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Tajikistan Agriculture Sector: Policy Note 3

Improving Access to Rural Finance

Demand and Supply for Rural Finance

The Asian Development Bank has conservatively estimated the capital investment needs for Tajik agriculture at US$ 700 million over the next 7 years, in order to sustain sector growth rates of 6%-7% per annum. This includes investment in irrigation infrastructure (US$500 million), farm machinery (US$60 million), cotton processing (US$45 million), food processing (US$30 million), and other needs (US$20 million). The additional requirements for rural investment in roads, power supplies and telecommunication are unknown. Seasonal lending requirements for cotton are estimated at US$75-80 million annually, plus a further US$15-20 million for non-cotton farming activities.

Current lending for agriculture falls well short of this requirement. Seasonal finance for cotton is now less than two-thirds of requirements due to the cotton debt crisis. Non-cotton seasonal lending is approximately US$5 million - most of it from donor projects. Annual capital investment in the agriculture sector is estimated at approximately US$30 million from the public sector and US$25 million from the private sector, equivalent to half of the total requirement.

Financial Institutions

Numerous bank and non-bank financial institutions have the potential to operate in rural areas. The characteristics of these financial institutions have a major bearing on their willingness and capacity to engage in rural lending.

Commercial Banks

The banking sector is extremely small, with an asset to GDP ratio of only 8%, and a loan to GDP ratio of 4%[1]. Deposits are a mere 4% of GDP, due to low public confidence in the banking system, and more than 80% of deposits have maturities of less than one year. This severely limits the capacity of commercial banks to make medium to long term loans for investment.[2] Most lending is for industry (40%) and commerce (40%), with only 10% for agriculture. Credit risks are high and most banks are very cautious as a consequence. Lending is subject to high collateral levels and/or guarantees, and most loans are for less than one year. These risks also lead to high premiums on lending rates[3], and current interest rates are in excess of 20%. Foreign investment in the banking system is negligible as current laws limit foreign ownership of commercial banks and preclude foreign managers.

These characteristics severely constrain both the supply of credit from commercial banks and the demand for bank credit by private enterprise. The banking sector's small capital base and the predominance of short-term deposits limit its capacity to lend, particularly for medium-term investment loans. The supply of credit is further limited by the cautious lending strategy adopted by most banks, and a very weak capacity for loan appraisal and loan management. In the absence of a well functioning land market and an effective land registration system, lending is also heavily constrained by the lack of suitable collateral - especially for larger, longer term loans. Existing law does allow the use of moveable assets as collateral but inadequate legislation and registration procedures limit the incentives to use this form of collateral.

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[1] In developed countries these ratios exceed 100%.

[2] The sector is also highly concentrated. Four of the twelve commercial banks control 70% of total banking assets, 80% of household deposits and 70% of non-government loans.

[3] In December 2004, the lending-borrowing margin in dollars for maturities of 13 months was 18 percentage points, and for maturities of 612 months over 12 percentage points. The corresponding lending-borrowing margins in national currency for these maturities were 11% and 5% respectively.

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Demand for credit is also limited, not only due to high interest rates but also by the constraining collateral requirements. Few businesses are profitable enough to pay the prevailing interest rates, in addition to having sufficient assets to meet current collateral requirements. Agriculture receives a very small share of the limited supply of credit which is available, first because banks perceive the sector as highly risky, and second because few agricultural enterprises are sufficiently profitable to service their debts.

The banking sector is growing quickly nevertheless, in response to improved macro-economic conditions and an IMF led program to improve commercial bank management and strengthen central bank supervision. This program has reduced non-performing loans to a more acceptable level, improved profitability, and improved bank management. Deposits are also growing in response to improved public confidence in the banking sector, which further enhances the prospects for growth. However, commercial banks remain weak and cautious, and their lending is still largely urban, although there is growing interest in moving into rural areas. Further work is needed to strengthen corporate governance and general banking skills, to develop a wider and more accessible range of loan and deposit products, and to develop alternative financial instruments such as leasing. An increased minimum capital requirement of US$ 5 million will also help to increase bank capital and consolidate the sector. Without stronger activity by foreign banks, however, the sector's capacity to provide a significant volume of capital at acceptable interest rates will remain severely limited.

Cotton Finance

Access to seasonal credit is critical for cotton production, and the income, employment and export revenue that cotton generates. Government has thus set up specific structures and mechanisms to ensure the supply and delivery of cotton credit. Although these systems have been progressively modernized since independence, inappropriate implementation of reform has culminated in the "debt crisis" which now paralyzes Tajik cotton production. Arrears of US$50-$150 million[4] have led to the termination of credit to all but the most creditworthy cotton producers, with a consequent fall in farm input use and cotton production.

