



DEPARTMENT: AGRICULTURE

BATAT Series: Finance 6

SECOND VAN EMPEL REPORT

INSTITUTIONAL ARRANGEMENTS

and

FINANCIAL INSTRUMENTS

for

BROADENING ACCESS

to

FINANCIAL SERVICES

G. van Empel

K. Nhlapo

J. Venter

DEPARTMENT OF AGRICULTURE

OCTOBER 1996

Introduction

On the invitation of the National Department of Agriculture of the Republic of South Africa, Mr Van Empel, Director of Rural Investment Advisory Services, visited South Africa from 13 to 25 October 1996, to assist the Department in the formulation of guidelines for an Agricultural Finance Policy and the development of a National Village Bank Support Programme. The direct costs involved with the visit were paid by the Royal Netherlands Embassy in Pretoria.

During the visit extensive discussions were held with representatives from the National Department of Agriculture, Provincial Departments of Agriculture, the Provincial D.F.I.s, Development Corporations and the Land Bank.

Discussions were also held with the heads of the political leadership of the Department of Agriculture, Minister of Finance and the Department of Trade and Industry. The enclosed report gives only major conclusions and recommendations and does not cover background analyses etc, as it will be incorporated in the policy papers being prepared at the Department of Agriculture.

1. Institutional arrangements

- 1.1. In the Strauss Report an important role is given to 5 wholesale institutions for financing the rural sector and for urban based emerging enterprises: the Development Bank of Southern Africa, Industrial Development Corporation, Khula Enterprises Finance, Land Bank and National Housing Finance Corporation.
- 1.2. These institutions are sectorally based, while the policy responsibility is with the relevant government departments. At wholesale level these arrangements can be regarded as adequate.
- 1.3. Their risk management will be mainly based on the financial status of the financial intermediary to which they provide the credit line, as their loan portfolio is mainly with on-lending financial intermediaries.
- 1.4. At retail level risks are related to the financial services taken by the end-user. Therefore risk management of these institutions is based on risk control at the enduser's level. If a retail financial institution is only involved in providing financial services to one sector there is also a sectoral risk involved. Experience worldwide has shown that retail banking towards small clients in one sector of the economy, such as agriculture, gives a too high risk profile for the financial intermediary and at the same time will increase delivery costs for small enterprises compared to a retail system based on an "all-finance" concept. An all-finance concept in banking means that the retail bank delivers all the financial services it can economically provide in the market it operates, while at the same time it will provide all the financial services a particular client needs. This will enable the retail bank to apply appropriate risk management toward this client, as the retail bank is aware of all the assets and liabilities of this particular client and at the same time can follow the cash flow of this client through the current account.
- 1.5. Sectoral wholesale banks providing credit lines to retail banks based on an all-finance concept, will have a lower risk exposure than sectoral wholesale banks providing credit lines to sectorally based retail financial institutions.
- 1.6. When working out the institutional and operational relationship between the different role-players in increasing the access to agricultural credit these factors have to be taken into account.

2. Role and function of Government, Development Corporations and D.F.I.s

- 2.1 As has been mentioned in the Strauss Report and the Ministry of Agriculture's so-called Van Empel Report of 1995, the State should cease its direct involvement in agricultural credit delivery, as the State lacks the infrastructure and expertise for the effective delivery and recovery of credit. Also final beneficiaries will consider state credit as the last to be repaid.
- 2.2 The role of the Government or its institutions is mainly to provide incentives and instruments to private based role-players in the market to change their behaviour and or adjust their activities towards the policy objectives of the Government. In this particular case it means increasing access to financial services for emerging new farmers, etc. At the same time Government and its institutions provide services direct to the end-user (extension, etc).
- 2.3 Taking these factors into account it is essential to clearly define the role and function of the Government, Development Corporations and D.F.Ls in rural development in general and agricultural development in particular. In South Africa there is little transparency in the division of the role and function between the various actors at both national and provincial level, which reduces the possibilities for adequate control and monitoring.
- 2.4 Taking the functions of the three role-players mentioned into account, the following major division can be made:

- Government Departments and Development Corporations are budget operated institutions that deliver products (extension, advice, project planning, etc).
- D.F.I.s have to be institutions based on financial return and especially at retail level have to be client orientated, using an all-finance concept. Although they have specific development objectives they have to operate at their own risk.

2.5. Both of the role-players mentioned require different forms of management and operating systems. Combining the functions into one organization will result in loss of efficiency with limited accountability and transparency.

