forms of collateral, including stored produce, equipment and chattels, and revise the discount factors applied to these collaterals.

The net effect on the economy from this incremental lending may outweigh the risks of a more flexible collateral requirement; here, we propose further analysis of both loan performance in agricultural finance and development impact to inform a cost-benefit analysis of more lenient regulations.

## 7. Consider adjusting Capital Adequacy Ratios downward so they are closer to the Basel III requirements.

The CAR adopted by the four East African countries we reviewed is 40–50% more

conservative than the international standard. While we would expect more conservative CAR given the increased systemic risk of lending in East Africa, we speculate that the existing levels may exceed the differences in actual loan performance between the four countries and the international markets targeted by Basel III. The Bank of Tanzania recently announced changes to spur lending to agriculture during the COVID-19 pandemic as outlined below.<sup>13</sup>

### TANZANIA EXAMPLE

The Bank of Tanzania announced in July 2021 that it will:

- ✦ Reduce the statutory minimum reserve (SMR). Akin to the CAR, the SMR is a requirement for a bank to keep a percentage of capital commensurate to the level of risk-weighted assets in reserve with the Central Bank. In its announcement, the Bank of Tanzania noted that “a bank that extends credit to agriculture shall be eligible to a reduction in SMR amount, equivalent to the loan extended.”
- ✦ Reduce risk weight on loans. The Bank of Tanzania will reduce the risk weighting on different categories of loans in computation of regulatory capital requirement of banks. This measure will provide an opportunity for banks to extend more credit to the private sector than before.
- ✦ Introduce a credit line of TZS 1 trillion (USD 431.2 million) to banks and other financial institutions at a 3% interest rate for on-lending to agri-SMEs at a maximum interest rate of 10%. This measure intends to increase liquidity to banks and reduce lending rates. The recent experience of interest rate caps in Kenya had a negative effect on lending to SMEs in general and particularly in the agriculture sector. However, the Kenyan caps were not accompanied by lower cost capital, as proposed in Tanzania. Time will tell whether the 7% spread between the cap and the cost of funds is sufficient to stimulate increased lending to the sector.

These policies are just beginning to be implemented at time of publication so future discussion should track their effectiveness.

<sup>13</sup>African Development Bank, MFWA-Agricultural Finance Policy Coordination in Africa, 2014.

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