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Fact Sheet

University of Stellenbosch
The BOP Learning Lab

Providing finance to emerging farmers : First National Bank's Supply Chain lending model

After a long and perhaps misguided emphasis on industrialisation as the preferred path out of poverty and towards development, agriculture is receiving renewed attention in development circles. The latest World Bank Development Report argues that agriculture "must be placed at the centre of the development agenda if the goals of halving extreme poverty and hunger by 2015 are to be realised"[1]. This has particular significance for the African continent, which despite rapid urbanisation remains the world's most rural continent, and where the potential leverage of agriculture and rural development is the greatest.

Among the obstacles that need to be overcome to transform the agricultural sector, access to finance is arguably one of the most fundamental. In South Africa, financial institutions are developing original models and approaches towards the low-income, subsistence farming sector in order to help it grow and become not only self-sufficient, but actually commercially productive. When this approach is successful, the impact in terms of poverty relief can be remarkable : according to the same World Bank report, GDP growth originating in agriculture is about four times as effective in raising incomes of extremely poor people than GDP growth originating outside the sector.

This latest fact sheet on the financial sector will look at how First National Bank, one of the big four retail banks in South Africa, is encouraging development in the emerging agricultural sector, through an original supply chain lending model that helps to secure markets and outlets for emerging farmers, while managing to avoid some of the challenges faced by emerging farmers to of secure credit when they lack collateral.

FNB's supply chain lending model is only one of many different solutions that banks and financial institutions in South Africa have been developing over the last decade or so, driven as much by regulatory imperatives as by their commercial interest.

1. Company profile

First National Bank is one of South Africa's oldest and largest financial institutions, tracing its history back to 1838 as the Eastern Province Bank in Grahamstown. A number of mergers and acquisitions later, it became the

[1] WORLD BANK DEVELOPMENT REPORT, 2008. Available online on http://econ.worldbank.org/

Some Key figures for 2008:

FirstRand Group

Employees : 40.000
Headline earnings : 9.9 bn Rand

FNB entreprise development :

SMME Beneficiaries : 6000

Amount ZAR 711 million

South African arm of UK banking group Barclays in the 1920's and operated in South Africa as Barclays Bank till the mid-eighties. By that time, South Africa's political situation led Barclays UK to divest its operations, which were sold to local investors and became First National Bank.

Today, FNB is part of the listed FirstRand Limited financial services group, a holding company which includes such major South African players in the financial sector as Rand Merchant Bank (RMB), and the Momentum Insurance and Asset Management group. FNB is one of the so-called "Big Four" retail banks whose other members are Nedbank, Standard Bank and ABSA (the latter, ironically, was purchased by Barclays when the UK-based bank returned to South Africa in 2002).

While FNB is still strongly focused on the domestic market, it has expanded in Southern Africa over the last decade and operates subsidiaries in Botswana, Namibia, Mozambique and Swaziland. It prides itself on its South African roots and actively promotes its local identity as part of its market appeal.

2. The Drivers

FNB's supply-chain lending model is one of a series of products developed by the bank to access and develop the market at the base of the pyramid. It is being driven in this process by the transformational objectives that currently shape the agenda of both government and business.

a. Broad-Based Black Economic Empowerment

Broad-based Black economic empowerment (BBBEE) undoubtedly constitutes the main legal driver of structural change in South Africa's economy. Based on the Black Economic Empowerment Act of 2003, BBBEE is designed as code of practice which businesses in South Africa, especially larger ones, are expected to follow and implement. Each of the 7 chapters of BBBEE constitutes a different component of empowerment : ownership, management, employment equity, skills development, preferential procurement, enterprise development, and socio-economic development.

Efforts to develop and increase the potential of emerging farmers help FNB to reach some of its requirements and targets contained in chapters 6 (enterprise development) and chapter 7 (socio-economic development) of the BBBEE charter.

b. The Financial Sector Charter[2]

In addition to BBBEE, which applies across the board to South African businesses, the Financial Sector Charter (FSC) specifically commits the financial sector to the general transformational objectives of the South African state. Following the general consensus that access to basic financial services is one of the biggest single empowering factors at the base of the pyramid, one of its main provisions is to commit the financial sector to broadening access to financial services to all South Africans. In this particular instance, the supply chain model of FNB offers a rather indirect finance channel to emerging farmers, but the end effect is undeniably access to finance for smallholder farmers who would not otherwise be able to get such access.

c. The commercial and strategic imperatives

While BBBEE and the financial services charter form the main regulatory drivers towards integrating the base of the pyramid into the economic value chain, the third critical driver is the commercial imperative for FNB.

As a volume-driven retail bank, FNB has long targeted the middle and lower income brackets among the regular earners, and over the last twenty years it has built significant expertise in developing customised banking solutions for first-time banking customers. This has enabled FNB to make significant inroads into the LSMs 4-6.

