Canadian International Development Agency’s (CIDA) Role in Enhancing Smallholder Food Security:
*Insights from the Informal Economy*

By Carlyn A. James
In the wake of the food price crisis of 2007-2008, hunger and overall food security remain a major problem throughout the developing world. Particularly in Sub-Saharan Africa, where small-scale farmers comprise 65 percent of the working population, systemic shocks to the environment or to the global market result in extremely devastating effects on national economies. For the small-scale farmer, global crises which increase risk and uncertainty exacerbate an already precarious financial position.

The provision of small-scale financial services - microfinance - has been championed as a major social and economic development tool which could help lift small-scale farmers out of dire financial straits. Since the boom of microfinance in the 1990s, it has become part of the *lingua franca* of global development. Still, in a region like Sub-Saharan Africa where awareness of the microfinance industry is strong, microfinancial products and services have yet to become a fixed part of people’s financial lives. Though it is a relatively new industry, microfinance has followed the pattern of previous formal financial institutions by failing to serve the largest employment sector in Sub-Saharan Africa, the agricultural sector. It is for this reason that most producers are not involved in the formal economy at all, but instead turn to friends, family, and other members of their social network to ensure that their daily financial needs are met.

Despite their relatively low income, small-scale producers (in Sub-Saharan Africa, most agricultural workers cultivate less than two hectares of land) are often faced with expenditure needs which are larger than that to which they normally have direct and convenient access. Particularly in East Africa where social life is deeply embedded in complex social networks, peer-to-peer lending has been the preferred way of banking since pre-colonial times (pre-colonial transactions were largely non-monetarized, so materials and time most often served as the media of exchange). In the academic literature and in common parlance, this collection of unregulated, untaxed exchange relations is referred to as informal finance.

Policymakers have entered the conversation on global microfinance largely in their efforts to build a legal and regulatory environment that allows for innovation, while maintaining standards of efficiency, accountability, and transparency. Underlining the argument in this policy brief is the idea that widening the conversation on microfinance to include an understanding of rural livelihood strategies can actually allow the industry to become more contextualized, more localized, and ideally, have much more effective outreach strategies on the ground level. The informal economy of East Africa has long been central to the livelihood of smallholder farmers. Moreover, it has been central to their ability to innovate, respond to threats, and plan for the future. Formal sector finance, on the other hand, is often too inflexible, inaccessible, and incomprehensible to meet smallholder farmers’ needs. Primarily, this policy brief seeks to bring CIDA’s attention to the importance of the informal sector to the lives of smallholder farmers in East Africa, and to how the formal sector can benefit from understanding the centuries-old informal money-sharing mechanisms that exist among smallholders.
Policy Goal
To strengthen the capacity of formal sector microfinance to best serve smallholder farmers in the East African subregion by highlighting the strengths of informal sector strategies, with specific efforts being made toward enhancing the accessibility, suitability, and diversity of microfinancial products and services.

Overall Significance

- The global microfinance industry’s growth has been staggering since the early 1990s. For example, in 1996, MFIs served about 100,000 Ugandans. By 2006, MFIs served approximately 3 million Ugandan clients.

- Most of smallholders’ total income is spent on daily household expenses such as foodstuffs, and studies show that women’s income goes directly to secure the well-being of the household. Therefore, increasing smallholder access to safe, cost-effective, flexible finance could have a direct impact on household food security, as women would be likely to put their income directly toward sustaining the household.

- Regulation and supervision of MFIs has become a global issue as a result of high profit margins and increased rates of private funding since the early 2000s.

- Across Sub-Saharan Africa, women lag behind men in holding accounts at formal financial institutions. Overall, only 21.5% of women in Sub-Saharan Africa hold accounts at formal financial institutions, compared to 26.5% of men in the region.

- According to the World Bank Group, there is a major unmet demand for microfinancial services in the developing world. Despite some success stories, MFIs probably reach fewer than 5 percent of potential clients.

- Because most Sub-Saharan African economies are “agriculture-based”, the rural smallholder population accounts on average for almost 70 percent of the total population. Still, they remain largely “unbanked” and more data is needed to understand why this is the case and where smallholders are currently accessing financial services.

- A 1% growth in GDP associated with agriculture would increase the expenditures of the poorest 30% of the population approximately 2.5 times more than it would in any other sector (Christen 2012).

- Rapid urbanization (and rapid expansion of off-farm work) in recent times has left many smallholders with an increased area to be cultivated per worker. Labor-sharing systems and other financial innovations can assist in making this trend more manageable.

- Many microfinance institutions across Sub-Saharan Africa have been replicated based on models which originated in South Asia. As a result, they have largely failed to
contextualize their products and services according to the needs of the rural Sub-Saharan client base.

