

Myth and Reality of Agricultural Micro-Lending – Experiences from a Commercial Bank in Georgia¹

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The majority of the international microfinance community holds a strong belief that agricultural micro-lending cannot be profitable due to higher risks and costs when compared to urban micro-lending. The experience of the United Georgian Bank indicates the opposite: agricultural micro-loans can be very profitable, even for a commercial bank.

Agriculture: the pariah of microfinance

“Over the past 40 years, billions of dollars have been provided to support agricultural production and the green revolution. But this financing has long been characterized by poor loan repayment rates and unsustainable subsidies. Accordingly, agricultural credit from some donors and multilateral development banks has dropped dramatically in recent decades and is now often considered too risky.”³

While urban microfinance is a success story in many developing and transformation countries, microfinance practitioners often look upon agriculture as a pariah. They don't even consider touching it. Therefore, supply of formal credit in rural areas is very limited, small farmers still rely heavily on borrowing from moneylenders, input suppliers, traders and processors. Moreover, self-finance and remittances from family members play a vital role in agricultural production. Due to a lack of financing options small farmers are often under-capitalised and forced to operate below the optimum level of inputs and technology.

There are some noteworthy exceptions to the wide-spread pariah attitude. Financial institutions, such as the Bank for Agriculture and Agriculture Cooperatives (BAAC) in Thailand, the Bank Rakyat Indonesia (BRI) or the National Bank for Agriculture and Rural Develop-

¹ SELP (Small Enterprise Lending Programme Georgia) was implemented by Frankfurt School of Finance & Management (formerly Bankakademie International) and its subcontracting partner Business & Finance Consulting (BFC) since August 2003 on behalf of EBRD (European Bank for Reconstruction and Development). UGB (United Georgian Bank) is one of the Partner Banks of SELP.

² Frankfurt School of Finance & Management was formerly known as Bankakademie International.

³ Christen, R.P., and Pearce, D.: Managing Risks and Designing Products for Agricultural Microfinance: Features of an emerging model. CGAP Occasional Paper No. 11, August 2005.

ment (NABARD) in India, roll out millions of agricultural loans every year. However, most of these exceptions are state banks with sufficient resources and the political will to partially subsidize agricultural lending operations, for example, to set up borrower groups or to build up rural bank infrastructure. This is not an option for profit-focused institutions and thus it comes as no surprise that worldwide very few private banks invest in small-scale agriculture – one exception being Georgia.

Georgia: a land of plenty – and plenty of troubles

Following the collapse of the USSR, Georgia went through years of turmoil. Poverty, corruption and crime were rife in those days. The peaceful rose revolution of November 2003 swept a new president into power who opened up the country towards the West. However, the Republic of Georgia, a nation of less than five million people, remains heavily dependent on Russia for its energy supply which also constitutes the main market for its agricultural products, foremost wine, fruits and vegetables. Political tensions with the powerful northern neighbour over the breakaway regions of Abkhazia and South Ossetia ruptured traditional trading ties and caused the Georgian economy to nose-dive. The situation even worsened at the beginning of 2006 when Russian authorities banned importation of Georgian wine and mineral water. Despite all these problems the Georgian economy has managed to pick itself up during the last three years. Real average annual economic growth was 8% p.a. and the gross national income per capita climbed up to 1350 USD in 2005⁴, although the country's economy is not well prepared to sell to foreign markets⁵.

Still, Georgia remains an agricultural economy. During the 1990s, state and cooperative farms of the Soviet period were abolished and the land was distributed amongst the rural population. All of a sudden there was a huge and mostly inefficient small farming sector. Today, agriculture employs 50% of the Georgian working population but generates only 18% of GDP.

⁴ World Bank website information.

⁵ Very few Georgian companies adhere to ISO 9000 standards and Hazard Analysis and Critical Control Point (HACCP) principles. For further information read: Heron, L., Lee, R. and Winter, M.: Georgia Agricultural/Agribusiness Sector Assessment. USAID/Georgia. Office of Economic Reform. March 2001, p.4.

Agricultural micro-lending in Georgia: a sleeping beauty

While urban micro-lending has experienced tremendous growth rates during the last decade, agricultural micro-lending in Georgia has been a sleeping beauty for many years. In 2001, only four institutions gave loans to small farmers.⁶ Three years later the total outstanding agricultural micro-loan portfolio in Georgia was a meager 4.53 million USD.⁷ Within less than two years, however, this figure grew to almost 14 million USD and the number of agricultural lenders reached eleven.

