CASE STUDY 01

Access to Finance in Malawi

Problem description

The Malawian economy is largely based on agriculture, in particular cash crops such as tobacco and maize. In 2014, 91% of Malawian households were involved in farming and 86% relied on farming or casual farm work as sources of income.[1]

1 FinMark Trust, *FinScope Consumer Survey Malawi*, 8 August 2014.

The lack of agricultural infrastructure (such as irrigation) in rural areas, as well as Malawi's volatile climate, presents a serious threat to agricultural production in the country. There are also significant, uncaptured opportunities in downstream agri-processing and agricultural exports that would boost the industry.

This constraint on current and potential agricultural production is often the result of a lack of access to agricultural financing, particularly among smaller producers. Boosting agricultural production requires investment in irrigation systems, new seed varieties and fertilizers, among others. Agricultural exports incur significant bulk transport and customs costs. Diversification of agricultural production to downstream processing requires upfront capital contributions. All of these factors depend on ready and affordable access to finance.

Table 1: Main household livelihood activity in 2010

Agricultural activities	%	Non-agricultural activities	%
Food crop production	63	Brewing	2
Cash crop production	11	Non-agricultural wage labour	3
Livestock rearing/selling	1	Handcrafts/artisan	1
Fishing	2	Petty trading/street vending	2
Agricultural labour (ganyu)	5	Selling firewood and charcoal	1
		Seller/commercial trader	2
		Salary/wages	4
		Self-employed (eg, carpenter)	2
		Others	1
Total	**82**	**Total**	**18**

Source: FinMark Trust, *Status of Agricultural and Rural Finance in Malawi*, Report, 2012, http://www.finmark.org.za/blog/publication/status-of-agricultural-and-rural-finance-in-malawi/

There are two major obstacles in accessing agricultural finance in Malawi. The first is the cost of finance from the private sector. Interest rates on commercial loans in Malawi are far higher than in other countries in the Southern African Development Community region. Estimates range from 20–40%, with some producers quoting rates as high as 55%. These rates are simply too high for the majority of Malawian farmers to afford.

Second, there appears to be an asymmetry of information on access to alternative financing within the sector. The purpose of development financial institutions (DFIs) is to recognise these types of market imperfections and correct for them – offering finance in key sectors that is cheaper and has less stringent regulations. However, existing financing opportunities for agricultural production, such as those offered by the African Development Bank, are not being used.

Political economy analysis

The issue of risk is behind the high cost of agricultural financing. Commercial banks are constrained by a need to be profitable, and risk is one of the major factors that banks incorporate into their pricing models. Sources of risk in agriculture include the diversion of inputs and proceeds to personal consumption, informal and unreliable markets for produce, financial literacy, lack of capital, lack of loan security, environmental factors (floods, droughts, pests) and the health of farmers, given the HIV/AIDS pandemic. Compounding this is the fact that banks do not possess complete information about agricultural producers due to their rural location, a lack of well-defined property rights and traditional sources of collateral, and a lack of information disclosure on the part of farmers. Commercial banks also believe that there is a culture of non-repayment among agricultural producers, particularly after the Malawian government supplied credit directly to smallholder farmers with very few conditions, leading to a high rate of defaults. As such, there is a perception among commercial banks that agriculture, especially in relatively undeveloped areas such as rural Malawi, is high risk and therefore agricultural financing carries a high price. The way banks price their products is set and unlikely to change. Risk perception is also an issue from the perspective of agricultural producers, who view the high probability of default and the possibility of over-leveraging themselves as a deterrent.

There is also structural constraint in terms of the incompatibility of the general business cultures of the financial and agricultural sectors in Malawi. Commercial banks, located in the formal sector and mostly situated in urban centres, tailor their financial products and services to large companies, which share a common professional business culture. This is in contrast with the relatively informal agricultural sector located in rural and peri-urban areas. Firstly, producers living in rural Malawi have little to no inclusion in formal financial institutions (FFIs). FinMark Trust's FinScope found that while 74.5% of rural people save for a mixture of investment and day-to-day needs, this is mostly done at home or in kind rather than in inaccessible FFIs. Banks and other FFIs have little rural presence in in the country, and most financial products are provided informally. Only 8% of all adults in the country get paid through a formal bank account and 67% prefer to be paid in cash instead of a bank cheque.[2] Opening a bank account requires proper documentation, which can be difficult and costly for rural residents. As such, there is a culture within rural communities of not pursuing formal channels for accessing finance. Secondly, it appears as though there is a lack of marketing, within these communities, of the financing opportunities available at the national and regional level. Commercial banks often offer their products and services in English rather than the vernacular in rural areas, leading to a communication gap.

