



An RSI enumerator (left, front) interviews a farmer (center, back) in Kandahar province during field data collection.

# **NATIONAL SURVEY IN BRIEF:** DEMAND AND SUPPLY OF AGRICULTURAL FINANCIAL SERVICES IN AFGHANISTAN

7 June 2018



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# National Survey: Demand and Supply of Agricultural Financial Services in Afghanistan

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## ACRONYMS AND ABBREVIATIONS

ACE	Agricultural Credit Enhancement Program (Phase I)
ABA	Afghanistan Banks Association
ACE-II	Agricultural Credit Enhancement II Program
ADB	Asian Development Bank
ADF	Agricultural Development Fund
AISA	Afghanistan Investment Support Agency
AMA	Microfinance Association
APP	Application
ARFC	Afghan Rural Finance Company
CARD-F	Comprehensive Agriculture and Rural Development Facility
CSPI	Community-based Savings Promoting Institutions
DAB	Afghanistan Central Bank
EMI	Electronic Money Institutions
FAO	Food and Agriculture Organization
FGD	Focus Group Discussion
FI	Financial Institution
FMFB	First Microfinance Bank
FXP	Foreign Exchange Providers
GIRoA	Government of the Islamic Republic of Afghanistan
GIS	Geographic Information System
GPS	Global Positioning System
IIFC	Islamic Investment and Finance Cooperatives Group
IP	Implementing Partner
KII	Key Informant Interview
Lat	Latitude
Long	Longitude
M&E	Monitoring and Evaluation
MAIL	Ministry of Agriculture, Irrigation and Livestock
MFI	Microfinance Institution
MNA	Mobile Network Agents
MSP	Money Service Providers
MTO	Medium Tax Office
NBFI	Non-Bank Financial Institution
PII	Personal Identifying Information
RSI	Rahman Safi International Consulting
TO	Task Order
USAID	United States Agency for International Development
USG	United States' Government

## **ABOUT THE AUTHORS**

The Agricultural Credit Enhancement (ACE) project established and managed the Agricultural Development Fund (ADF) until it was transferred to the Afghan government in 2015. The follow-on project, ACE-II, seeks to build on results achieved by the previous program and expand access to agriculture-related credit to increase commercial viability of small- and medium-size farms and agribusinesses as a necessary condition for a thriving agricultural economy. ACE-II provides technical assistance to improve ADF's management systems and catalyze its transition to a sustainable agricultural development financial institution.

ACE-II contracted RSI Consulting and Alcis on November 17, 2017 to undertake the National Survey of Supply and Demand for Agriculture Financial Services to understand the current landscape of such services in Afghanistan. The scope covered farmers and agribusinesses throughout 16 provinces. Alcis, a geospatial firm, provided sampling for the survey according to remote-sensed agricultural diversity across Afghanistan, while RSI Consulting carried out the field work. A unique aspect of the sampling included the ability to undertake the survey within 250 meters of the Alcis-identified grid point which resulted in high sampling accuracy. The results of the survey are presented herein.

## ABOUT THIS SURVEY

The National Survey of Demand and Supply for Agricultural Financial Services in Afghanistan aims to empower agricultural producers and the associations and policymakers who support them, with the data they need to advocate for expanded agricultural credit and financial services—especially for rural, agrarian populations. Expanding access to financial services is a priority for the Government of the Islamic Republic of Afghanistan’s (GIROA) and its Ministry of Irrigation and Livestock (MAIL), not least because fully half of the country’s population relies on agricultural production for survival. With livelihoods in the balance, boosting farmer and agribusiness access to a range of financial services—from credit to savings to insurance—is ultimately about Afghanistan’s long-term stability.

## WHAT IT OFFERS

Despite this imperative, there is relatively little information available on the demand and supply of financial services and agricultural credit. Where data is available, it is limited and often outdated. This survey seeks to fill that data gap with sufficient detail, facilitating improved financial intermediation in the agricultural sector. As such, the following sections offer:

- A data-driven overview of both the supply of and demand for agricultural financial services as well as an exploration of gaps between the two.
- A more detailed segmentation of supply- and demand-side participants and how each could be better served by financial service providers.
- A holistic view of the financial services required to support agricultural policy objectives, expanding beyond credit to include savings, transfers, payments, and other financial services that facilitate improved agricultural production.
- A review of traditional and digital financial services to identify opportunities for improved services through development of alternative credit origination and payment channels.

## WHAT IT IS NOT

Although the report concludes with a set of recommendations, its main aim is to inform the independent advocacy and reform efforts of agricultural producers, associations, and policymakers. As such, the findings are presented with minimal interpretation, allowing the data to speak for itself rather than constructing specific policy interventions which, to be sustainable, must first earn the buy-in of stakeholders at all levels of the sector. That said, the report’s authors hope that the richness of the data and the depth of knowledge it reflects will bring new possibilities to light, ultimately contributing to expanded agricultural credit nationwide.

## A WORD ON METHODOLOGY

Interviews with 2,736 farmers and 541 agribusinesses were completed, drawn from 16 provinces covering five regions; Central (Bamyan, Ghazni, Kabul, and Parwan), East (Kunar, Logar, and Nangarhar), North (Baghlan, Balkh, Faryab, Kunduz, and Takhar), South (Kandahar), and West (Badghis, Farah, and Herat). Data collection with 541 agribusinesses was carried out in regional centers, where majority of these agribusinesses were located.

The sampling for farmers for this survey is based on a diverse range of variables (data layers) important for agriculture. These variables are summed up into an index weighting which rated each farm on a scale with a minimum value of 7 and maximum value of 130. Based on the available data for these variables, each province, district, and sub-district was assigned particular value. Within a given province and district, analysis through GIS selected blocks of land 250m square that have a



particular score representing the farm situation of that area of land. This selection process was approved by MAIL by the acting Deputy Minister. Accordingly, *farms* were selected in a diverse stratification that represents all strata, i.e. most to least agriculturally advantaged areas of the country.

Once these target farms were identified, a final list of GPS locations representing each field plot was prepared for each district and province. The navigation system in the tablet-based survey application was designed and auto-locked with the GPS data point, through satellite, of the target field. Overall, the navigation was routed through Google earth maps, and made in a way that field team could not proceed to carry out the survey without first arriving at the targeted field. Upon reaching the target farm (identified plot), the field teams identified the farmer and then carried out the survey with them.