3. Recommendations related to institutional arrangements

Relationship between National Department of Agriculture and Provincial Departments.

- 3.1. Agriculture is an economic sector and therefore at national level it has to be ensured that no unfair competition will be practised, by means of highly differentiated support levels rendered by the different provinces. Therefore the financial instruments provided by Government should be designed at national level, while refining based on the practical circumstances can take place at provincial level, based on the predetermined variations allowed in target grouping, eligibility criteria and support levels.
- 3.2. Financing of these instruments should be preferably done on a 50/50 basis, involving the National and Provincial Departments. Implementation of the instruments is the responsibility of the Provincial Department; control and monitoring is the prime responsibility of the National Department.
- 3.3. There is big variation among the different provinces in structure, some have only a Department of Agriculture, others have a Department of Agriculture, a development corporation and a D.F.I., others have the D.F.I. incorporated in the development corporation, etc. It is strongly recommended that where a D.F.I. is incorporated in a development corporation, these two functions to be allocated separate independent agencies. The development corporations are making development plans and are orientated towards budget spending. The D.F.I. has to be able to make its own independent evaluation of the financial viability of these plans before it decides to get involved in financing a project or other initiatives taken by the development corporation. This separation will enhance the transparency of the operations of the two organizations and will increase the quality of decision-making. With regard to information exchange these two activities should not be totally separated. In operations, however, they should be separated.
- 3.4. During the implementation phase both organizations have to cooperate and agree on their various responsibilities. This should be also laid down in the project loan agreement.
- 3.5. As has been mentioned earlier no preference is given to whether the activities of the Department and the development corporation are integrated or separated with respect to services provided to the farming community. However, it is strongly recommended that clearly defined plans for the year are made for these activities using the format of a business plan.
- 3.6. This should include the:
- mission statement with objectives
 - quantitative targets
 - means required
 - products to be delivered.
- 3.7. In order to enhance beneficiary participation it is recommended that a Board be created with strong participation from beneficiary representatives, which should approve the plan and monitor progress.

- 3.8. The D.F.I. should be operated as an independent financial institution, with specific development objectives such as broadening of access to financial services for the emerging farm sector and/or rural entrepreneurs. To make this possible it will need access to some specific financial policy instruments. However, it will have to carry the full financial risks of its operations. It will have to design a business plan comparable to any other financial institution. Although the State can be a shareholder, it should never force the institution to finance a specific client or activity at its own risk, which is regarded as unacceptable from a risk evaluation point of view.
- 3.9. Based on the earlier mentioned risks relating to sectoral financial institutions, the D.F.I. should be allowed to be involved in the financing of various sectors and besides loan products to provide other financial services, such as current accounts, savings deposits etc as well.
- 3.10. Most D.F.I.s are supposed to make use of retail banking, while they are structured like a wholesale bank. This makes it impossible for them to broaden access to credit for small emerging entrepreneurs, including farmers at an acceptable risk level. Proximity to borrowers that require only a small loan is essential to be able to manage a loan adequately.
- 3.11. They have the following options to become an effective retail bank:
- 1) to develop an extensive branch network ; 2) to link up with institutions that have this network; 3) to develop these institutions. As the commercial banks are not interested or do not have the network to provide financial services to the target group, only the first or third option is available. Option one would result in the development of a State Bank that can provide all the required financial services in the rural areas. As it is government policy to privatize and to reduce the role of parastatals this is not a viable option. This leaves only option three, which will be further elaborated on in the chapter dealing with village banks.
- 3.12. If the recommendation is taken over that D.F.Ls should be allowed to develop into a financial institution based on an all-finance concept, a number of steps have to be taken, such as:
- Making the D.F.I.'s operations independent from other government institutions.
 - Ensuring that the financial ratios of the D.F.I. are adequate, eg ensuring sufficient equity, improving the quality of the loan portfolio, a department dealing with bad debts etc will be necessary.

Transforming the operational system comparable to a commercial bank.