Following independence, seasonal credit for cotton production was provided by the government through Agroinvest Bank (AIB) and managed by Pakhtai Tojik, the public agency in charge of cotton. In 1997, budgetary problems then led the government to form a partnership with P J Reinhardt, a Swiss-owned cotton trading company, who assumed responsibility for credit provision in return for the right to market Tajik cotton. The agreement was backed by several international banks and secured by a government guarantee. Significant changes were made to this agreement in 1998, primarily with the removal of the government guarantee and the creation of a "commercial" financing scheme. Reinhart became a major shareholder of AIB and Pakhtai Tojik was replaced by local agents, referred to as financiers, futurists or investors. The loan repayment mechanism remained unchanged, however, through the delivery of baled cotton to Reinhart.

This structure remains the basis for cotton finance, with investors' supplying farm inputs to producers in return for the right to collect, process and deliver baled cotton to Reinhart. Finance is provided by AIB, based on a tri-partite contract (AIB, investor, and producer) which specifies the maximum level of credit the farmer can obtain and the equivalent value of cotton which must be delivered to the investor. However these contracts give investors' considerable freedom to set both input prices and cotton prices as they choose during the production season, and so raise their own profitability at farmer expense. Farmers also complain of poor service from the investors, with late delivery of inputs and low input quality. Unfortunately farmers are in a weak position to counteract this situation, first because they have limited information on actual input and output prices, second because there are few alternative sources of credit and farm inputs, and third because local authorities coerce cotton farmers to deal with local investors - creating a local monopsony. Moreover, once a producer falls into arrears with an investor, current laws and administrative procedures make it extremely difficult to switch to an alternative credit supplier. Prolonged exploitation of this situation since 2001 has led to the high accumulated debt noted above.

[4] An ongoing dispute as to the actual level and cause of these arrears is a major element of the debt crisis.

The government responded to this crisis in 2004 by transferring 80% of AIB's debt to Kredit Invest (KI), a non-bank financial institution set up to assume this debt and so allow AIB to re-engage in lending for cotton production. Although AIB now restricts its lending to debt-free producers, this change allowed it to lend US$4 million in 2004 (5 million somoni to cotton farmers and 7 million somoni to input suppliers); and an estimated US$8 million in 2005 (13 million somoni to cotton farmers and 10 million somoni to input suppliers). A few other financial institutions are also lending to cotton farmers with no debt, including local financiers backed by Russian cotton traders and banks, and Tojiksodirotbank. With a charter capital of US$300,000 and client debts allegedly in the region of US$100 million, Kredit Invest was ostensibly created to facilitate debt resolution. However, it has also begun lending directly to cotton producers, creating uncertainty as to its future role. More recently, the government has established the Independent Commission to assess actual levels of debt (based on a review of input and output prices, lending practices and borrower repayment) and to apportion it. Debt resolution will be implemented on a case by case basis, with donor technical support.

As important as these policy responses are, they will not resolve the underlying problems of the current system of cotton finance. Further measures are needed to remove the monopsony powers of the investors', improve the contracts which define borrower and lender relationships, and increase support for the development of alternative sources of credit.

Micro Finance

Micro-finance is growing rapidly in Tajikistan, albeit from a very small base. The sector had an outreach of around 60,000 clients in mid 2005, and an outstanding loan portfolio of US$ 14 million. Average loan size varies from US$ 35 to US$ 2,600, and interest rates vary from 2-4% per month. Loan recovery rates are high in the well run MFIs and programs, at around 98%. The government has formally acknowledged the role of micro-finance in poverty reduction, and recently enacted a Micro-Finance law that gives micro-finance institutions full legal status, and specifies the institutional forms and activities in which they can engage. This new law allows for deposit taking among qualified MFIs, although none have initiated this service as yet.

Sources of micro-finance include micro-finance institutions (MFIs), commercial banks and donor projects and programs. There are now 17 micro-finance institutions active in Tajikistan, which together lend approximately US$6 million. Of these MFIs', four account for two-thirds of total micro-lending[5], and have considerable potential for growth. The others are very small and tend to focus on particular localities or target groups. Commercial bank micro lending programs now amount to US$ 3.5 million as a result of EBRD and IFC support to four banks. A specialized micro-finance bank (the First Microfinance Bank of Tajikistan[6]) has also been established, with an outstanding loan portfolio of US$ 1.3 million. The main sources of project and program support include World Bank funding for six savings and credit associations, with an outstanding loan portfolio of US$ 1.2 million; and the UNDP supported Jamoat Revolving Funds, with an outstanding loan portfolio of US$ 1.9 million.