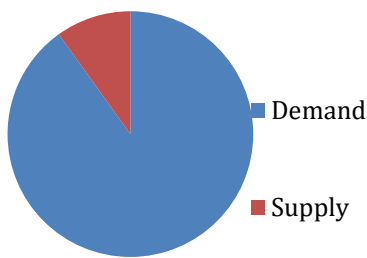
To determine the number of surveys (farms) in a given district, a proportional approach was adopted whereby those districts with more hectares devoted to agriculture had more surveys allocated than those districts with more limited farming occurring. Collectively, this exercise led to the most representation throughout the whole spectrum of agricultural land.

A total of 28 focus groups were conducted in five regional centers (Kandahar, Balkh, Herat, Nangarhar and Kabul). The FGDs were comprised of 266 farmers and input suppliers, divided into six distinct value chains: dried fruits, edible oils, fresh fruits and vegetables, poultry, saffron and wheat. Because suppliers often cater to multiple value chains, these were carried out as distinct focus groups in each region (total of nine).

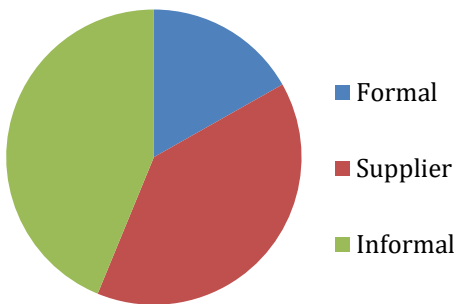
*Please see Annex I of the National Survey Final Report for a full review of the quantitative and qualitative methods used to arrive at the data contained in this survey.*

# Demand for Agricultural Credit at a Glance

**Demand vs Supply for Formal Farmer Ag Credit**



**Farmer Credit Demand by Source**



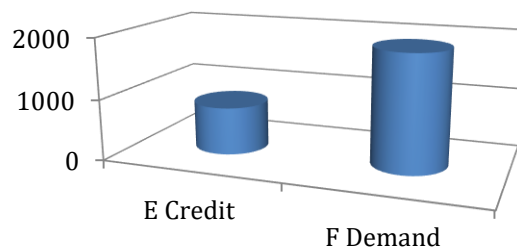
Survey results clearly show the enormous gap between **demand for** and **supply of** agricultural credit.

The National Survey found only 5% of farmers were likely to apply for credit from formal institutions. Applying that to an estimated total number of farmers, there is a demand for \$322,061,159 for credit.

- MFIs, the most likely source of credit for these farmers, currently provide \$35.4 million in credit to farmers, only about 10% of the demand.
- The reduction of some constraints to ag credit cited by farmers could result in an increase in the percentage of farmers seeking formal credit sources.
- Such constraints include trust, awareness, cultural and social issues, distance to branches, and preferences for Islamic credit.
- Total farmer demand for agriculture credit from all sources, informal loans and formal institutions is \$1.9 billion.
- The total of all commercial credit in Afghanistan (provided by banks, MFIs, and the ADF) is \$784 million, of which only 11.3% is provided to the agriculture sector.
- Current demand for farmer credit is over twice as large as existing commercial lending to all sectors.
- The comparison of total demand for all sources of credit shows the enormous gap between demand and supply.

*Note: This demand data is for farmers only, not including agribusinesses demands for credit.*

**Existing Total Formal Credit Supply Vs. Total Farmer Ag Credit Demand**



# Supply of Agricultural Credit at a Glance

**27.5%**  
Increase in Ag Credit, 2015 to 2017

**11.2%**  
Percent of Women Ag Borrowers

**6.188bn AFN**  
Total formal credit in Afghanistan

Providers of formal agriculture credit include a variety of types of financial institutions, including commercial banks and non-bank financial institutions (NBFI) entities. NBFIs, who are not regulated lenders, include: IIFC, microfinance institutions, ARFC, an AISA registered finance company; CSPIs, and the ADF.

### Agriculture Lending:

Agricultural credit has increased 27.5 % since 2015, and now comprises 11.3% (AFN billion 6.188) of total formal credit.

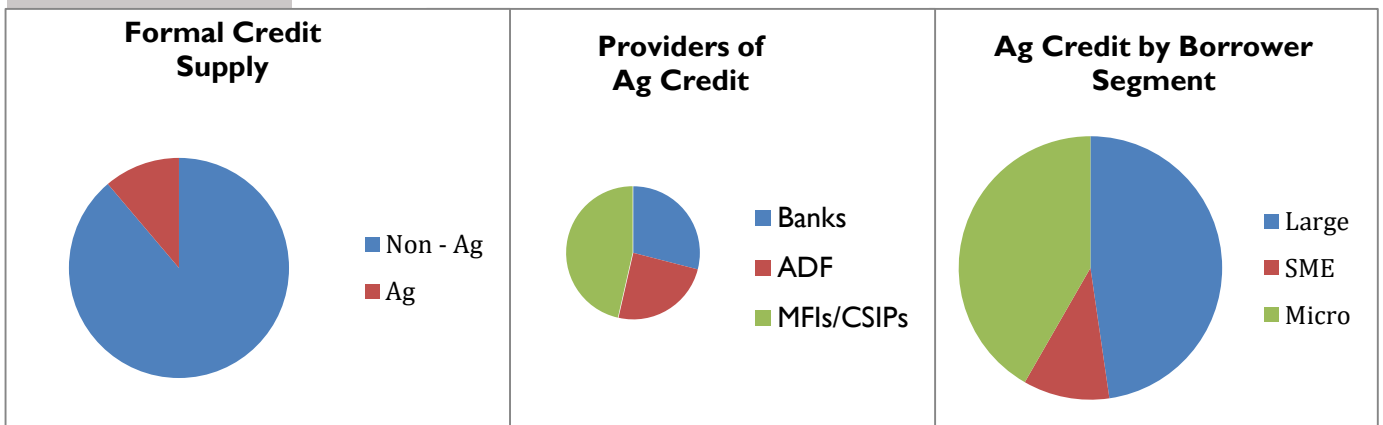
The MFI sector is the largest provider of credit, followed by the commercial banking sector, and then the ADF.

“Large” and “Micro” borrowers receive the largest proportion of agriculture credit at 47.7% and 41.7% respectively.