As more financial institutions venture into agricultural lending concentration is decreasing. In December 2004, the four major agricultural lenders held 82% of the entire agricultural lending market. Today, their share has decreased to 70%. Agricultural lending is an increasingly popular line of business for financial institutions in Georgia since competition in urban micro-credit and consumer credit markets has become very tough. At present, most lenders target the middle range of the small farmers market, with average loan sizes ranging from 1400 to 2300 USD. Nevertheless, lending to agriculture still makes up only 1% of total formal credit supply in Georgia.⁸

United Georgian Bank: kissing the sleeping beauty awake

The United Georgian Bank (UGB) is one of the largest commercial banks in Georgia, established in 1995 as a result of a merger of three former state-owned banks: Savings Bank, Eximbank and Industrial Bank. By the end of 2005 the bank was worth 220 million USD in assets (15.3% of the banking sector in Georgia), had 13.8 million USD equity and reported 1,165 million USD profit before tax. UGB employs 850 people and serves 115,000 clients from its 27 outlets. In April 2002, the bank launched micro-lending operations. EBRD financed the accompanying technical co-operation under its Small Enterprise Lending Programme (SELP). Even though the bank had no previous experience with micro-lending the portfolio started to grow at a very fast pace at the end of 2003 and continuously maintained a low loan loss risk position. By the end of October 2006, UGB had 7,883 micro-loans outstanding, with an average outstanding balance of 3,290 USD per loan, indicating that the bank has focused on the upper range of micro-lending when compared to the average GNI per capita. The portfolio at risk above 30 days stands at 0.2% which reflects the bank's

⁶ All data in this subchapter - if not noted otherwise - is based on informal surveys conducted by the Small Enterprise Lending Programme (EBRD, Georgia).

⁷ Hirche, S.W., and Kortenbusch, M.: *Entwicklung & Ländlicher Raum*, Vol. 39,4/2005.

⁸ National Bank of Georgia: *Bulleting of Monetary and Banking Statistics* N 2 (88), January-June 2006.

excellent risk management practices but also the potential to further probe into riskier micro-lending operations.

In spring 2004, UGB decided to embark on a pilot test in agricultural lending. Only 85 loans totalling 63,125 USD were disbursed to apple farmers in one branch location. The first experience was rather mixed: due to bad weather conditions some farmers had poor apple yields and could not pay back their loans on time. However, eventually all borrowers (except for two cases) paid back their loans. In spring 2005, lending to the same target market continued with the disbursement of 80 loans totalling 80,677 USD. During the pilot phase the bank decided to pay higher incentives to loan officers in order to encourage them to go into the villages.