**CIDA’s Interest**

- Canada’s Food Security Strategy is rooted in interconnected economic, land, and rural finance-related issues. Making effective, evidence-based policies on these issues in East Africa requires an in-depth understanding of how these systems interrelate and operate at the ground level.
- CIDA has been supporting microfinance for over 30 years, affirming its special role in building sustainable livelihoods. CIDA has expressed its commitment to stepping outside of strictly financial services and providing skills training, social intermediation, literacy training programs, and more.
- In 2008, Canada untied 100% of its food assistance budget, driving food security to priority status and further proclaiming its commitment to issues surrounding food security.
- Canada is a founding member of the World Bank Consultative Group to Assist the Poor (CGAP), which is committed to helping the global poor access financial services. It is vital, however, that this commitment be carried into the future with a more nuanced perspective of existing local financial demands. Microfinance must not be blindly imposed as a model, but must rather be a response to the existing demands on a local level.
- Canada is openly committed to sustainable and equitable progress throughout the world. CIDA incorporates this into their programming by insisting that sustainable, equitable development is not possible without addressing issues through a gendered lens (i.e. taking into account differences between genders). Finance tends to be a highly gendered issue in rural Sub-Saharan Africa, which is why this research is crucial to CIDA’s work in the region.

**Policy Recommendation**

CIDA should assist microfinance institutions in East Africa to be much more effective in their outreach to underserved rural populations by recognizing the unique financial needs of smallholder farmers. That is, East African farmers’ active engagement in informal finance can offer important insights into making more suitable products and services in the formal sector. CIDA should find ways to lower interest rates, make banks and microfinance institutions more accessible, incorporate gender-specific products/services, allow for repayment schedules to be more flexible, and broaden collateral requirements. Because farmers’ financial lives are seasonally dependent, microfinance will be most effective only when it offers flexible, cost-
effective, simplified products/services to low-income rural clientele. While this policy brief focuses on the challenges of East African smallholders, these issues bear implications which are relevant to the financial lives of smallholders across Sub-Saharan Africa.

**INTRODUCTION**

*Context*
This policy brief was prepared as part of the CIDA Research to Practice Fellowship, which supports academic research in an effort to develop evidence-based policy solutions. This document presents data based on both field research and scientific literature with the main objective of introducing CIDA to the ways in which it can address the faults of formal microfinance in servicing smallholders in East Africa by looking first at the strengths of the deeply-rooted informal economy. Furthermore, exploring this topic will provide parallel insights for CIDA’s interests in agricultural finance throughout Sub-Saharan Africa.

*The State of Microfinance*
For the two billion people who live and work on smallholder farms in the developing world, reliable access to capital is of paramount importance. Weak institutional support and restricted access to markets are oft-cited as barriers against greater yields in smallholder farming. Microfinance, the small-scale provision of financial services (including but not limited to credit, savings, and insurance), has been hailed as a stabilizing structure that provides low-income clientele with a cost-effective way of investing, mobilizing savings, or insuring themselves against future vulnerability. Moreover, microfinance is meant to provide low-income clientele with an appropriate suite of financial products and services that is scaled according to need. Microfinancial services are commonly dispensed through microfinance institutions (MFIs), which differ from commercial banks most prominently, of course, in the

**TABLE 1: FORMAL FINANCIAL MARKET**

| Microfinance: Financial services for poor and low-income people |
| Rural finance: Financial services used in rural areas by people of all income levels |
| Agricultural finance: Financing of agriculture-related activities, from production to marketing in rural and urban areas |

scale of their account and transaction services. MFIs offer small-scale services, and often target low-income or non-traditional clientele (e.g. women, small-scale farmers). MFIs traditionally provide a broad range of products and services, including but not limited to savings facilities, microinsurance policies, and even financial planning and career training programs. Moreover, many MFIs openly commit to humanitarian social objectives through outreach, advocacy, and awareness programming, further setting them apart from traditional banks. In the 1990s, many even claimed that microfinance had the “potential to do in finance what the green revolution has done in agriculture—provide access on a massive scale to the poor” (Otero and Rhyne 1994). Apart from its primary focus on microenterprise development, the global microfinance industry has also had proven success with facilitating an increase in savings strategies among the poor who generally do not have long-term monetary savings plans. Safe and easily accessible deposit facilities, along with general microcredit products (which help generate surplus, making monetary hoarding and savings possible), have become a baseline product for MFIs throughout the developing world. Researchers have shown that it is saving strategies and savings mobilization, not credit, which ultimately provide the poor with the leverage needed to lift themselves out of poverty (Buckley 1997, p. 1085). Apart from savings and credit, insurance policies have been much less common among the poor. As most of the global poor are farmers, microinsurance policies would need to account for unexpected environmental challenges, crop pests and diseases, and other risks. Due to the small-scale nature of microinsurance premium payments and the often harsh, high-risk environments in which the global poor live, microinsurance policies have been difficult to streamline in a way which still allows for the basic coverage of operating and transaction costs. In more recent years, the burgeoning microfinance industry has come under major scrutiny as a strategy for social and economic development (Bateman 2010). Due to small loan sizes, MFIs often charge relatively high interest rates to balance transaction and overhead costs. Intense criticism also surrounds MFIs’ concern with profitability, driving low-income clientele to think of MFIs no differently than large-scale commercial banks.