SME agricultural borrowers receive a disproportionately small amount of the credit: only 10.6%, a number that underscores the difficulties for SME’s to access credit.

Lender Borrower Segments
Large (\$250,000+): Banks, ADF
SME (\$25,000-250,000): ADF, ARFC, FMFB
Micro (Up to \$25,000): MFIs, CSPIs

The microfinance sector provides loans to 90+% of all borrowers receiving agricultural credit. Only 5,209 recipients of MFI agricultural loans are women. Illustrative of the constraints to women receiving agricultural credit, they comprise 39% of total MFI borrowers, but only 11.2% of the MFI agricultural credit borrowers.



## SURVEY IN BRIEF

*“We can’t grow and expand our business without providing credits, so, we are forced to provide our customers and farmers with credits, because majority of farmers do not have cash on hand. So, if we stop providing them with credits it will affect their harvest which indirectly affects our business too.”<sup>1</sup>*

It is well established that investing in agriculture is critical as the sector accounts for a quarter of the Afghan economy and plays an important role in the livelihoods of approximately 76% of the population who live in rural areas. A full 50% of all households in the country derive at least part of their income from agriculture.<sup>2</sup>

However, limits in agriculture investments persist: The study found that a lack of widely accessible, low-cost credit continues to constrain the Afghan agriculture sector nationally. Despite the availability of land (reportedly only about one out of every six hectares that is suitable for agriculture is currently under cultivation),<sup>3</sup> inputs, equipment and technical knowledge for expansion, farmers simply did not access long-term formal credit, citing its high costs and steep financial and moral downsides. Distance to points of service further discourages uptake of services, and unfamiliarity with services persists: only 18% know about or access formal financial services, and marketing by financial institutions has reportedly reached only 1% of farmers.

### INDIVIDUAL FARMERS

Focus groups reveal nearly universal credit needs, while the farmer survey in 16 provinces found that 30% of farmers required a loan at present. The problem is largely one of insufficient supply, however. Farmers report taking an average of 52,066 AFN (\$755) credit (cash and in-kind) annually, primarily from informal sources; at the same time, they report average annual agriculture credit needs of approximately 200,000 AFN (\$2,866).

Not surprisingly, the study also highlights a general trend whereby farmers source small, interest-free cash loans from friends and family (65%) or via short-term informal agreements with Sarafi/Hawala (17%) and as trade credit from input suppliers or local businessmen.<sup>4</sup> A few obtain bank loans (8%) or MFI loans (5%). There are some variations within this overall pattern, however. Those who receive more income from farming are also less likely to seek loans from friends, preferring more formal sources, presumably for their ability to provide larger loans.<sup>5</sup> Overall use of financial services is also positively correlated with total household expense and total household farming expense<sup>6</sup> Additionally, the more land farmers own, the greater the use of formal financial services.

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<sup>1</sup> Male, 28, Agricultural Machinery and Medicine, 8<sup>th</sup> Nahia District, Kabul Province.

<sup>2</sup> See <http://www.worldbank.org/en/country/afghanistan/publication/revitalizing-agriculture-for-growth-jobs-and-food-security-in-afghanistan>

<sup>3</sup> <https://www.pajhwok.com/en/2017/04/06/investment-agriculture-can-accelerate-economic-growth-generate-jobs>

<sup>4</sup> Only 1% in the survey reported that the last form of loan they took was from an input supplier; this reflects the season of the survey, which was in the winter. Focus groups reported a high reliance on input suppliers.

<sup>5</sup> Question 5.14, Farmer’s Survey. Land & Income from farming variable.

<sup>6</sup> Question 4.7, Farmer’s Survey. Household Expenses variable.

# The Typical Afghan Farmer

*Using aggregate data, the profile below represents the average farmer respondent in the National Survey*



RSI Enumerator (left) and Farmer (right) in Bamyan Province.



Farmer from Kandahar Province taken during field survey.

The typical farmer in the survey is 43 years old, has 12 household members in his family and average landholdings of 22 jeribs (4.4 ha), on which he uses 14 jeribs (2.8 ha) for irrigated agriculture. He has four years of formal education, is not aware of formal financial services nor does he use them, largely because all of his transactions are done in cash locally and the nearest financial institution is 1.5 hours distance from his home. His household income is \$335 per month, or about \$28 per person.\* He has no savings.

He relies on family and friends for his seasonal credit needs, which are highest in lean winter months when money from his last harvest has run out, and at spring planting time. In addition to family and friends, the farmer takes credit for seeds and fertilizer from a local input supplier, who he pays back at a markup after harvest with cash from the sale of his crop. In total, he borrows \$755 per year.

He would like to access long-term, low-cost credit to buy solar panels that will power his farm's water and irrigation needs, which would allow him to expand his farm's productivity to his land that lays fallow, but friends and family cannot provide the 200,000 AFN he needs for the investment.

He is reluctant to access a formal loan because he does not want to take an interest-based loan, both for its moral implications, and because he is unsure if he can meet

the strict terms of the loan and pay it back within the short-term timeframe the bank has set. Taking a formal loan would also put his farm at risk, given that he would need to provide his land as collateral. Instead, he uses some of his small crop sales to buy fuel to power electric water pumps, but can only do so for some of his land.

Without low-cost credit, the typical farmer is locked into a subsistence-based livelihood from which there is little hope of moving up, spending money on short-term solutions and stop-gap measures instead of productive investments. With millions of such typical farmers in Afghanistan, the sector remains limited in its productive expansion despite a myriad of low-cost and relatively low-risk opportunities.

*\* This income average is higher than overall income averages in Afghanistan, which are usually reported between \$175 and \$250 per month; this is about \$28 per person per month given the household size. However, given the large landholdings of farmers in the survey, these incomes are reasonable; Lowest income expected from 22 jeribs of wheat (2,500 kg/ha and 25 AFN per kg = 275,000 AFN, while the figure for surveyed farmers is 277,393 AFN). The survey excluded landless households, which typically bring down income averages.*

Often, however, those who needed larger loans report that this need goes unmet. Instead, farmers typically deal with major cash-flow issues by selling crops early or foregoing longer-term investments; both scenarios limited their long-term income prospects and the expansion of the agricultural sector at large.