Furthermore, because it is so firmly rooted in the South African market, FNB arguably has a competitive advantage in terms of local expertise, strengthening the business case to expand its offering in the lower income segments.

Another more fundamental driver is FNB's strategic goal is to contribute to transformation in South Africa by helping to provide economic actors in the informal circuit with the tools to bridge the gap with the formal economy. Providing financial tools to SMMEs (small, medium and micro-enterprises), among them emerging farmers, is part of that process.

FNB's strategy is also partially designed to formalise the informal sector of the economy. Much has been written over recent years in South Africa about the merits of "formalising" the informal sector, but there is a general consensus that in the long term, formalisation can unlock much wealth and provide structural conditions for higher averages of economic growth. For small and micro entrepreneurs one of the main single benefits of formalisation is easier access to finance and the ability to legally employ people. And from a collective point of view, formalisation of enterprises eventually translates into a broader tax base and increased prosperity through more sustainable economic actors. Furthermore, by helping informal economic actors to make this leap, FNB is building up its customer base and furthermore contributing to the long-term prospects of the main market it is operating in.

3. Emerging farmers in South Africa : historical background and challenges

a. A dual agricultural economy

For historical reasons the question of agricultural land use in South Africa is a deeply politicised and emotional issue. As in so many other areas of South African society, there is no escaping the legacy of decades of racially-based policies which resulted in unequal land distribution, and the existence of two distinct agricultural sectors in the economy[3].

2 For further information on the Financial Sector Charter please refer to www.fscharter.co.za
3 Government Communication and Information Service, South Africa Yearbook 2008/2009, Chapter 3 - Agriculture and Land Affairs, p60
4 OECD Policy Brief, "Agricultural Policy Reform in South Africa", April 2006. Organisation for Economic Co-operation and Development, Paris, 2006

The contrast between a highly developed and productive commercial sector on the one hand, and a largely underdeveloped, subsistence-oriented farming sector on the other, could hardly be starker. For the past two decades, authorities have tried very carefully to bridge this gap and address this legacy, trying to balance the interests of the commercial sector and those of emerging farmers and poor rural communities in general.

As one of the most employment-intensive sectors of the economy, agriculture's potential impact on empowerment and poverty relief is much larger than its actual weight in the economy : while the primary sector contributes only 2.5% of GDP measured in value, it represents 10% of formal employment. If the entire value chain of agriculture is taken into account, its contribution to GDP actually reaches 12%[4]. As a result, the empowerment benefits of assisting emerging farmers are, in many ways, much more significant than in most other economic sectors, especially when adding other crucial factors such as the stabilising social and political effects of rural development in general.

Given the generally strong real impact of development efforts in rural areas, there is, therefore, a strong case for multiplying initiatives to support models of interaction that are sustainable and workable. There are, of course, many challenges to be overcome.

a. Challenges

Working on the assumption that emerging farmers were indeed in need of finance and that the main issue was one of access rather than demand, FNB set out to design a model that could serve the interests of all parties involved while minimising the risk factor and maximising its impact on the ground, not a straightforward task given the challenges involved :

- Lack of knowledge about the informal economy

By FNB's own account, the financial sector's understanding of the informal economy is still evolving. The lack of quantitative and qualitative data on this sector of the economy translates into higher levels of uncertainty and therefore risk, than is the case with the formal economic sector. In order to get around this issue it made sense to build an intermediary into the model that could not only insulate FNB but also provide with knowledge that was not directly available, especially to help the bank understand the underlying business and reduce performance risk.

- Practical issues

More often than not, one of the biggest challenges when it comes to providing access to finance for lower income segments is not that no funds are available, but rather that practical issues come in between : in cases where people are functionally illiterate, for example, they are unable to fill out even the most basic paperwork needed for a bank loan, even when such paperwork is available in their own language. In such conditions, it is imperative that trusted intermediaries form a buffer between the financial institution and the end-users to establish a balanced relationship and reduce risk to a level that can be accepted both by the financial institution and the final beneficiary.

- Lack of collateral on borrower's side

Most of the underlying emerging farmers lack any sort of collateral, even after successful land claims. Contrary to loan agreements with established commercial farmers, land gained via a claim often cannot be used as collateral for a number of years post the claim, as title only passes to the claimant gradually in terms of the government's land reform policy, based on past experiences. As a result the lending model had to find alternative ways of securing any funding channels. This aspect reinforced the argument to channel loans through an intermediary, thus not only insulating the bank but actually protecting the interests of the emerging farmers by being able to offer better terms than through a simple, direct micro-lending model.