Many consider the microfinance industry to be part of a larger movement toward greater “financial inclusion” to incorporate more traditionally disadvantaged clients. Traditionally disadvantaged clients include small-scale farmers, women, and youth. Financial inclusion policies typically result from state-driven intervention or voluntary efforts in the banking community, but have not been entirely successful in East Africa. Still, the resounding conclusion today seems to be that the microfinance industry represents only one of many strategies aimed at the immense problem of global poverty. It is also worth noting that harnessing microfinance in a way which makes it effective and sustainable in its communication and outreach with the poor requires a stronger regulatory framework. That is, effective outreach in microfinance not only requires a more acute understanding of gender and rural/urban differences in financial needs—issues which will be discussed in this policy brief—but it also requires a stronger
regulatory framework which further defines the role of NGOs and governments in building a financially inclusive ecosystem (Leeladhar 2006). NGOs and governments are well-positioned to curb exclusive banking activities in that they can redirect the industry toward market-led demands and more flexible lines of products/services which better suit the local clientele. For instance, identification requirements, high interest rates, gender-specific signatory requirements, collateral requirements, and physical locations of banking institutions often pose barriers toward effectively reaching out to rural clientele. These barriers represent opportunity costs that “time-poor” and “resource-poor” smallholder farmers are simply not willing to endure.

**Defining Food Security**

The World Food Summit of 1996 defined food security as existing “when all people at all times have access to sufficient, safe, nutritious food to maintain a healthy and active life.” Largely considered to be the three pillars of food security are access, availability, and use. The 2007-2008 food crisis followed global financial collapse, leaving many of the world’s producers in dire positions. Because agriculture remains the dominant employment sector across the developing world, spikes in food prices and global financial shocks result in devastating circumstances, increasing the vulnerability of those already in fragile financial circumstances. Moreover, smallholder farmers cannot wait for best prices to come for their crops, sometimes being forced to sell at lower prices to ensure they make immediate profit. Farmers are not only producers, but also consumers, and high cereal prices force many low-income farming households to purchase lower quality foodstuffs, ironically leaving many farmers with poor nutrition levels. Increased risk of malnourishment and undernourishment threaten farmers’ overall productive capacity on and off the farm. Despite their importance in regional food production, smallholder farmers represent the majority of the world’s undernourished population (UN Millennium Project 2005). In the wake of a drought and post-election violence in 2008, the Kenyan government declared a national emergency with 10 million citizens at risk of food shortages. In early 2009, the government appealed for USD 400 million in aid. Unfortunately, ground-and-satellite-based systems for forecasting weather and seasonal agricultural output (as are present in countries like India) are rare in East Africa.

For commercial banks who look to lend to rural clients, fluctuating commodity prices also make for a riskier venture. For farmers who look to receive credit from formal institutions, weak infrastructure (limiting access to input/output markets), various trade restrictions, and a fragile natural resource base exacerbate smallholder food insecurity by limiting developing world farmers’ return on investment. In East Africa, land subdivision, land degradation, and land alienation have long been major issues related to food security. Land is often subdivided and titled due to the high demand for arable land, typically leaving the cultivable land in small and
uneconomic units (Brixiova, Kamara and Salami 2010). Not only do smallholder farmers typically have smaller plot sizes, but they are also faced with infertile soils due to erosion (a major problem in East Africa). These land inefficiencies are driving many East African smallholder farmers to sell their lands in the hope of migrating to urban areas and finding wage labor. Statistics show that this trend has not been notably profitable in the short- and long-run for such farmers, leaving them less self-sufficient when it comes to food security (IFAD 2013).

Exploring the Link between Microfinance and Smallholder Food Security in East Africa

Since 2000, most Sub-Saharan African countries have suffered absolute declines in agricultural production and environmental conditions, despite consistent efforts to improve farming practices, water harvesting, and natural resource management (UNDP 2008). In a region where most of the population is employed in smallholder agriculture, and more specifically for those smallholders who face the often fierce environmental challenges of the East African landscape, safe and reliable access to financial services can have an enormous impact on food security at the household and community levels. This is because food accounts for a very high portion of the weekly and monthly expenditures of rural East African households. Most smallholder operations occur in farming systems that see the family as the center of long/short-term planning and decision-making. They also operate within a broader network of social relations at the community level. It is for this reason that engagements with smallholder food security must begin at the household level, because innovations at this level will eventually affect the complex community networks in which African households are deeply embedded.

Since the early 2000s, several East African governments (including Kenya, Tanzania and Uganda) have announced microfinance as a pillar of their agricultural and rural development strategies. As it stands, financial services are notoriously scarce for the agricultural sector in East Africa. In Uganda, for example, only 38% of Ugandans have access to financial services (with an estimated 21% accessing formal and 17% accessing informal services). Furthermore, the agricultural sector represents approximately 40% of GDP, but receives only about 10% of all credit that is dispersed (International Trade Centre 2011). Why does credit remain unavailable to the sector that is the bedrock of economic development in most East African countries? What can CIDA do to ensure that there are safe credit, savings, and insurance mechanisms for rural populations in East Africa? The answer to these questions is complex and certainly depends on the country, but this policy brief seeks to provide some alternatives.
Obstructions in the Microfinancial Landscape

Reflecting the immense complexity and diversity of microfinance—as an industry, a socially conscious business model, and a market based on reciprocity—this policy brief will follow FJA Bouman (1994) in employing the term “landscape” to describe the suite of products, services, pathways, and techniques which exist to meet small-scale financial needs. Historically, microfinance as a development tool has been targeted toward financially and socially empowering the poor. There may be a lack of consensus on whether or not microfinance truly empowers the rural poor, but the question posed here for CIDA’s interest in the East African context is whether or not it is well-suited to smallholder farmers’ needs as they work toward enhancing their own food security (UN Women 2009).