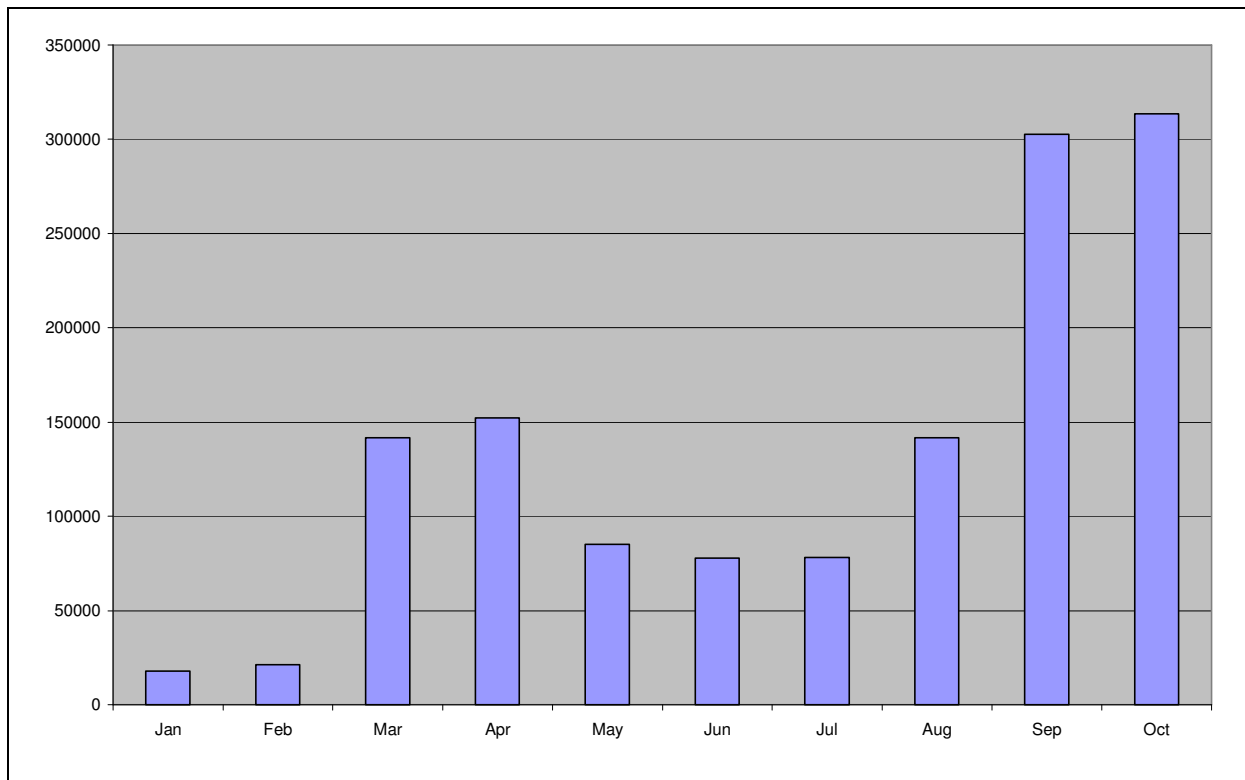
Encouraged by the good repayment discipline of farmers and supported by technical assistance financed by EBRD, UGB extended the pilot during the autumn season 2005, disbursing 96 loans to wheat, greenhouse, fruit and livestock farmers in two locations. Loan officer productivity remained poor when compared to urban micro-loans.

The situation changed markedly during the roll-out in spring 2006. After a study tour to the Agriculture Cooperative Bank of Armenia, UGB introduced the so-called cluster approach. Instead of the previous approach of first-come-first-serve, loan officers now approached loose groups of farmers in selected villages.

Due to the cluster approach and the increasing experience of agricultural loan officers who work with both, urban and rural clients, the loan officer productivity increased to 30 loans disbursed per month and 160 loans outstanding. From January until the end of October, ten loan officers disbursed 856 agricultural loans at the value of approximately 1.3 million USD⁹.

⁹ Calculated on the basis of 1 USD = 1.74 GEL.

Chart 1: UGB's disbursement of agricultural loans (in USD) from 1.1.- 31.10. 2006



The recipe for success: people, products, processes

Executive management of UGB's retail lending department considers agricultural micro-lending a full success after only two years of low-cost experimenting. Although the portfolio at risk for agricultural loans is slightly higher than for the entire micro-loan portfolio, agricultural loans are considered less risky and more profitable than urban micro-loans, foremost due to the following reasons:

- average loan sizes are smaller which reduces the loan loss risk;
- farmers prefer express loans even though they have to pay higher interest rates and up-front fees;
- farmers have fewer financing choices, therefore they are more loyal to the bank and readily offer information about themselves and others in the community;
- loan officer productivity is very high due to the cluster approach and because most farmers in a particular location are engaged in the same kind of agricultural activities which enables loan officers to partly standardize the loan appraisal.

Table 1: Micro-Loan Portfolio of UGB as of 31 October 2006

Total loans outstanding	7,883
Agricultural loans outstanding	700
Volume of loans outstanding (USD)	25,939,429
Volume of agricultural loans outstanding (USD)	1,055,242
Portfolio share of agricultural loans (numbers)	8.9%
Portfolio share of agricultural loans (volume)	4.1%
Average micro-loan size outstanding (USD)	3,290
Average agricultural loan size outstanding (USD)	1,507
Portfolio at Risk (up to 30 days) volume of all loans	0.2%
Portfolio at Risk (up to 30 days) volume of agricultural loans	0.4%
Portfolio at Risk (above 30 days) volume of all loans	0.2%
Portfolio at Risk (above 30 days) volume of agricultural loans	0.3%

By the end of October 2006, agricultural loans made up only 8.9% of all micro-loans and 4.1% of the entire portfolio value. However, the share of agricultural loans is growing fast. Since productivity has increased tremendously, loan officers are keen to lend to farmers. So much that the bank could even set the bonus scheme for agricultural loans on par with the bonus scheme for other micro-loans without de-motivating staff.