Lastly, there is a legislative constraint in the form of contradictory and harmful government policies that make loan provisions more difficult. Inconsistencies between policies such as the Credit Act and Banking Act make it difficult for banks to provide loans legally. For example, the Banking Act requires banks to withhold personal information while the

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2 *Ibid.*

Credit Act requires them to release information to credit risk bureaus. The unpredictability of export bans under the Control of Goods Act has saddled Malawi with a reputation for unreliability when it comes to commodity exports. The 2013 ban on maize exports, for example, forced Malawian grain farmers to renege on international contracts that the Grain Traders and Processors' Association of Malawi had secured for its members by attending international trade fairs. Together, these policies hamper domestic investment and business opportunities in foreign markets.

The way forward

The problem of risk in agricultural financing in Malawi is a textbook 'market for lemons' market failure.[3] The asymmetry of information between formal lending institutions and smallholder farmers creates an adverse selection problem in which FFIs are unwilling to provide or are apprehensive about providing credit to smallholder farmers. In order to overcome this problem, agricultural producers must be able to signal that they are creditworthy.

It is very difficult for large commercial banks and DFIs to deal with individual, small-scale farmers. Isolated farmers are almost always served by itinerant middlemen, who carry out the tasks of bulking and transportation, but at a considerable cost. These traders have also traditionally provided short-term financing to help farmers meet emergency cash needs through pre-financing future procurement – but at a high cost to the farmer, who receives a much lower price than on the open market. Farmers can play an important role by organising themselves for collective action through the formation of co-operatives and agricultural producers' organisations, for example. However, this has rarely been accomplished without outside assistance (either from non-governmental organisations (NGOs) or through private sector support) or government by-laws in favour of co-operatives linked to marketing boards. The expansion of information and communications technology, such as mobile banking, can also assist in reducing the large transaction costs incurred when exchanging information between commercial banks and isolated farmers. About 72% of Malawians have access to a mobile phone, but only 4% of adults actually use mobile money services.[4] The majority who do not use mobile money services simply are not aware that the service exists.[5] This is a significant information and marketing gap identified by the FinScope Survey – and an area which mobile telecommunication companies, and also banks interested in this market, should consider carefully.

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3 Stemming from George Akerlof's 1970 paper titled 'The Market for Lemons: Quality Uncertainty and the Market Mechanism', the term refers to any situation where the seller knows more about a product than the buyer, causing an asymmetry of information and imperfect market conditions.

4 FinMark Trust, *op. cit*.

5 *Ibid*.

Figure 1: Mobile money service usage in Malawi

4% of adults use mobile money services	96% of adults do not use mobile money services
DRIVERS	**BARRIERS**
Malawians maily use mobile money services to: › 32% purchase airtime › 25% withdraw cash › 14% send money › 12% receive money	Malawians do not use mobile money services mainly because: › 80% are not aware of mobile money › 9% do not have enough information about mobile money

Source: FinMarkTrust, *FinScope Consumer Survey Malawi*, 8 August 2014, http://www.finmark.org.za/wp-content/uploads/pubs/Broch_FSMalawi_2014.pdf

The use of state credit guarantees can also reduce the risk to commercial banks in lending to the agricultural sector. However, commercial banks are sceptical of state intervention that does not follow best practice in terms of risk assessment, because of its potential to cultivate a culture of non-repayment and default within the agricultural sector. To prevent this, a greater degree of interaction between the state and the private sector is needed to harness the institutional knowledge and experience of the formal financial sector. This interaction could involve the formation of an agricultural bank that specialises in providing financial products and services catering specifically to the agricultural sector. This could facilitate the longer repayment periods and recognition of alternative forms of collateral that smallholder farmers need. For example, FDH Bank in Malawi has a special division that deals specifically with financial solutions to agribusiness projects, including sugar, tobacco, seed production and irrigation. FDH offers four classes of agriculture loans: seasonal loans for working capital; harvest loans; asset loans; and bridging financing. These are available to producers, processors, suppliers of inputs, exporters, logistics firms and farmers trading in a commodity exchange.

In dealing with the structural incompatibility between the formal financial and informal agricultural sectors, it is important to encourage the financial inclusion of rural agricultural producers. A key recommendation of FinMark Trust's extensive report on agricultural financing in Malawi is for the private sector to focus on the expansion of a range of financial services to rural areas. Other than financing products, these include mobile money transfer and micro-insurance. These products have been identified as being the easiest to integrate into the rural market. The integration of the rural market into FFIs would create important linkages between rural producers and FFIs, helping to break down the cultural and reputational boundaries that are contributing to rural exclusion.

Furthermore, both the Malawian government and the private sector must support initiatives that further financial and business literacy and education on best farming practices. This will help farmers navigate banking procedures and create the business proposals necessary to secure financing.

Secondly, it appears as though there is a lack of marketing within rural farming communities of the financing opportunities available at the national and regional level. The Malawi Microfinance Network and the Malawi Union of Savings and Credit Co-operatives are two institutions operating in these communities that facilitate exchanges of information and advocate for members with the credit regulator and the government. They should, therefore, play an important role in collecting and disseminating this information to members and ensuring that there is not an overlap between local, national and regional financing efforts. Development banks also need to increase their outreach activities to make their services better known and more trusted. For example, greater presence could be achieved at local and regional trade shows.