While the microfinancial market represents only a portion of the global formal financial market, its presence as an employer and service provider in the formal economy of East Africa is quite strong. East African governments have started strongly promoting the financialization of their economies, and the growth of microfinance institutions in this region has been enormous over the past decade (International Trade Centre 2011). This is not to say that microfinance is preferred or even commonly used by the general population, but simply to note that it has become a permanent and prevalent fixture in the financial landscape of East Africa. This is in contrast to the financial landscapes that we see in much of the Western world, for example, where microfinancial options are quite limited. Furthermore, while microfinance serves only a portion of those active in the formal economy, there are a multitude of small-scale financial operations which occur within extensive unregulated (at least by the government), untaxed informal networks.

Informal vs. Formal Microfinance

The microfinancial landscape of East Africa is dichotomous, largely divided into formal sector operations and informal operations. Though microfinance emerged in response to an ineffective and exclusive formal financial system, formal sector microfinance still does not seem to be as cost-effective and convenient as informal finance (UN Women 2009). Microfinance in the formal financial sector is nationally and internationally regulated, involves heavy documentation and recording, and receives funding from public and/or private sources. In East Africa, formal microfinance is most typically provided through savings and credit cooperatives (SACCOs, also known as credit unions), MFIs, formal banks, or insurance companies. Informal microfinance, conversely, is largely unregulated by the national government and not included in calculations of the GDP. Informal microfinance is much more multifarious than formal microfinance, being delivered through savings/credit clubs, deposit collectors, interpersonal reciprocal lending, and much more. Informal microfinance in the East African context may also be provided in more traditional bank-like settings, such as through unregistered village banks,
accumulating savings and credit associations (ASCAs, common in Uganda), and financial services
associations (FSAs, common in Kenya) (International Trade Centre 2011). Informal forms of
savings, credit, and insurance are understood by smallholders to be both more convenient (i.e.
low transaction costs), more appealing (i.e. social benefits of working with friends/neighbors),
and more flexible. Contrary to widely-held beliefs in the West, East Africans strongly believe
that relying on others when it comes to money-sharing actually enhances the likelihood of
repayment and profit. East Africans consider private loan-taking to be a high-risk venture, while
seeing working with others as increasing the capacity to generate income. Furthermore, East
Africans expect exchange relations to strengthen existing social relations or establish them
where they are absent. Being indebted to someone is in fact a mechanism for social cohesion in
East Africa, because it keeps the relationship “open” and “active” (Burman and Ardener 1996).
Policymakers should not discount the importance of social benefits when it comes to banking
and money-sharing in East Africa. Indeed, there is a long correlative history between financial
gains and social capital gains in this region.

Much of informal money-sharing in East Africa is carried out in a group setting, reflecting “the
communitarian African spirit” and a deep-rooted cultural theme of mutual reliability (Kinyanjui
2012, p. 35). These groups, largely referred to as rotating savings and credit associations
(ROSCAs) in the literature, are not licensed to operate as financial institutions, but can register
themselves under certain East African governments to receive benefits (e.g. grants). ROSCAs
are variably referred to as “merry-go-rounds” or chama in East Africa, though they exist across
Sub-Saharan Africa under the name of tontines, esusu, and others. Moreover, these groups are
highly diverse in composition and operation. They range in size from about 5-8 people up to
200+ people. Some are externally motivated by development projects or government funding,
while others are formed organically and in an ad hoc manner according to shared
needs/interests. ROSCAs are sometimes gender-controlled, with women’s groups being the
most popular form in East Africa. Informal groups have a long history in the East African
context, exchanging labor, knowledge, capital, and materials (and often, combinations thereof).
For the sake of this brief, however, our discussion will be restricted to groups that are primarily
or exclusively involved in monetary exchange.

With scattered regional efforts to increase “financial inclusion” for non-traditional clients (e.g.
Kenya’s Finance Act of 2010, which made provisions for mobile banking outposts in remote
areas), formal banking in East Africa is still not adequately or appropriately servicing the
smallholder population. East African women are statistically more active in informal banking
activities than formal banking, and at significantly higher rates than their male counterparts
(Rutherford et. al. 1999). As most women are smallholder farmers, there is a clear and present
need for microfinancial products and services that adequately address any gendered
differences in financial needs. Several studies have shown that roughly 90% of women’s income
funnels back into the household (International Trade Centre 2011). Therefore, if CIDA seeks to contribute directly to food security at the household level, it is worth understanding which household members manage the finances, and exactly how he/she/they access them in times of need.