### USE OF CREDIT

Credit needs were focused on maximizing existing and expanding cultivated land. Short-term credit is needed for family living expenses, fertilizer, seeds, hired labor, fuel for water pumps, and tractor/plough rental—with the costs of the latter two being the most sizable. Medium- and longer-term credit is needed for investments in fencing, buildings, livestock, machinery, and, in particular, water infrastructure (and associated solar power). Other long-term credit uses include building construction and land purchases.

Since long-term credit was not accessed for water infrastructure, short-term credit was often used as a stop-gap in the form of fuel purchases for water pumps, eating into crucial capital needed for inputs and to give farmers the flexibility they need for their crops to reach maturity without being compelled to sell at low prices or enter into imbalanced trade agreements with input suppliers during cash emergencies. Cash flow problems and cash emergencies were reportedly a common scenario, with up to 80% of farmers reporting seasonal cash flow problems.<sup>7</sup> Often, the inability to meet farm and family needs led farmers into a debt cycle that was difficult, if not impossible, to overcome.

### CHALLENGES ASSOCIATED WITH FORMAL CREDIT ACQUISITION

While knowledge of formal financial services was low (18% overall) and use even lower (9%), low knowledge was not the primary factor in low formal credit acquisition. The general problem with accessing formal capital appears to be one of low marginal returns on farming investments, which dissuade farmers from borrowing high-interest, high-fee loans. These loans are also bureaucratically difficult and time-intensive to obtain.

Only 8% of farmers overall reported obtaining a bank loan—5% from an MFI and 1% from a cooperative. For those who did not access loans, a total of 61% said they were not interested in loan products that charge interest (and are not Sharia-compliant), and 31% were concerned primarily about their ability to repay their loan.<sup>8</sup>

The benefit of accessing credit through a bank is receiving a higher loan payout; however, none of the farmers who had accessed bank loans in focus groups felt positively about their experiences. All described the process of acquiring such loans as exhausting and complicated, and most noted that they have struggled or are struggling to repay their loan with the added cost of interest.

Not only are the terms and acquisition processes thought to be prohibitively complicated, but financial and personal risks associated with repayment problems inspire a great deal of anxiety and perceived risk. Formal financial loans are seen as financially expensive and ethically dubious: charged

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<sup>7</sup> Focus groups. This question was not covered in the farmer survey.

<sup>8</sup> Interestingly, in the Central region, the frequency of these two responses is reversed: more were primarily worried about the ability to repay loans

interest is considered *haram*, strict timelines for repayment and harsh penalties for late repayment are anxiety-producing and travelling long distances to banks is both expensive and risky.

Farmers worry that, were they to seek a loan, they would be shamed if their applications were rejected and unsuccessful. The prevailing sentiment is that seeking credit from banks is simply not worth the associated anxiety, shame, and inconvenience. In some cases, farmers accessed bank loans out of desperation, but found themselves in even more desperate situations when they were unable to cover the repayment installments.

Collateral is often cited in Afghan market studies as a major barrier to accessing credit. This was true for a minority of farmers and agribusinesses. A total of 62% of farmer survey respondents said they were able to provide collateral on loans<sup>9</sup>--the majority in the form of land (58%) and house (34%) deeds.<sup>10</sup> Instead, regardless of their ability to provide collateral, focus group data suggest that farmers are not eager to do so. Focus group participants note that official, government-issued deed documentation is time-consuming to obtain or produce. Reticence to provide collateral is not only based in frustration in providing formal documentation, but also anxiety over loss. Farmers were, overall, uncomfortable with using their property as collateral for credit, given the risk involved.

### CHALLENGES ASSOCIATED WITH INFORMAL CREDIT ACQUISITION

While most farmers indicate very few constraints associated with informal credit, there are some barriers that prevent or limit access to informal credit. One such barrier combination can be season and production yield. If the season is promising, then lenders are more flexible, and credit is easier to access. However, a low-yield season with late returns can seriously limit access to credit the following season.

Another constraint is the marked-up cost of supplies received through trade-credit, which is a consistent practice across all provinces – a system called *Murabaha*. The process of *Murabaha* provides some profit to a lender, but is still considered morally and socially acceptable. Additionally, the lending/borrowing relationship in *Murabaha* transactions often includes an exclusive product-sale agreement, meaning the borrower is obligated to sell their harvest to the shopkeeper/supplier at reduced rates, while borrowing supplies that have been marked-up. Many farmers appear to be comfortable with this arrangement, provided the profit margin is small and the lender trustworthy and familiar to them.

While many accept these conditions, these mark-ups can not only be prohibitively expensive for some farmers, but they can also lock them into lending relationships that may be non-beneficial or even exploitative. If repayment and/or exploitation difficulties arise within this partnership, farmers can feel trapped in a limiting (and increasingly expensive) lending arrangement.

### AGRIBUSINESSES

The survey showed that agribusinesses also have significant ongoing credit needs. What's more, they face many of the same challenges as farmers. For agribusinesses, credit is reportedly used not only to manage current business ventures, but also to expand business opportunities. Credit is critically

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<sup>9</sup> Question 6.1, Farmer's Survey.

<sup>10</sup> Question 6.2, Farmer's Survey.



important as suppliers' report that they rarely, if ever, have enough in-house capital to support their business model.

Average annual business turnover was \$31,710. Only 4% of businesses reported that they had financial reserves; (9% for those with 1,000,000 AFN / \$15,000 or more turnover). Interviewed agribusinesses report that they typically need to carefully move and manage funds, goods, and services to stay afloat. A total of 40% of businesses said that they experienced seasonal cash-flow issues, which mirrored those of various farming seasons. This was true in all regions except the East, where specific seasonality was reportedly not a factor. This is because of its climate; the East (especially Nangarhar) has a year-round growing season for different crops, and poultry is also a year-round endeavor.

In addition, just 27% nationwide reported having an account with a bank or MFI (43% for businesses with turnover of 1,000,000 AFN / \$15,000 or more), highlighting Afghanistan's largely cash-based agriculture economy.

A total of 37% of agribusinesses surveyed indicated that they currently require a loan,<sup>11</sup> though focus group data indicate that the need for credit is nearly universal among input suppliers. Only six percent reported ability to access a non-formal financial loan; this is because non-formal sources cannot provide the levels of credit required, which ranged from \$10,000 - \$800,000 and averaged \$30,243. Survey data indicates that a history of loan application is positively correlated with annual financial turnover, a possible indication of higher credit needs.<sup>12</sup>

Despite the need for capital, only 12% of all agribusinesses surveyed reported that they have applied for a formal loan in the past and just 5% reported a current loan.<sup>13</sup> These loans averaged \$16,782.