What is the recipe for this amazing success? The bank deems three aspects of utmost importance: empowering staff members, developing products and procedures which match the farmers' realities and reaching out to farmers in a cluster approach.

Empowering staff

Starting agricultural lending in a profit oriented commercial bank which has launched individual urban micro-lending only two years earlier is quite a challenge. It first of all needs full commitment from all relevant executive managers at the head office. In the case of UGB, micro-lending is part of the retail department. Therefore, micro-loans internally compete with other retail products such as credit cards and consumer credits. Yet, UGB's General Manager and the retail managers realized that urban markets are soon becoming saturated and that the bank needs to look beyond these "easy" markets.

The next challenge was to motivate branch managers, micro-loan unit managers and loan officers to whole-heartedly engage themselves in agricultural lending. In the beginning this was no easy task. Branch managers had to organise transport for the loan officers and the loan

officers had to spend much time travelling to the villages. On top of that they had to deal with a completely new type of customers which also meant that they had to get their hands and feet dirty during site inspections. Not surprisingly, there was initial resistance. The bank responded by introducing an agricultural lending bonus scheme which paid higher incentives for each loan disbursed. However, the agricultural lending bonus scheme caused internal frictions and it was soon set on par with the normal bonus scheme. The loan officers accepted this without problems since productivity of agricultural lending at that stage was already higher than in urban lending and because they earned better bonuses on their outstanding portfolio considering that most farm loans have grace periods and balloon or bullet repayments.

Far more impact on staff motivation, however, was achieved by head office managers going into the villages together with loan officers, coaching them on the job. To see their bosses getting their hands and feet dirty made a big impression on the loan officers and unit managers. It became very clear that head office is serious about agricultural lending.

Staff motivation was also enhanced by increasing productivity through the cluster approach. It convinced loan officers that agricultural lending can be done just as efficiently as urban lending.

Another possibility of getting motivated staff is to locally recruit new loan officers and to explicitly employ them as agricultural loan officers. Hence they will not compare agricultural lending to urban lending. At a later stage urban clients can be added to their portfolio.

In fact, UGB does not want loan officers to only do agricultural loans for two reasons: firstly, agricultural lending is a seasonal business and does not keep a loan officer busy all year round; secondly, during the peak periods agricultural loan officers need support from other loan officers who should also be trained in agricultural lending. Thus, UGB follows a team approach where some loan officers are mostly in agriculture and others are mostly in non-agriculture but both groups can help each other when the need arises.

As agriculture-loan officers and unit managers accumulated experience and agricultural know-how, the approval limits of local credit committees have been set up and extended gradually. This is a type of recognition for the branch staff and it also increases the efficiency and processing time.

Developing suitable products and procedures

UGB offers two out of its four micro-loan products designed for urban clients to farmers. However, in order to reduce risk exposure the loan amount limits for agricultural lending were initially reduced. Agri-Express loans up to 6,000 GEL (approximately 3,448 USD) can be granted with a personal guarantor and movable assets as security. Standard loans up to 50,000 GEL (approximately 28,736 USD) require immovable assets as collateral which can be rather expensive to register; therefore interest rates and up-front fees are lower than for express loans. Due to the collateral requirements, more than 80% of all agricultural loans are express loans, with an average disbursed loan size of 1,556 USD (close to the GNI per capita).

The eligibility criteria for both products were initially based on a subjective risk assessment of different farming activities. In order to keep the covariant risk exposure of the bank low, the focus was on irrigated crops, controlled environment farming and low market and price risks. Thus, irrigated wheat farming, greenhouses, apple farming and sheep and calf fattening were included in the initial list. In addition, farmers could take a consumer express loan. However, during the roll-out these narrow definitions have been abolished and loan officers could lend for any kind of purpose as long as the risk assessment and debit capacity met the requirements.

