Series 1 – Economic Pillar: Financial Services

Using Flexible Loans to Improve Access to Credit for Farmers in Kenya

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Key Messages

Lenders are designing loan products with flexible terms to respond to the unique needs of farmers in a bid to improve access to credit.

However, these products are moderately flexible thus are not improving access to credit for farmers as envisaged.

Lenders should redesign loan products to make them more flexible by providing flexible options such as bullet payments and credit lines.

Lenders should also educate farmers on full product features to increase their financial literacy in order to improve their agency.

Government should provide credit guarantee schemes for institutions that lend to farmers to encourage the lenders to design more flexible loan products.

Context

Lending to the agricultural sector in Kenya is low. According to a report by the Kenya Bankers Association (KBA), only four percent of commercial banks' lending goes into agriculture (KBA, 2018). Most of these loans go to large farmers as smallholder farmers are unable to meet banks' requirements as well as the stringent repayment terms demanded by banks. Thus, smallholder farmers have to rely on other sources of finance for farm financing. As Kenya seeks to achieve the food security goal as enshrined in Vision 2030, it is increasingly important to finance smallholder farmers in order to improve agricultural production and productivity and transform the rural economies.

Given that farmers do not have regular incomes, making regular repayments from agriculture is untenable. Some lenders, especially microfinance lenders, have designed loan products that offer farmers some flexibility in repayment. Such loans mostly contain features such as grace periods and flexible repayment schedules. Other features include bullet/balloon payments, loan refinancing, loan rescheduling, and credit lines. Flexible loans are expected to be attractive to farmers given that they usually match the cash flows of farmers. Thus, access to credit is expected to improve when loan products are designed with flexible terms. This has been a subject of debate among scholars.

There are conflicting results on whether flexible loans improve access to credit for smallholder farmers (see Weber & Musshoff, 2013 and McIntosh, 2008). This may be due to the differences in the measurement of flexible loans. Previous studies have used single indicators of flexible loans where only one aspect of flexibility is examined. However, it is possible for a single loan product to have more than one element of flexibility (Labie et al., 2017). Thus, loan products may differ in their levels of flexibility. Previous studies have failed to model flexibility in this manner. This policy brief discusses the extent to which loans offered to smallholder farmers are flexible as well as whether credit access increases with the increase in the level of loan flexibility. The paper then discusses the implications of results for practice and policy.

Approach and Results

This policy brief summarises the study by Odhiambo (2019) who examined the influence of flexible loans on access to credit among smallholder farmers. The study collected primary survey data from 103 farmers who had borrowed from lending institutions in Ugenya Sub-county of Siaya County. The sub-county has a high concentration of financial institutions that offer flexible loans to smallholder farmers. The study used a simple random sampling method to select respondents from a list of members in farmer groups and individual borrowers.

The results indicate that the loans products offered to farmers were moderately flexible. With the flexible loan index ranging from 0 (low flexibility) to 1 (high flexibility), the study showed that the index had a value of 0.42 (moderate flexibility). Descriptive analysis showed that the most common flexibility features in the loans offered were grace periods and flexible repayment schedules (see Figure 1).

As shown, all farmers reported that the loan products had flexible repayment schedules and, therefore, they were allowed to make loan repayments at intervals that they chose. Further, 98% of the farmers reported being given grace periods before they began loan repayments. About a third (35%) of farmers agreed that they could be

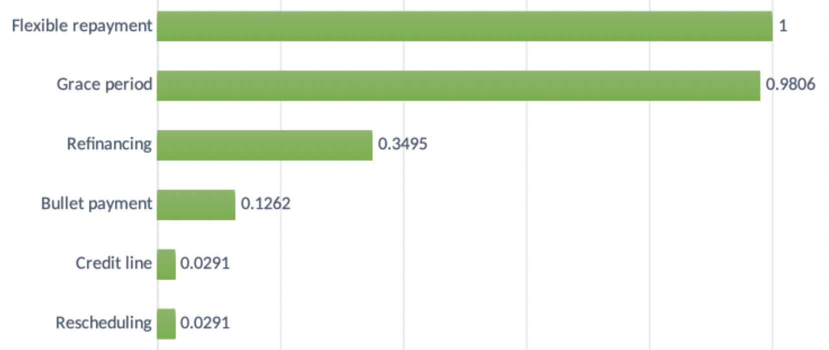

Figure 1 – Percent of Farmers with Various Flexible Loan Features

refinanced in cases where their crops were affected by some shocks such as flood or draught. Only a handful of farmers (13%) said their terms of loans allowed them to make bullet payments. The results also show that few farmers agreed that they would access a credit line (3%) or their loans be rescheduled (3%) in case of any shocks that affected their farm output.

However, these were rarely exercised by borrowers, especially those that were in farmer groups. This is because the borrowers were pressured by their fellow group members to repay their loans quickly in order to improve the group's overall credit rating. Lenders provided incentives to groups for paying up their loans more regularly and for finishing their loan repayments earlier than scheduled. Because groups competed to get rewards for having maintained clean records and repaying their loans earlier, the incentives pushed borrowers to repay their loans regularly and complete their repayments before the loan period expired.

The bivariate results showed that access to credit differed across sex, education, type of credit, and wealth status of households. Access to credit also differed across three features of flexible loans namely bullet payments, loan refinancing and loan rescheduling.

On whether flexible loans influence credit access, the results showed that flexibility had no influence on the amount of loan farmers borrowed. The main drivers of access to credit were the type of loan, education level of the farmer, and the household wealth. More specifically, higher credit access was associated with higher levels of education, wealthier households, and provision of cash-based loans as opposed to asset-based loans.

Policy Recommendations

Short-Term

- Lenders should re-design their flexible loan products to improve the level of flexibility by introducing more flexible loan options. More options such as credit lines and bullet payments should be included within the portfolio of flexible loan features.
- Lenders should also educate farmers on all the features of loan products available to them to improve the financial literacy and, therefore, their agency. Farmers are most likely unaware of their choices because the loan officers do not educate them more about their options.
- Farmers should be offered more cash loans instead of in-kind credit to improve access to credit. Lenders who offer in-kind credit argue that the fungibility of cash explains the provision of farm inputs. However, the results showed that offering in-kind credit was associated with lower access to credit.
- Lenders should also improve the loan administration and allow borrowers to exercise the rights within the loan contracts such as allowing borrowers a grace period before they begin loan repayments or allowing them to make repayments at time intervals of their choosing.

Medium-Term

- Provide Credit Guarantee Scheme: Lenders consider agriculture a risky sector. Smallholder farmers are even considered riskier. In order to incentivise lending institutions to provide more credit to smallholder farmers, the government can provide credit guarantee schemes. This will act as a way to de-risk lenders from any loan defaults.
- Disburse credit through lenders: Smallholder farmers are more likely to be credit-rationed when the loan product is highly flexible. Thus, the government can provide more funds to the farmers through lenders that offer flexible loan products. This will encourage more lenders to offer highly flexible loans and limit credit rationing.

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