A number of government policy changes would help to rectify the legislative constraints. A basic requirement for receiving credit from a commercial bank is being an account holder. In order to open an account all banks want some form of identification. This is a fundamental key to opening the bottleneck in the supply of credit in Malawi. Due to the absence of national identification cards and the cost of acquiring alternative forms of identification, most Malawians do not possess a form of identification and so are excluded from interaction with formal lending institutions. The Malawian government must introduce a costless or cheap national identification card, which will meet the basic requirement for opening a bank account.

A further requirement for receiving a commercial loan is a form of collateral or security. With the support of policies such as the National Land Policy and the Personal Property Security Act (PPSA), Malawi may become the first African country to have a modern and efficient legal framework in place for security interests in personal property.[6] This will provide small, medium and micro enterprises (SMMEs) with the basic tools for leveraging securities in exchange for credit. For smallholder farmers it is crucial not only to be able to prove ownership of land – movable property such as machinery or even livestock can help secure investments for SMMEs. The Malawian government must help to support market infrastructure, such as a collateral registry and a commodity exchange, and reinforce the PPSA and National Land Policy. The government also needs to re-examine the Control of Goods Act in terms of how it imposes export bans and grants licences, and harmonise these policies with domestic agricultural exporters to ensure predictability for international buyers. In transitioning to an export economy, the government will also need to expand such policies as the National Export Strategy. In order to ensure the longevity of these policies, it could consider establishing inter- and intra-departmental task teams with more inclusive mandates that are not dependent on lead individuals in the various ministries. Establishing a road map for building a productive and efficient export agricultural sector and reducing the demand for imports will not only lower the trade deficit but also provide policy support for farmers seeking foreign markets.[7]

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6 Dubovec M & C Kambili, 'Using the UNCITRAL Legislative Guide as a tool for a secured transactions reform in sub-Saharan Africa: The case of Malawi', *Arizona Journal of International and Comparative Law*, 30, 2013, p. 163.

7 See African Economic Outlook, 'Malawi', http://www.africaneconomicoutlook.org/en/countries/southern-africa/malawi/ (accessed 21 July 2014).

Box 1: Roundtable on 'Access to Agricultural Financing in Malawi'

After conducting a mix of desktop research and firm-level interviews, it was unclear to which extent the various players involved in this situation were aware of the problem, or its scope. Agricultural producers may not be aware of the alternative financing that is available. Development banks may not know that their products are not being disseminated on the ground. Both commercial banks and producers may suffer from misperceptions about risk, thereby souring relations and preventing future co-operation. It was clear that information asymmetries and perceptions played a major role in this problem.

To deal with this issue, the South African Institute of International Affairs decided that the best approach would be to bring both sectors – agricultural producers and traders, and the financial services providers – together in open dialogue to facilitate the type of information sharing that is not currently occurring. This represented a pilot study in the project which, given its success, should be considered part of the solution in other cases where information asymmetry contributes to regional business barriers.

The central objective of the dialogue was to:

- create an understanding of the sources of risk in agricultural production, and the means to minimise them;
- create and strengthen network linkages between rural producers and FFIs; and
- facilitate the dissemination of information relating to development finance at a local, national and regional level, and investigate where information blockages occur.

Delegates participating in the roundtable on 'Access to Agricultural Financing in Malawi', held in Lilongwe on 9 June 2014

The roundtable was hosted in Lilongwe on 9 June 2014 with 35 participants drawn from agricultural producers and traders and their regional business organisations (RBOs), commercial banks and their RBOs, credit and savings co-operatives, DFIs, the Malawian government, NGOs and civil society organisations involved in agri-finance and financial inclusion in Malawi, as well as the local media. The event consisted of three sessions, based on the three objectives outlined above, with a panel of presenters and discussants drawn from the participants based on their areas of expertise. The event concluded with a fourth session that allowed the participants to discuss the finding of the previous three sessions and formulate a workable plan to move forward.

The model used for the roundtable proved to be immensely successful. Despite the concept being very simple, no one had previously taken the initiative to bring the disparate stakeholders into the same forum to overcome information asymmetries and harness their collective experience and knowledge. What resulted was a robust and frank discussion that generated a wealth of intellectual capital, which could not have been produced without the interactions between the stakeholders from the various sectors. The presence of the media at the event was also highly valuable as a local newspaper, *The Nation*, published articles on the issues that the roundtable had brought up. One of the articles was picked up independently by a representative of the Malawian Ministry of Trade and Industry – evidencing the success of the roundtable and its media coverage in highlighting the policy implications of the roundtable's findings for the relevant policymakers.

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