The loan structuring is flexible in terms of disbursement and repayment, based on a cash flow analysis which considers all incomes and expenses of the household. Since harvesting and sales of produce differ from case to case and depend on the current market prices, the bank is offering “generous” repayment schedules with rather long duration. At the same time, the bank abolished prepayment fees for agricultural loans in order to encourage farmers to pay back their loans as early as possible, for example if they sell their produce earlier than originally expected.

Compared to appraisals of urban micro-borrowers the agricultural loan appraisals show two differences: firstly, a cash flow analysis is required which can be quite complex due to the seasonality of farming and therefore also makes allowance for grace periods, bullet and balloon repayments; secondly, the income statement has been abolished from agricultural loan appraisals because it did not add much information value for the credit committee.

Cluster approach

Agricultural lending would not be feasible for UGB if it had not been for the cluster approach. While it is true that most successful agricultural micro-lenders in other countries work with groups or as cooperatives, the case was not that simple in Georgia. There are hardly any farmer organisations in this country and credit unions had failed. To make things worse, the Georgian mentality is rather of an individualistic nature and farmers have no good memories of being forced into cooperative (kolkhoz) farming during the Soviet period.

Therefore, UGB had no choice but to go for individual lending. However, this approach is very expensive in rural areas if the first-come-first-serve principle is applied. In the beginning, UGB loan officers spent a lot of time travelling to individual clients for site visits.

The basic idea of the cluster approach is simple. The bank selects larger villages with good agriculture potential and talks to the responsible village headman, a political administrator elected by the people, about the loan scheme. Then the village headman spreads the word in the village and organizes a farmer meeting in the village hall. The meetings must be held at times when farmers are free from other obligations. In these meetings loan officers and unit managers inform the farmers about UGB's agricultural loan products and interview applicants on the spot. In many cases the farm inspection can also be done the same day.

Apart from the obvious marketing advantage, the cluster approach has improved almost all operations in the credit cycle:

- The application-to-disbursement ratio has been increased from 10:2 to 10:9 because loan officers have trustworthy informants in the villages who can give references about applicants.
- Since most farmers in one village do more or less the same type of farming, loan appraisals are much easier to prepare and different farmers can be compared to each other.
- Credit committee members find it easier to take decisions when there are several appraisals from the same village which can be compared.
- Disbursement and repayment is streamlined, most farmers of one village get their loans on the same day and have to repay on the same dates. This makes it easier for the loan officer to monitor repayment and several or all farmers of one village can send their money with one villager to the next town's bank branch.

- Monitoring visits are scheduled according to the farming cycle, for example, on days when farmers in the village harvest their crops and loan officers can visit ten or more clients in one trip.
- In case of delinquency the loan officer can talk to the client and his personal guarantors or other farmers in the village during one visit, putting pressure on the delinquent farmer by threatening to stop future lending to the entire village.

An alternative to the above approach is sending the bank's credit-mobile to farmer markets. The credit-mobile is a re-equipped mini-bus which allows bank staff to carry out first meetings and interviews with clients in a comfortable and private setting. The credit-mobile turned out to be of great assistance for working with rural clients.

Challenges ahead: simplify and diversify

UGB has ambitious targets for the future, 100% growth rates are envisaged for the years to come. The bank aims at an agricultural loan portfolio of 3.5 million USD by the end of 2007, without increasing the average loan amount. More rural branches and more loan officers will join the ranks. Considering the very low loan loss rate of UGB's micro-loan operations, the bank is willing to take on more risk and venture into new products, new farming areas and additional farming activities. The bank is aware of the fact that just doing more of the same will not be sufficient to be successful in a dynamic market. Therefore, the bank has plans to simplify the main products and processes and to diversify operations:

- The loan application and appraisal process will be more standardized. Simple check-lists and land-to-profit-to-loan ratios for typical farming activities will replace complex cash-flow analysis. This approach is called scheme lending.
- Product loan amount limits and loan durations will be increased to encourage loan officers to lend not only for working capital but also for small investments.
- New products will be offered to good clients, such as turbo loans (no collateral, no site visit), overdraft facilities and inventory credit.
- Cross-selling of other bank products, foremost deposit products, will be encouraged.
- As the agricultural portfolio share increases risk-pool based portfolio management practices will be introduced, for example, portfolio limits for different risk pools such as wheat or greenhouse farming and different appraisal techniques for different risk pools.