There is excellent potential for continued growth in the micro-finance sector, led by the four main MFIs, and the new Microfinance Bank. This growth will need to be accompanied by strong support for institution building, as opposed to the current situation in the sector which is highly fragmented, with many tiny, weak institutions. Managerial and lending capacity is weak and the current, limited range of financial products needs to be expanded. Particular support will be needed to expand lending networks into rural areas, including the establishment of new branches and training additional staff, as most micro-finance is currently directed to urban areas and urban clients.

[5] The four major MFIs are: the National Association of Business Women of Tajikistan, the largest MFI with US$ 2 million outstanding loan portfolio; Humo, with US$ 800,000 outstanding loan portfolio; ACTED, with US$ 760,000 outstanding loan portfolio, and MDTM-ACDI/VOCA with US$ 650,000 outstanding loan portfolio as at end April 2005.

[6] The principal shareholder is Agha Khan Foundation, with other investors including IFC, KfW, and CIDA.

Other, Non-Bank Financial Institutions and Financial Instruments

As a means to develop alternative sources of credit, particularly for cotton, IFC has supported the establishment of a farmer owned input and credit supply organization operating in the Sughd region. Called SugdAgroServe, this enterprise has a corporate ownership and management structure, with lending of around US$1 million annually. Full responsibility for management will be transferred to Tajik staff when the project ends in 2006.

The enactment of a leasing law in October 2003 has created a legal and regulatory environment conducive to leasing. As yet, few financial institutions have begun leasing (i.e. Tojikisodirotbank and SugdAgroServ) and their level of activity is limited by lack of experience and a shortage of long term capital.

Constraints to Rural Finance

Two sets of constraints limit agricultural lending: (i) problems associated with the current system of cotton finance and the cotton debt crisis; and (ii) a more general set of constraints which limit lending for all activities, including agriculture. Both are important, as an improved system of cotton finance ultimately depends on the emergence of alternative credit sources. Thus while measures to improve cotton finance are the immediate priority, overall access to rural finance will not improve until the more general constraints are removed.

Cotton Finance

- *The monopsony position of local investors* has not only allowed them to reduce farmer incomes and their capacity to borrow and invest, it has also inhibited the ability of other financial institutions to lend to cotton producers. Excessive and inappropriate control over the ability of farmers to transfer their debts from one financial institution to another further inhibits the expansion of other financial institutions.

- *Poor design of the contractual agreements between AIB, investors and cotton producers* makes producers highly vulnerable to both illegitimate exploitation and legitimate but adverse movements in input and output prices. This not only reduces their incomes, but also increases the probability of involuntary loan default.

- *Slow and/or inappropriate resolution of the cotton debt* will impede both the supply and demand for rural credit. Among the lenders, investors have limited scope to continue lending until their financial status is clarified; and other financial institutions will be reluctant to lend to cotton producers without knowing their actual debt. Cotton producers will also be reluctant to borrow until their financial position and debt repayment obligations are known.

General Constraints:

- *Weak financial institutions*. Commercial banks and MFIs are characterized by a weak financial base and limited management capacity. While the financial institutions and investors involved in cotton finance are much larger, their financial position is precarious as a result of the cotton debt crisis, and they also suffer from weak management. A rapid expansion of rural credit from such a weak base would be unwise, unless it is accompanied by an equally rapid strengthening of institutional capacity.

- *Weak lending skills*. Financial institutions lack adequate skills in loan appraisal and collateral valuation, particularly in risk appraisal and risk management. This is particularly true for agricultural loans. Commercial banks and most MFIs focus their lending and training on the trade and service sectors, and so lack the capacity to analyze the risks and income flows which characterize agricultural lending proposals.

- *Restrictions on foreign ownership and management of commercial banks*, further constrain the capacity for expansion by depriving financial institutions of a significant alternative source of (external) capital, and the opportunity to benefit directly from improved management. These restrictions will need to be relaxed if the commercial banking sector is to play a major role in financing private sector investment and expansion.

- *Weak support for broader institutional development within the banking sector*, through activities such as the establishment of a banker's association for knowledge sharing, and a credit bureau for improved risk management.

- *Lack of suitable collateral and a weak legal framework for secured transactions.* Inadequate collateral is a major disincentive for financial institutions to lend, especially given the high risks of lending in Tajikistan. The uncertainty surrounding land user rights and the absence of a functional land market makes land unsuitable as collateral, and legal and administrative weaknesses limit the ability to use moveable assets.

- *A limited range of financial instruments.* Most commercial banks and MFIs offer a limited range of financial products, usually simple traditional loans. Leasing has also been slow to develop, even though it offers an effective means to address the lack of collateral. Although the legal and regulatory framework for leasing is in place, lack of adequate skills and long term capital has limited its use.

- *An acute shortage of long term financial resources*, due to the weak capital base of financial institutions and the predominance of short-term deposits. Loan portfolios are thus overwhelmingly short term, making them unsuitable for capital investment in livestock, tree crops, and farm machinery. Even donor credit lines are largely for short term lending.