**Gendered Aspects of Smallholder Household Expenditures**

Rural livelihoods in East Africa center around income from smallholder farming, a mixture between commercial farming (usually through brokers or directly to friends and neighbors) and subsistence farming. Around 80 percent of smallholders in Sub-Saharan Africa farm less than 2 hectares of land. Division of labor on the farm is generally balanced and shared between the genders for both subsistence and cash crop production. With respect to the income produced from such activities, however, cash crop and any off-farm income tends to be controlled by men.\(^1\) Because cash crop and off-farm incomes are controlled by men, they tend to be more comfortable dealing with large sums of money than women. Research shows that smallholders overall, however, are not comfortable controlling very large sums of money, but that men are more likely than women to seek higher loan sizes.\(^2\) In Susan Johnson’s 2004 analysis of gender norms in Kenyan financial markets, she reported that in higher-income smallholder households, it was most likely that husbands would regularly give their wives a portion of the income to use as they wish. This money was typically spent on personal expenditures, household items (e.g. sugar, utensils), and other modestly sized “assets that men tend to overlook” (p. 1364). In less well-off households, wives are given money from their husbands upon request and according to need, although women reported that this was not always sufficient to meet the needs of the household. At all income levels, it is understood that finances related to basic household assets and day-to-day household needs tend to fall under the responsibility of the wives. Men in both better off and less well-off households, complementarily, tend to consider school fees, farm inputs, and major household assets to be their responsibility when it comes to expenditures. Therefore, they tend to manage larger sums of money than women at any given time. In conclusion, in order to deepen the effectiveness of microfinance outreach, policymakers must incorporate a gender-sensitive perspective. For instance, it is clear that smallholder women need regular access to small sums of money, and similarly need to deposit small sums of money regularly in order to save for the long-term. Moreover, land ownership rights are highly gendered in East Africa, and financial institutions should offer options that account for these differences. Delivery channels also sometimes benefit the genders differently. As women smallholders mostly cultivate and maintain the household, their mobility tends to be less varied.

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\(^1\) The term “control” here is used to mean that men are the first recipients of the income and seem to have primary decision-making power over how it is distributed.

\(^2\) “Large sums” here is relative, but generally, smallholders do not deal with sums any larger than $50,000 Ksh ($590 CAD).
than that of men. Alternative delivery mechanisms should be further explored, such as branchless and mobile banking.

**Gendered Preferences in Informal Microfinance**

Because informal microfinance is flexible and adaptive by nature, it has evolved with East African societies as they have monetarized and financialized over time. Informal microfinance, particularly group-based lending schemes, has a centuries-old history in the East African context. Apart from being a center for income generation, money-sharing groups can act as forums for social, civic, and intellectual engagement. They have long been documented as trust and solidarity mechanisms, enforcing a general sense of commitment and unity. In practical terms, this results in relatively stable membership and the very low default rates which are characteristic of these groups (Ardener and Burman 1996).

Returning to household expenditures, recall that gender plays a role in how much money is passed through which hands, and for what expenses. It appears that this gendered management of household income further influences smallholder interactions with the microfinancial sector. That is, the genders interact with (and within) the informal and formal microfinancial sectors quite differently. Most East African smallholder men are responsible for purchasing/renewing/balancing farm inputs, major household assets, and school fees. Because these expenditures tend to be seasonally-dependent, men do not require constant access to credit or savings facilities. When money from their husbands is not enough, and often times it is not, women convert their periodic small sums into a steady flow of larger funds by relying mostly on informal money-sharing schemes. Unlike men, women desire the unmitigated access to financial services that credit/savings clubs and other informal mechanisms provide (Johnson 2004, p. 1367). Due to of their responsibility over basic household needs and upkeep, smallholder women also prefer the regularity of informal group lending schemes. They also tend to find informal groups to be more flexible in scale, as women deal with relatively small sums of money in the day-to-day, but sometimes face sizeable unexpected costs for family illnesses, weddings, graduation, etc. According to one study, Kenyan men reported that, if they were to be involved in informal money-sharing groups, they preferred to develop their own all-male groups because women were more concerned with “small things,” whereas they wanted to accumulate funds for larger investments (Johnson 2004, p. 1368). As men seek to develop larger sums of money, the cost-benefit tradeoff becomes less agreeable in informal group settings.

Defaulting in an informal group can have grave social consequences for a member due to the highly social nature of these groups. Social learning is especially prominent in women’s groups, and women seem to openly value this aspect of the groups. As one study describes, “This social context enables them to learn how to speak properly in public and the older women educate...
the younger women on how to handle things in their homes and discuss problems with their husbands” (Johnson 2004, p.1368). If a member defaults in a women’s group, she is shamed among her peers. Men’s groups reportedly do not find social shaming to be effective, due to their more “individualistic culture” (p. 1368). As follows, the prevalence of all-male money-sharing groups in East Africa is remarkably low. Compounded with a competitive atmosphere (associated with managing larger sums of money) and the ineffectiveness of social shaming, informal group-based money-sharing seems to be an inappropriate venue for smallholder men to access credit, savings, and insurance services.