### **AGRIBUSINESS CREDIT USE**

Surveyed agribusinesses who have applied for loans indicated that they used the loan to purchase inputs (31%), purchase vehicles (21%), pay off debts (19%), repair and construct buildings (17%) and purchase machinery (13%).<sup>14</sup> These data are little different from the stated credit needs of those currently requiring a loan. Those who currently require loans are much more interested in acquiring building loans (29%) than previous-borrowers and much less interested in purchasing inputs (12%) than previous borrowers.<sup>15</sup>

### **PREFERRED TERMS OF AGRIBUSINESS CREDIT**

Agribusinesses would prefer long term credit (repayment in years, not months) ranging from 2 - 5-year terms, with half to 1-year terms deemed too short for projects to turnover profit to repay loans in time. Obtaining long-term credit would allow for the redistribution of credit on a short term/seasonal basis to farmers. Suppliers can then recoup credit during the harvesting/planting cycle

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<sup>11</sup> Question 55. Agribusiness Questionnaire 2017.

<sup>12</sup> Question 41. Agribusiness Questionnaire 2017.

<sup>13</sup> Question 41. Agribusiness Questionnaire 2017.

<sup>14</sup> Question 45. Agribusiness Questionnaire 2017

<sup>15</sup> Question 55. Agribusiness Questionnaire 2017



and make repayments on an annual basis but doing so would be extremely difficult if suppliers are subjected to monthly repayments.

### CHALLENGES ASSOCIATED WITH FORMAL CREDIT ACQUISITION

The majority (89%) of agribusinesses who had applied for loans in the past had those loan applications approved.<sup>16</sup> For those who did not, the primary reasons were: inadequate financial records (43%), inadequate collateral (29%), and inability to afford repayment (29%).<sup>17</sup>

As with farmers, the lack of applications to formal loan sources resulted from the perceived high costs and steep downsides to such credit. Applying for bank loans was seen as “tedious”, “not worth the effort” and the pre-conditions demanded by banks to transferring legal deed titles to land/property to the banks during the duration of the credit being granted, the amount of collateral/guarantee for the credit amount granted (up to five times the loan disbursed), unfavorable repayment terms (often in months instead of years) and amount of interest charged were seen as highly restrictive conditions that dissuaded most suppliers from applying for bank credit.

### SUPPLY SIDE

Afghanistan is a country with low levels of financial inclusion: only 10% of Afghans have an account in a formal financial institution. Thus, within the context of the financial exclusion prevalent in the country, the limited access to credit to support the agriculture sector is part of the larger issues of financial exclusion in the country. However, the lack of credit for that sector is also impacted by a variety of financial institution constraints, including the real and perceived risks in lending to the sector, and to a variety of cultural and religious constraints that have contributed to the limited uptake of formal financial services, including a mistrust of FIs by a substantial portion of the population.<sup>18</sup>

The formal sources of agriculture credit in Afghanistan, include commercial banks, MFIs, two finance companies and the Agricultural Development Fund (ADF). These providers had outstanding loans of AFN 6.188 billion in credit to the agriculture sector at year end 2017, a 27.5% increase from 2015. Agricultural lending now represents 11.3% of total formal sector lending in Afghanistan, compared to 8.7% in 2015. This growth is primarily attributable to increases in the commercial bank and MFI Ag credit portfolios, with only modest growth from the ADF. The ADF had limited its portfolio growth during the 2015-2018 due to deteriorating economic and security conditions that caused an increased risk profile for the agriculture sector. Commercial banks’ percentage of portfolio invested in Ag credit was 4.2% vs. 27% by the MFIs and 100% by the ADF. An increase in the 4.2% proportion of credit that commercial banks provide to agricultural credit can make a significant contribution to expanding access to Ag credit.

The limited availability of agricultural credit in Afghanistan remains a constraint to the expansion and improvement of the sector. Although the sector provides 22% of GDP and 78.6% of employment in

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<sup>16</sup> Question 44. Agribusiness Questionnaire 2017.

<sup>17</sup> Question 54. Agribusiness Questionnaire 2017.

<sup>18</sup> Mistrust of banks is traditional, in part because of perceptions of the conflict between bank practices and Islam, but has also been fueled by the failure of the Kabul Bank and the perception of a corrupt system.

Afghanistan where 53% of the population is rural,<sup>19</sup> its access to credit is insufficient to transform the sector into the motor of economic growth it should be for the economy. Exacerbating the situation is a variety of government, regulatory, policy, legal and judicial issues discourage the uptake of agricultural credit making it more difficult for lenders to provide credit, as well as limiting potential borrowers' access to it.

## NON-CREDIT FINANCIAL SERVICES

The availability of non-credit financial services is highly variable, depending on what types of businesses provide the services. Those services are limited to commercial bank and MFI bank branches.

**Savings Accounts:** Commercial banks and two microfinance banks, IIFC and FMFB provide formal savings services. Informal savings services are provided by Community-based Savings Institutions Programs (CSPIs). The CSPIs are both non-governmental and governmental organizations that offer some microfinance services along with other development activities.<sup>20</sup>

**Foreign Exchange Providers (FXP):** Foreign exchange services are more widely available as they are provided by a broad network of foreign exchange service providers, of which there are 1,776 registered with DAB. Commercial banks branches are included in those numbers.

**Money Service Providers (MSP):** Registered money service providers are also widely available with 1,082 registered MSPs distributed throughout the country. This number has more than doubled since 2012, and now there are estimated to be between 3,000 and 5,000 Hawala agents in Afghanistan, and according to DAB.<sup>21</sup>

**Electronic Money Institutions (EMIs) Registered Agents (Mobile Network Agents):** There are three Electronic Money Institutions in Afghanistan: Roshan (M-Paisa), Etisalat (mHawala) and AWCC (My Money). The total number of registered EMI agents is 2,032, and current DAB estimates conclude that around 1% of mobile phone users are using mobile money in the country.<sup>22</sup>

## AGRIBUSINESSES AS CREDITORS

*“It is not possible to run a business without loans. We directly lend to shopkeepers and they lend to farmers, who in turn repay after harvest. If we are lent money with easy conditions, then we can also lend to farmers on easy conditions. We are hopeful for the day when an easy system for lending money exists in Afghanistan.”<sup>23</sup>*

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<sup>19</sup> Afghanistan, CIA World Fact Book, May, 2018. Data excludes opium production.