- *High Interest Rates*. In the absence of better risk management mechanisms, banks charge high spreads on their loans. MFI interest rates are also high relative to other countries, due to their small size and high operating costs.

- *Most commercial bank and MFI loan portfolios are overwhelmingly urban*, and these institutions have a limited presence in rural areas. Business advisory service programs are also geared toward urban businesses, and are unavailable to rural residents.

Policy and Program Responses

While the need for increased access to rural credit is clear, the deep seated constraints to achieving this objective preclude rapid solutions. Indeed the weak status of existing financial institutions and the difficult environment in which they operate suggest that rural finance is best developed gradually. Increased access to capital without accompanying measures directed toward legal and administrative reform, as well as institutional strengthening, will inevitably lead to inappropriate lending. This would not only further weaken financial institutions but also impede the development of a credit culture among borrowers (i.e. the understanding that loans must be repaid). Sustainable financial institutions will not evolve under these circumstances.

A range of policy and program responses are required to address the issues and constraints described above. Most of these measures address general constraints to credit rather than issues specific to agriculture, but they are a pre-condition for associated measures to expand access to rural finance.

(1) Strengthen the capital base and management capacity of commercial banks

This process has already begun. Ongoing measures by donors and the central bank include an increase in the minimum capital requirement to US$ 5 million, which will also facilitate consolidation; the development of a secondary market for treasury securities, which will permit collateralizing inter-bank loans and so improve the use of bank resources; a progressive reduction of reserve requirements from the current 18% that will increase the availability of funds for loan; and stronger supervision as a means to improve commercial bank performance. These measures should be accompanied by a relaxation of restrictions on the entry of foreign banks into the Tajikistan financial market, particularly elimination of the ceiling on foreign capital participation and the requirement that Tajik nationals must head commercial banks.

(2) Strengthen the capital base and management capacity of MFIs and other non-bank financial institutions

Current relevant measures include a donor program to improve the central bank's capacity to supervise micro finance institutions, and transform the NGO micro credit programs into MFIs in accordance with the new MFI law. Further donor support is needed in the form of capital grants and credit lines, accompanied by technical assistance for institutional strengthening.

(3) *Improve access to long-term capital*

Ultimately, improved access to long-term capital will come from an increase in bank capital and term deposits. This is a medium-term objective, however, as it relies on increased confidence in the economy in general and banking in particular, together with better access to capital from external financial markets. In the short-term, donors will need to increase the supply of concessional credit lines suitable for medium and long-term credit.

(4) *Strengthen the capacity for loan appraisal and risk assessment in general, and agricultural lending in particular.*

The EBRD is currently working with selected commercial banks to improve their loan appraisal and monitoring skills for small loans and to provide lending resources through the Tajikistan Micro and Small Enterprise Facility. This input should be broadened by other donors to encompass loan appraisal and risk analysis for medium and large scale loans for agro-processing and agri-business, as well as micro-loans for farmers. The capacity to manage an agricultural loan portfolio should also be strengthened. Increased support for programs to assist small businesses to improve their financial management and make them more "bankable" would further enhance the impact of these measures.

(5) *Improve the legal and administrative basis for secured transactions*

Existing legislation for land ownership, land registration and moveable asset ownership needs to be reviewed and strengthened to provide the clarity and protection needed by both borrowers and lenders to engage actively in secured transactions. The administrative structures and procedures for registration of security, over land and moveable assets, also need to be modernized and made more accessible to property owners and financial institutions.

(6) *Support the development of a wider range of financial institutions and financial instruments*

This includes existing measures to establish savings and credit associations; commercially run, farmer-owned credit and input organizations; and MFIs should be extended to other regions and expanded into rural areas. There is also scope to promote supplier credit by improving the access of agro-processors and farm input suppliers to seasonal credit from commercial banks. All of these institutions are accustomed to lending without fixed assets as security, and so are suited to the provision of credit for small farmers. Donors should also continue to encourage leasing by providing long-term capital and training; and assist bank and non-bank financial institutions to develop more appropriate lending instruments. Savings mobilization should also be encouraged through technical assistance to MFIs.

(7) *Reform the current system of cotton credit and expand the range of financial institutions involved in cotton credit*

(8) *Complete the resolution of cotton debts as soon as possible*

(9) *Support the expansion of financial institutions into rural areas*

A range of measures is needed to facilitate the expansion of financial institutions into rural areas. Donors can support the creation of rural branch networks, as well as training in agricultural loan appraisal and portfolio management; additionally, they can provide credit lines to encourage supplier credit, and loans for primary production, agro-processing and agri-business. The government should eliminate the policies which restrict rural lending, such as support for the monopsony position of cotton investors and the restrictions on transferring debt from one financial institution to another.