**Informal Sector Influences on the Formal Sector**

Although informal groups do not seem to suit the financial needs of smallholder men, there are important takeaways from the success they have had among smallholder women, who seem to be most the responsible for household food security. For instance, informal credit unions, village banks, and cooperatives are bolstered by community ownership. Community members feel a sense of ownership, accessibility, and trust related to something in which they have a voice. CIDA should assist in transferring this philosophy of bottom-up ownership to the formal sector. One example where this has already been successful is in the case of the Kenyan Rural Enterprise Development Bank (or K-REP), a longstanding MFI which has developed a new program to support (in the form of initial physical assets and ongoing audit and training services) community-owned and operated village banking associations. These local banking branches (known as “financial service associations” or FSAs) are dedicated to local-level, group-based microfinancial services, being located not always in a high-traffic area but in areas where they are most needed. For example, the Bumala FSA branch in Kenya’s Western Province is located in an area where the nearest commercial bank branches are about 25 km away (Dupas and Robinson 2013). These branches often operate in the local language and, with the help of K-REP, are able to operate with minimal processing/legal fees incurred by the client. By applying this framework of locally-appropriate, low-cost banking supported by a licensed commercial MFI, remote areas throughout East Africa could be better serviced. Moreover, because the flexibility of informal group-lending seems to be a major factor in smallholder women’s preference thereof, the more locally-owned and small-scale an MFI can be, the more flexibility it may have in terms of seasonally-dependent loan products and services.

**Where does the Formal Microfinancial Sector Fall Short?**

In contrast to widespread informal sector activity among smallholder women, interactions with formal microfinance seem to be quite low for both men and women. In 2012, The African Development Bank reported that the number of Sub-Saharan Africans taking a loan from a
formal financial institution was only 5.2% for men and 4.3% for women, with loans coming primarily from “family or friends”: 48.3% for men and 45.3% for women (AfD Bank 2012). According to research conducted by the International Trade Centre, most people in East Africa do not save or borrow from any formal microfinance sources. This begs the question: What are the forces at work which deter people from the formal bank sector? Alternatively, have people been excluded from formal finance or is there evidence of self-exclusion? Social scientific research has much to say in response to such questions. First, as mentioned, it is well understood that women who lack access to formal property rights or asset ownership due to gender norms are unable to engage effectively with banks or other formal lenders that require collateral. Additionally, banks have traditionally been concentrated in urban centers. Therefore, this is some evidence in support of the idea that more low-income, more rural populations have been excluded from formal banking. Still, we also see many people (mostly women) self-excluding from formal finance due to financial illiteracy, intimidation, negative perceptions, and more (Mosley and Hulme 1998). Therefore, to address some of these issues, policymakers will need to identify context-appropriate ways that make banking much more approachable. In some places, this means simply speaking the local ethnic language. This can also mean simplifying legal and financial jargon so that people do not feel as though they are not fully informed when making decisions about their own finance. East Africans also seem to respond more to outreach that involves some kind of genuine community engagement, because it builds trust. While most commercial banking institutions focus on marketing/promotions outreach, there is space to think outside of the box here. Considering the fact that most microfinance institutions have a socially conscious bent, they are poised to benefit from more long-term investments into the local community (e.g. financial literacy courses or job training programs) rather than strictly focusing their outreach/programming budgets on marketing.

According to a 2007 FinScope survey conducted in Uganda, 47% of the smallholders who access credit were doing so informally from shops, wholesalers, or agro-vets. The percentage borrowing from banks, MFIs (7%), and SACCOs (4%) was much lower (International Trade Centre). Smallholders’ savings and microinsurance activity seems to fall into the same pattern. See the table below for a snapshot of smallholders’ activity in both the informal and formal microfinancial sectors.

<table>
<thead>
<tr>
<th>Source of Credit</th>
<th>Rural (%)</th>
<th>Urban (%)</th>
<th>Male (%)</th>
<th>Female (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shops, wholesalers, agro-vets</td>
<td>47</td>
<td>48</td>
<td>47</td>
<td>46</td>
</tr>
<tr>
<td>Family, friends</td>
<td>21</td>
<td>23</td>
<td>24</td>
<td>20</td>
</tr>
</tbody>
</table>
## Smallholders are not the Archetypal Microentrepreneur

Of the world’s 1.6 billion working poor, one study carried out by global consulting firm Oliver Wyman in 2008 estimates that just over 10 percent are classic microentrepreneurs. That is, they are microbusiness owners seeking small-scale forms of credit from a banking institution. Smallholders are much more numerous, and their financial lives are quite different from that of classic microentrepreneurs. On-farm finance is inalienably linked to smallholder food security at the household level, since most of smallholders’ daily nutrition comes from farm products. Furthermore, their financial lives are seasonally-dependent, with credit needs fluctuating according to the time of year, rainfall levels, and climatic/environmental risks (e.g. drought, crop diseases).

Many MFIs operate on the assumption that savings, as a result of returns on credit, is the key to lifting the poor out of poverty. Traditionally, however, monetary saving strategies are not common among smallholders in East Africa. Still, farmers save in other ways. Dry cereal storage and other season-to-season storage is quite common. MFIs may look into providing savings programs which offer in-kind facilities and other opportunities that meet post-harvest storage needs.