<sup>20</sup> CSPIs offer financial services to their beneficiaries using several different models such as Village Savings & Loan Associations (VSLAs), Self Help Groups (SHGs), Community-Based Savings Groups (CBSGs), Savings and Credit Groups (SCGs) etc. Most often the group members save regularly and then borrow from the groups' internal savings funds.

<sup>21</sup> This is particularly true for transfers from Gulf countries to Afghanistan.

<sup>22</sup> The National Farmer Survey found that only 2% of the farmers with mobile phones (93%) were using mobile money

<sup>23</sup> Male, 43, Tractor Spare Part Supplier, District 5, Kabul Province.

Credit is given to farmers and shopkeepers as a means for suppliers to expand their business clientele. Despite the associated risks and difficulties as credit providers, suppliers are aware that without providing credits, it would not be possible for most farmers to carry out their agricultural activities. Credits are given based on trust and history with farmers - those who have been reliable are granted credit.

Amongst all the suppliers interviewed in focus groups, nearly 100% give credit to farmers. Only Kandahar suppliers shared that they don't provide credit anymore due to past problems. Others were selective about which clients are given credit. In the agribusiness survey, only 20% reported providing credit directly to farmers. Of those surveyed agribusinesses that do not provide credit, 54% said they either do not do business with farmers (39%) or that farmers do not approach them for credit (15%). Only 18% of suppliers said they cannot afford to provide credit to farmers with 27% refusing to offer credit to farmers, fearing repayment failure.

The amount of credit given is variable depending on the season and capacity of lender to provide credit during different seasons though suppliers share that they normally provide credit up to their maximum capacity. Agribusinesses typically lend at values between 25,000 AFN and 75,000 AFN.

Suppliers rarely, if ever, report charging interest, though all report charging a commission/markup on supply prices (*Murabaha*), ostensibly as a compensation for market fluctuations. In concordance with farmers' responses, suppliers report that an exclusive sales relationship is often a condition when providing credit to farmers.

The vast majority of credit was given for inputs (93%) and the remaining for machinery (7%). Credit is given primarily in the form of materials or supplies (e.g. feed, seeds, fertilizer, fuel, etc.), service (e.g. renting machinery, etc.) or sometimes cash loans. Some suppliers reported providing a mix of credit in kind and credit in cash. Contract terms were largely informal: 65% reported verbal contracts, 21% written contracts with collateral, and 14% written contracts with no collateral. Repayment was reported either as cash (49%), in-kind with crop or animals (44%) or loan amount deducted at point of sale (7%).

In general, suppliers shared that they are mostly confident of receiving repayments on time and if not, at the earliest opportunity that the farmer is able to do so. For the most part, creditors must recoup debts themselves, reporting little legal recourse to compel farmers to pay. Some creditors do report taking debtors to the police station and then the court, but outcomes are reported as lengthy and unfavorable.

Agribusinesses reported that they are providing credit at their maximum capacity, and that they would greatly appreciate any efforts from the government or NGOs to help them financially take on larger amounts of credit to provide in turn more credit to larger numbers of farmers.

### **AGRICULTURAL CREDIT SUPPLY: MARKET SEGMENTATION**

Most current agricultural lending goes to either large borrowers or to the micro loan market, with those loans representing 89.4% of total lending. A modest 10.6% of agricultural lending goes to the agriculture SME market, often referred to globally as the "missing middle".

With financial needs beyond the scope of MFIs and with little access to commercial bank loans, the SMEs have few places to turn. The ADF has provided lending to some in the sector and is expected to increase its exposure to it by the introduction of loans in the \$25,000 to \$100,000 range. Although finding financial solutions to address this key sector is a problem globally, the lack of access to credit for it in Afghanistan is a serious constraint to growth for the sector.

## FORMAL SUPPLIERS OF AGRICULTURAL CREDIT

### COMMERCIAL BANKS

The commercial banking sector consists of fifteen commercial banks including three state banks, nine private sector banks and three foreign banks. Commercial bank lending is very limited in general with the sector posting total loans to total assets ratio of 13.5% at yearend 2017, a remarkably low level. The total bank credit portfolio has even declined over the last two years, dropping from AFN 45.5 billion to AFN 42.7 billion, a 6.2% decline. A key indicator of the banks' lending, the total loan to total asset ratio, also declined from 16.6% as the total loans to total assets ratio to its current 13.5% level. During this period, bank deposits increased 24%, from 1.226 billion to 1.795 billion. The banking system serves 3,396,618 depositors and only 64,110 borrowers. These funds are clearly not being invested in the lending portfolio.

Credit to the agricultural sector is even more limited, although it did increase 46% from its very low base, and it now comprises 4.2% of the lending portfolio, including production, agriculture processing and other related agricultural activities. Most of the commercial bank lending that is provided is done by a few banks (including AIB, Ghazanafar and Bakhtar) and is focused on a limited number agricultural processors and exporters. Only 10% of the "agriculture portfolio" of the banking sector is provided to agricultural production and livestock.

Some commercial banks recognize the market potential that could exist in lending to the agriculture sector. However, they have very limited appetite for the risk it entails.

### AGRICULTURE DEVELOPMENT FUND

Disbursements as of December 2017 totaled \$103mm, including a \$22mm portfolio at that date. Because of the deteriorating economic and security conditions in Afghanistan, the ADF has followed prudent lending and asset allocation policies which have restricted portfolio growth. With a minimum loan size of \$100,000, the ADF originally exclusively targeted the larger end of the agricultural credit market with direct lending. Its recently introduced smaller loan sizes, (\$25,000 - \$100,00) are addressing the "missing middle", the agricultural SMEs that are too small for most banks but too large for MFIs. It has also introduced a special smaller loan for women, offering lower interest rates and maturities.