- Access to finance as part of an integrated approach

Access to finance is a necessary, but by no means sufficient factor of success for emerging farmers. They also need to be in a position to understand their markets, use efficient farming techniques and have access to an overall support network. This challenge goes beyond what a financial institution can offer on its own, and it strengthens the argument for a holistic, integrated approach with regards to emerging farmers, where the financial institution's points of entry can be positioned at different levels of the value chain.

5. The Model[5]

The supply chain loan model has been devised with these challenges in mind. Because of the obstacles and risks associated with a direct relationship, FNB sought to partner with local stakeholders and representative organisations of small holder farmers and emerging farmers. After conducting extensive research and consultations, a model was devised around a central entity acting as an intermediary between emerging farmers and their customers - most especially, a customer in the form of a 'Supply Chain Leader', which is a large firm that seeks to procure goods from emerging farmers. A Special-Purpose Vehicle (SPV) was created as the principal legal structure through which FNB could provide finance to emerging farmers. FNB and the supply chain leader are contractually linked to the SPV. FNB then provides finance in the form of loans and credit lines to the SPV, which provides collateral in the form of an irrevocable purchase order issued by the supply chain leader but ceded to FNB by the special purpose vehicle. The SPV acts as the financial intermediary with farming project entities, usually registered as a Pty (Ltd) company. The Pty (Ltd) is the vehicle through which funds are channelled to cover labour costs and other inputs such as equipment for farmers, in exchange of the farmers committing their produce to the Pty (Ltd). In effect, the Pty (Ltd) entity functions almost like a co-operative in which emerging farmers pool their resources in order to access finance and markets for their produce.
The insertion of the SPV between the bank and the co-operative, in turn, insulates the bank by mitigating the risk involved in dealing directly with emerging farmers with no credit history, no usable collateral and low levels of financial literacy. At the same time, by providing finance through a sustainable model, it helps to provide groups of emerging farmers with

5 David Milliigan, Business Unit Head, Enterprise Development Solutions, FIRST NATIONAL BANK. BOP Learning Lab workshop, Cape Town, 9 April 2009

vitally needed resources to grow and develop, thereby helping them to secure their economic future and providing them with the essential tools to break a cycle of poverty and subsistence farming. Emerging farmers and rural communities therefore benefit, while FNB gains in terms of exposure to a growing market, crucial expertise on the lower income segments and fulfils some of its targets in terms of complying with its BBBEE obligations and its own stated objectives toward assisting the drive toward transformation.

Launched as recently as August 2008, the Supply Chain Lending model is showing sure signs of success : so far, 28 transactions are being pursued by FNB, by being offered to large corporate clients who need to procure from emerging farmers. One of these projected transactions will involve the creation of a new agri-processing business. The original pilot project has directly benefited 20 emerging farmers and their families, and it enabled the Supply Chain Leader to obtain additional finance to procure from these emerging farmers over and above the credit lines that the bank was previously willing to make available.

Another key dimension of the model is that it seeks to build on, and expand, existing links between the informal sector and the commercial agricultural sector : it quite strikingly illustrates how the dependancy links do not go just one way but that the formal sector also needs the informal sector in order to prosper and build new markets, and has a vested interest in ensuring that emerging farmers succeed.

Conclusion

The lack of access to financial services remains an obstacle to economic development, not just in South Africa but in most parts of the developing world. Due to its central enabling capacity in expanding economic opportunity, the financial services industry has a leading role to play when it comes to integrating the Base of the Pyramid (BOP) into the economic circuit. In many ways, South Africa's unique economic structures, with its unusual combination of developed and developing sectors make the study of the local financial sector particularly interesting, with implications far beyond South Africa's borders : successful approaches could be replicated in other parts of the world, most certainly in many parts of the African continent where the potential for agricultural production is still very largely under-exploited. The leverage effect could be very significant.

FNB's supply chain lending model offers a different take at enterprise development and the financing of emerging farmers and SMMEs by enabling informal economic actors to enter the financial value chain without some of the usual challenges traditionally associated with direct micro-finance, such as high interest rates for beneficiaries and high operational costs for the bank. By channelling loans through a intermediary entity, FNB can offer lower rates and cut costs associated with administering large numbers of micro-loans. There may however be other costs associated with the model, including the fact that the relative security offered by the model to the end-users could stifle innovation and risk-taking by individual emerging farmers and encourage a form of complacency and inertia.

Access to finance does not, on its own, constitute a silver bullet for emerging farmers. Rather, it is about "widening the horizon for the poor" and creating a viable basis for further wealth creation and economic development[5]. While FNB's role in this model is essential, its efficiency depends on all its players fulfilling their respective roles.

South Africa's financial institutions operate in an extremely challenging and diverse environment, and FNB's model is one of several examples of how South African banks are responding in serious and innovative ways to create opportunities and encourage sustainable economic growth in the country.

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