Smallholder financial needs vary according to geo-political and socio-cultural bias, but in general, this policy brief would argue that formal microfinance fails to meet their needs in the following ways:

- **Microfinance tends to be focused in urban centers**, keeping transaction costs high for smallholder farmers
- **Collateral requirements are too marginalizing** and sometimes involve title deeds, which many East African smallholders do not have
  - Those who do possesses title deeds are almost always men, excluding women from accessing some forms of microfinance
- **High interest rates** – Given high interest rates, even true microloans are not worth the transaction costs involved

### Table 2. Source: FinScope Uganda, 2007.

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<tbody>
<tr>
<td>Schools, hospitals, clinics</td>
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<td>Informal groups</td>
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<tr>
<td>Commercial Banks</td>
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<td>Savings and Credit Cooperatives (SACCOs)</td>
<td>7</td>
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<td>MFIs</td>
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<td>Moneylenders</td>
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- **Additional fees are excessive** – application, processing, legal, and other fees drive away low-income clients
- **Trust and interpersonal relations are weak** – many smallholders simply do not feel comfortable taking money from an institution and a staff of people with whom they are not familiar
- **Formal institutions often assume financial literacy** – many smallholders additionally feel intimidated by the bureaucratic atmosphere and legal jargon associated with formal financial institutions
- **Repayment schedules are inflexible** – due to their seasonally-dependent lifestyle, smallholders need access to financial services which are flexible according to seasonal changes and unexpected environmental challenges (e.g. drought insurance)

### FINDING EVIDENCE-BASED POLICY SOLUTIONS

**How can CIDA help?**

CIDA’s expressed interest in agricultural finance and smallholder food security, in addition to their longstanding commitment to Sub-Saharan Africa, places them in a strong position to positively impact the microfinancial climate. The existing microfinancial products in East Africa are simply not appropriate for smallholders, but the anti-poverty social objective which is central to the industry provides the leverage needed for an agency like CIDA to sustainably expand the client base. The financial infrastructure of rural Sub-Saharan Africa is still nascent compared to other regions of the developing world. Improving the financial infrastructure means thinking about finance holistically, and for the agricultural sector, this means addressing the needs of all value chain participants. One place to start is in addressing the major knowledge gap between the agricultural and financial sectors. While microfinance institutions have traditionally been involved in outreach and training programs focused on financial literacy, career development, and more, there remains a distance between the industry’s underpinning philosophy of social consciousness and the real challenges involved in financial decision-making and planning among farmers. Policies should be introduced which increase knowledge mobilization and sharpen understandings of market prices, risk assessment techniques, weather indexing, etc. In this regard, **CIDA should explore weather-indexed microinsurance, in-kind loan programs, and voucher systems which reduce some of the anxiety surrounding money management and help ensure that money is redirected to non-investments, and more.** CIDA should also consider infrastructure projects which would ultimately impact smallholder access to microfinance institutions, such as early-warning programs for large-scale emergencies that might impact farming, credit information registries, community radio and other mechanisms for announcing current market prices, and more. Furthermore, East African smallholders lead
highly interconnected and interdependent lives, and formal microfinance must become more adaptive and flexible to account for unexpected environmental challenges, family emergencies, life cycle occasions, etc.

**Reducing Costs**

Incongruent with their aims of assisting the poor, MFIs actually tend to be quite expensive ventures, which is why they are commonly accused of being overly concerned with profit margins. Still, there are many ways in which the formal microfinancial sector can cut down on operating costs. Mobile banking—the use of mobile phones for peer-to-peer and individual financial services—has become intensely popular among urban and rural populations alike in East Africa. Kenya’s M-PESA and M-Shwari services allow clients to inexpensively make payments, transfer, and save. Because airtime is commonly used as a proxy for money transfer among East Africans, mobile banking has now become a way of enhancing practices and behaviors that were already present. Furthermore, following the low-cost nature of informal group lending structures, group lending models have also become cost-effective ways for formal institutions to avoid major losses. Groups which operate in this way do so with confidence in social capital as a form of reputational collateral—that is, social shaming among peers serves as a no-cost enforcement mechanism for loan repayment. Farmers who know and trust one another form small groups which are collectively responsible for repayment. If a member risks defaulting, the rest of the group assists in making the individual payment so as to avoid group default. Preserving group unity and a sense of solidarity is incredibly important in these contexts. The member who risks default also stands to face shaming, which further incentivizes him/her against future defaults. In the case of FSAs in Kenya, members are treated as shareholders, purchasing as many shares as they wish, and having the flexibility to reduce/increase their number of shares according to changes in need. As a result of this adaptability, the shareholder structure tends to operate with very low default rates. Group lending models of microfinance are effective in the East African context mostly because they are iterations of traditional methods of collective exchange, mutual assistance, and social learning which have long strengthened the social fabric of rural Sub-Saharan Africa.