### MICROFINANCE INSTITUTIONS

The Afghanistan Microfinance Association (AMA) membership includes a variety institutional types, including: 4 microfinance institutions (FINCA Afghanistan, Mutahid, OXUS Afghanistan, and ExchangerZone); the IIFC Group (the national association of Islamic Investment and Finance Cooperatives); FMFB (a microfinance bank that also serves SMES); ARFC (an AISA registered non-bank financial institution); and 4 CSPIs (Afghanistan Women Council, Aga Khan Foundation, AREDP, and Hand in Hand Afghanistan). As of December 31, 2017, microfinance institutions reach 198,797 borrowers (39% women) and 326,523 savers (34% women) that are not served by the commercial banking sector.

The microfinance sector has 152 MFI branches<sup>24</sup>, of which 42 or 39% are in non-city districts. The MFIs with agricultural programs include IIFC, Mutahid, OXUS, FINCA, and FMFB<sup>25</sup>, providing loans from \$1,000 to \$25,000 for microfinance borrowers. ARFC, although also a member of the Afghanistan Microfinance Association, provides loans from \$20,000 to \$500,000. MFI lending to the agriculture sector reached AFN 2.9 billion or 27% of the entire MFI portfolio at year end 2017.

Capital constraints for the most MFIs can limit their portfolio growth, as only FMFB and IIFC mobilize savings. To address their capital needs, MISFA provides donor funded access to loans for its members. The MFIs are seeking to diversify their funding sources.

### RISK MITIGATION PRODUCTS

Commercial banks have expressed interest in risk mitigation products to support expanded lending to agricultural credit. Donors have recognized the importance of risk mitigation in encouraging lending to sectors with high risk profiles. The simplicity of using such guarantees, along with their cost, are key factors in attracting their uptake by financial institutions.

Two donor programs provide credit guarantees in Afghanistan:

- Afghanistan Credit Guarantee Fund (ACGF) provides both SME credit guarantees and technical assistance to its participating institutions. It has provided guarantees of over \$180mm to nearly 5,000 Afghan SMEs. Only about 15% or an estimated \$2.7 million of the ACGF guaranteed portfolio was in agriculture.
- USAID Development Credit Authority has provided \$24mm in credit guarantee support to SME lending in Afghanistan. Current data was not available on how much of DCA guarantees have been used to support agricultural SMEs, though FINCA, OXUS, and FMFB utilize the program.

### THE ROLE OF ISLAMIC FINANCE

Formal Islamic finance is still relatively new in Afghanistan; However, Islamic banking has traditionally been used in the daily lives of the Afghan people. The new Banking Law of Afghanistan addressed the lack of Islamic banking regulations. Guidelines and regulations have been developed by the DAB that should have a positive impact on attracting more deposits into the banking system, facilitate further implementation of Islamic banking, and assure that the system is consistent with Islamic finance. Current data does not yet demonstrate that has occurred: the amount of deposits increased 24%, while the number of borrowers increased only 1.7% between 2015 and 2017.

There is a clear stated preference by agricultural borrowers in Afghanistan for Islamic finance loan products. This is consistent with the more conservative nature of rural and agrarian populations in Afghanistan. Unfortunately, many mullahs lack any formal training in Islamic finance and advise those who seek their opinion that paying interest is not acceptable and therefore the proposed loans are

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<sup>24</sup> The 152 branch count include those of FMFB,

<sup>25</sup> FMFB also provides SME loans from \$25,000 to \$100,000, with SME lending comprising 17% of its total portfolio. Only 3% of its SME lending is to the agriculture sector.

not acceptable. Reaching the conservative Muslim masses and educating them in how Islamic banking differs from the conventional system is challenging.

After a slow start, Islamic finance is moving forward in Afghanistan. Commercial banks, Microfinance Institutions, and the ADF have all rolled out fully Islamic products to date.

### KEY CONSTRAINTS TO ACCESSING CREDIT

The 477 commercial bank branches provide a population/branch ratio of 115,011, which understates the problem, given the overwhelming concentration of branches in urban area compared to the 27% of the population living in urban areas. The cost to potential clients in terms of time and transportation is a disincentive to potential clients and contributes to the high levels of “lack of awareness” of available services. The widespread lack of basic information about credit: the benefits of credit to help build a business, access to information about who provides, and what is required to qualify for it is a significant barrier to both men and women whose agricultural activities could benefit from credit.

Given the low levels of literacy in general in Afghanistan (male: 52%; female: 24.2%), even lower levels of financial literacy in the country are to be expected. Although no data exists to measure it, those engaged in providing agricultural credit identify it as a limiting element both for the clients as well as for lenders. The lack of financial literacy impacts business skills and ability to seek credit in several ways. Efforts to improve financial literacy and business skills will require the work of all stakeholders for agricultural credit, as the effort that will be required is beyond the scope of a single type of stakeholder.

Farmers and agribusinesses often cite lack of collateral, or insufficient collateral to support their loans. Few farmers in rural area possess a court-registered deed of land (Sharia title deed), limiting substantially the number of borrowers who can access credit. Borrowers resent and do not understand the need for the overcollateralization frequently requested by lenders.

Complaints on interest rates, and their high cost are common from borrowers. The borrower’s business may not be capable of generating the income needed to repay the loan and interest. Complaints about high interest rates are more commonly directed at traditional credit products rather than Islamic. The interest rates charged by lenders reflect the elevated risk perception they have of agricultural loans, weak court enforcement, valuation issues, inability to recover the debt from collateral repossession, and a variety of other factors including security risks are factors.

Although FGD participants agreed that loan repayment was morally and socially necessary and many farmers go to great lengths to pay off their debts, there are perceptions that Afghanistan has a weak credit repayment culture. These reasons include relative newness off the organized banking sector and limited access to formal credit. Few farmers and agribusinesses have borrowing experience, and donor programs have created a “grantee mentality”, where borrowers expect and prefer grants.

A variety of social and cultural constraints limit the demand for credit. Opposition to borrowing can be based on both religious objections, as outlined previously, but also on cultural norms. Other cultural limitations particularly impact women, who may not feel that going into a financial institution

is socially acceptable. Although financial institutions have begun to recognize these issues,<sup>26</sup> much more needs to be done to overcome the cultural constraints.

### **DIGITAL FINANCIAL SERVICES AND IMPROVED ACCESS TO AG CREDIT**

Although introduced to Afghanistan in 2007, mobile money services have failed to reach national scale. The three services offered by electronic money institutions, provide deposits, cash withdrawals, credit/loan options, and alternative delivery channels for a variety of commercial users.

The key challenges for scaling up the use of mobile money include: Lack of inter-operability and no single point of integration with MFIs and banks, high price of services, very weak/costly agent networks, no user-friendly interface for users, poor liquidity management, and narrow products and services due to limited eco-system development.

Solutions are being developed that will address the needs of farmers and rural populations. Payment Service Providers (PSP), banks, MFIs, and the Afghanistan Payment System can work together to provide a variety of delivery channels for consumers, intermediaries and farmers to interact among themselves and with the financial institutions.

Although the proposed improvements to mobile money will address several the weaknesses of the current platforms, more work will be required to tackle the significant challenges to agricultural and rural uptake of such channels. Solutions for these constraints must be found if up-scaling usage is to occur in rural and agricultural areas.

### **RECOMMENDATIONS**

The below observations and recommendations come from the ACE-II team with support from RSI, Alcis, and other key stakeholders, drawn from the findings of the National Survey.

### **OBSERVATIONS**

As a point of departure, several observations were delineated by the ACE-II team. These observations are critical to understanding the conditions and environment in which the recommendations must function. Some of the most poignant observations include:

- Unrealistic expectations on behalf of potential borrowers: interest-free and fee-free products, no collateral, and open credit application processes.
- Low levels of both literacy and financial literacy, and an extremely low financial inclusion rate.
- Relationships: the importance of trust, relationships, and communal norms in establishing credit and financing.
- Women and Gender: the legal, cultural, and religious obstacles that face Afghan women farmers and agribusinesses are even more severe than the overall population.
- Grantee Mentality and Weak Repayment Culture: donor dependency has created a culture of expectation.

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<sup>26</sup> As an example, FMFB recently opened its first women's branch, staffed with women and providing a play area for children.



## RECOMMENDATIONS

The recommendations below have been laid out by Institutional Recommendations, focusing on the government, donor community, and private sector; and Financial Institutions, focusing on the role that FIs can play to expand agricultural credit nationwide. These recommendations speak directly to the findings of the National Survey, but are meant to exist within the environment of the above observations.

### INSTITUTIONAL RECOMMENDATIONS

#### Government:

- **Policies:** There is a need for a collaborative intra-government effort to develop “pro ag credit policies”.
- **DAB Regulatory Impact:** DAB regulations can have a negative impact on institutions’ capacity to provide agricultural credit, given the impact of asset classification, collateral requirements, and sector limits on lending.
- **Financial Inclusion:** Requires a significant scaling up of efforts to reach the excluded with a variety of credit and deposit services.
- **Improving Women’s Access to Credit:** Coordinated government efforts are needed to improve women’s access to credit to support their agricultural activities. Women borrowers account for less than 10% of agricultural credit
- **DAIL:** Expansion of DAIL services to include credit and finance information through technical support to farmers.
- **Improving Understanding of Islamic Finance:** The Ministry of Haj and Religious Affairs has an important role to play the provision of training for mullahs on Islamic Finance.

#### Donors:

- **Inclusion of “Access to Finance” Components in Agricultural Projects:** Donor support must focus on sustainable agricultural credit approaches through the inclusion of a strong “access to finance” component.
- **Long Term Finance Needed for Capital Investment:** Finance options are needed for longer term investments, including large scale irrigation projects, land conversion, and orchard development.
- **The “Missing Middle”:** Capital for Agriculture SMEs: Support lending to the SME agricultural sector should be an important area of production, revenue and employment growth for the country as a whole.
- **Support to MFIs for Scaling Up Agricultural Lending:** MFIs will require access to funding to strengthen their internal operations, technology platforms, outreach, and initiatives.
- **Help for the Small Subsistence Farmers:** Savings groups, self-help groups, and other similar organizations have a large role to play in helping subsistence farmers.
- **Risk Mitigation:** Donor provision of risk mitigation for agricultural lending can help to increase commercial bank and MFI lending to the agricultural sector.
- **Awareness, Outreach and Capacity Building:** There will be no dramatic increase in the uptake of agriculture credit until more farmers and agribusiness have the basic knowledge and skills that will facilitate access to credit.

#### Private Sector:

- **Support of Outreach and Awareness Activities:** The private sector incorporation of activities that support outreach, awareness and capacity building on financial topics could support increased access to credit.
- **Access to Quality Business Development Services** The expanded availability of business development services is vital to improved performance of the agriculture sector.



## RECOMMENDATIONS FOR FINANCIAL INSTITUTIONS

The National Survey highlights significant gaps that exist between demand and the availability of agricultural financial services provided by formal institutions<sup>27</sup>. There are untapped financing opportunities across multiple value chains for those institutions willing to respond to the unique needs of agriculture. However, providing appropriate financial services and lending to farmers and agribusinesses presents challenges that multiply as financial institutions move from larger enterprises and high value chains to smallholder farmers and lower value crops.

### Key recommendations:

- When financing agriculture, fully understanding the needs and risks of the client, business activity, and sector is crucial.
- There is a critical need to build institutional capacity to suitably address the financing needs of farmers and agribusinesses.
- Increased familiarity with the ADF through promotional materials and outreach.
- Institutions should consider developing financing products that reflect the unique characteristics of agricultural production and upstream processing. Lending institutions need to better understand the income and expenditure cycle and the challenges faced by farmers and agribusinesses when they make loan repayments.
- Given the country's very significant environmental and infrastructure constraints, added to the issues around the cost of credit, institutions should place a high priority on implementing distribution models that offer effective and efficient solutions to agricultural clients — including mobile banking, branchless banking, and mobile payment systems.
- To increase accessibility, financial institutions could open more branches in rural areas. By rather focusing on low-cost distribution channels, financial institutions can reduce transaction costs through efficient loan disbursement and repayment systems.
- Institutions need to have a well thought and far-reaching communications strategy to support entry into or expansion of their agricultural credit programs.
- When pricing their financial products, institutions must properly understand and find a balance between the need to cover costs through revenue with the need for simplicity, transparency, and affordability for farmers and agribusinesses.

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<sup>27</sup> Banks are almost entirely absent from lending to the sector and only in rare instances are willing to finance large agribusinesses. Due to the typical nature and cost of their services, MFIs have tended to provide rural financial services that are most appropriate for nonagricultural purposes.