Many institutions blindly replicate the marketing strategies of large-scale commercial banks by promoting the loan products themselves, without showcasing the ways in which they meet the specific needs of smallholders. Many smallholders are simply uninformed when it comes to formal finance, and these gaps in knowledge can be creatively addressed through marketing/outreach. The knowledge gap may not be a lack of understanding the range of products available, but rather what specific and perhaps non-traditional services are available to address smallholder needs. Moreover, the microfinance industry has been operating for too long under the false assumption that simply “reaching out” to the poor will make certain a
sustainable development trajectory for them. Instead of MFIs promoting the fact that they provide loan products, they can start doing much more outreach about how and why they as institutions are well-suited to address smallholder financial insecurity. For instance, as previously mentioned, many potential clients self-exclude due to a lack of financial literacy, intimidation, etc. Policymakers should encourage microfinance institutions to carry out financial training programs (short-term, cost-free, in the local language), which are cost-effective methods for reducing the likelihood of default (reducing costs incurred by the institution). Such methods also ensure that the clientele feels as though formal microfinance is accessible and easily understandable. Moreover, CIDA can help to address some of the bureaucratic intimidation of formal banking by pushing institutions to shed legal/financial jargon in their interactions with potential/current clients. With a history of colonial-period coercion and confiscation in much of East Africa, it is important that banks are not seen as a site of distrust or intimidation. Similarly, CIDA should encourage the banks to reduce legal fees, application fees, and any other additional fees as much as possible. Added fees complicate the process, and if there is one major takeaway from the informal sector, it is its simplicity and transparency. Banks should also consider reducing the amount of work put on clients when they are in the process of applying for a loan/savings account/etc. Smallholders in East Africa are relatively risk-averse due to the precarious nature of small-scale farming on degraded land, and as such, are not in a position to spend time going from office to office getting loan documents signed/approved. In the long run, of course, directly addressing issues of self-exclusion stands to expand the client base for MFIs across East Africa.

**Finding Market-Led Solutions**

In order for formal microfinance to be most effective among smallholders in East Africa, the institutions themselves must find products and services which are suitable to the financial lifestyle of small-scale farmers. MFIs must look to the atmosphere of the current market, and discover what market-led and policy-driven solutions have been successful.

Many formal institutions are focused on a risk-based approach to agricultural finance, although they fail to understand the specific risks of their clients. Risk management is a key piece of smallholders’ financial lives, as they must always find themselves in a position to respond to unexpected environmental challenges and other shocks. Still, formal insurance programs remain the least common product to have been extended to the agricultural sector. To mitigate drought-related losses, for example, an organization partnered with South Africa’s largest commercial bank, Standard Bank, has introduced weather-indexed microinsurance products (Brixiova, Kamara and Salami 2010). Drought insurance is a much better option for smallholders than crop insurance (with which some MFIs have experimented), because the farmers are not forced to sell off their assets when there is low rainfall, avoiding a dependence on aid and other
external supplements. Crop insurance may be more appropriate for certain production systems, however, such as in the case of constant pests and diseases or soil infertility. CIDA should explore weather-indexed microinsurance products in areas where drought and climate change are having major effects on smallholder farming.

Formal sector savings products have also been improved according to the tried and true informal practices of the microfinance market’s client base. Some MFIs have started experimenting with what Stuart Rutherford et. al. (1999) refers to as “saving through” strategies. Rather than “saving up” (which is self-explanatory), “saving through” is a savings strategy in which people upkeep a continuous flow of savings by making small deposits which are converted into a lump sum at some point during the flow. This “merry-go-round” structure is a long-held practice in East Africa’s informal sector. Policymakers at CIDA must encourage more group-based lending, which ensures that clients receive the social benefits that appeal to them (through intimate peer-to-peer lending), but that they are also ensured against defaulting by the other group members’ shared commitment.

Outreach programs on financial products, career training, and money management are often time-consuming and costly to the smallholders. Similarly, MFIs incur many transaction costs by trying to extend their services to remote populations who are not necessarily accustomed to formal sector interactions. Some MFIs have started training agro-dealers and other intermediaries in order to address the needs of the whole value chain rather than targeting the producers alone. Smallholders need quick access to easily understandable information that supports their technical knowledge as farmers. Most smallholder farmers do not think of their farms as businesses, and thus they must be addressed not as entrepreneurs or business owners, but as farmers.
Key References


While this paper focuses on smallholder activities in the coffee value chain, there are parallel insights from this technical paper which can be carried over into other sectors and value chains in smallholder agriculture. This paper offers a balanced, realistic perspective on microfinance and how it could best serve East African smallholders. Additionally, there are important details on how the genders interact with formal banking differently.


With extensive experience researching the effects of microfinance on the lives of the poor, Rutherford and his team of researchers provide some very important ground-level insights on the ways in which the poor actually save. The classic narrative surrounding poverty implies that the poor are unable or simply do not know how to commit to long-term savings, but in fact they most certainly do save. Conclusively, the paper suggests that microfinance institutions broaden their products and services to include more flexibility in terms of length and volume.


This paper is an important reflection piece on the link between food security and smallholder agriculture in East Africa. Additionally, it supplements its data on current trends and developments in agriculture with case studies.


An annual report of the African Development Bank’s “Making Finance Work for Africa” Secretariat, this paper has a continent-wide scope but offers many important policy recommendations that parallel my points in this policy brief.

Full Bibliography


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