- Improving the performance of staff, as there is limited banking knowledge presently in the D.F.I.s.
 - Making the required legal amendments that govern the operations of a D.F.I.
- 3.13. It is recommended that a five-year period be set to make the necessary changes and to phase out any direct State financial assistance. For each D.F.I. a plan should be drawn up with specific yearly operational and financial ratio targets, during this restructuring period.
- 3.14. It is recommended that consultants be hired with substantial operational banking knowledge to assist in the transformation of the D.F.I.s.
- 3.15. Studies should be done to determine the conditions under which the provincial Land Bank branches can be incorporated into this new structure, especially concerning the so-called retail role of the Land Bank towards commercial farmers and land reform beneficiaries. The concept of sectorial Wholesale Banks as recommended in the Strauss Report becomes more transparent if the regional branches directed towards retail services are incorporated into the new D.F.I.s.
- 3.16. The role of Agricultural Production Co-operatives in rural development in general and in credit delivery in particular should be reviewed. Co-operatives should cease to operate as financial

intermediaries as it is in conflict with their main objective to create turnover from sales to the same borrower. They also lack the skill and the operational systems to perform banking functions. Experience in Brazil and other countries has shown how risky it is for production co-operatives to be involved in banking. Many of these co-operatives have become insolvent as a result of their banking activities. Equity is also lacking in relation to the exposure of their loan portfolio.

4. Village banks

- 4.1. In the previous chapter the conclusion has been reached that D.F.Ls are not able to provide effective financial services to emerging farmers and rural entrepreneurs at retail level. The same can be said about other financial institutions operating in South Africa. At community level initiatives are being taken by N.G.O.s and other institutions to develop community banks, village banks, etc, all with the objective of improving financial services to the rural community. Unfortunately, many of these initiatives are temporary solutions, with limited if any, effective backward and forward institutional linkages.
- 4.2. With the current approach towards these institutions, their sustainability has to be seriously questioned, because they can provide, as single independent financial intermediaries, only limited services. Under the current conditions this is already insufficient for the current top entrepreneurs at village level, such as shopkeepers. They already require some money transfer systems. Therefore with the current concept, the best that these institutions can hope for, is that they could assist a client to become a client of a commercial bank. This leads to institutions that can only serve the lower segment of the financial services market at the village level, resulting in a very small portfolio and therefore high operational costs, with a high dependency on subsidies in the long term and a low viability. The sustainability and viability of these institutions can only be enhanced if they are capable to develop their services at the same rate as the financial services required by the top segment of their clients/members. Their development according to these lines will also reduce their dependency on subsidies. Taking cost efficiency into account it is essential that these first-tier organizations will have a second-tier structure which can perform the treasury function, operate the payment clearing system of the total organization, etc. It is envisaged that the transformed D.F.I. can perform these functions, which would also mean that over time they should be jointly owned by the village/community/co-operative banks in a province.

5. Village Co-operative/Community Bank Concept

- 5.1 The current initiatives taken at village level are strongly inclined towards savings mobilization, for which an account is kept with a commercial bank. There are still very limited if any activities within these institutions to use the savings they mobilized for rural credit, therefore they currently contribute to the outflow of rural savings towards the urban economical sector.
- 5.2. If these institutions want to play a role in the development of a diversified rural economy, they should have as an objective the provision of credit to the rural sector in a sustainable and effective way. This objective would be similar to credit cooperatives as they operate in many countries. Although much attention is given in credit co-operatives to savings mobilization, this is essentially considered an instrument towards its objective and not an objective in itself.
- 5.3. Essential aspects associated with the development of these institutions:
 - Self reliance, self governing and strong member participation are the basic governing principles of these institutions.
 - A strong bottom-up approach has to be practised without any interference from the State.
- 5.4. The State should create the appropriate environment and instruments to facilitate development. This includes appropriate legislation, assistance in development, such as training of staff and

board members, expertise in local institution building and empowerment, transaction cost subsidies, limited saving guarantees, etc.

- 5.5. They should have a clear objective, such as providing credit to members in an efficient and sustainable way. This implies that they are economic instruments for the community, as they cannot finance a member with insufficient payment capacity at their own risk. In other words they can broaden access to financial services for the rural community, but they cannot provide social support (eg income support to the needy in the community). They can, however, play an important role in vitalizing the rural economy and can be an instrument in the development of a diversified rural economy.
- 5.6. Standardized statutes should be used that govern the operation of the organization, including the role and function of the elected board of directors, the general assembly of members, etc. No barriers for membership should be established. However, any local entrepreneur who applies for credit has to become a member. For members of the community who only use the savings services, membership should be optional.
- 5.7. They have to be based on an all-finance concept, in other words providing the required financial services to their members and across economic subsectors.
- 5.. Spreading the loan portfolio over all economic activities is essential in order to minimize sector risks. At the same time client risk will be managed better if all the banking services of the client take place through one institution.
- 5.9. Taking the financial market in the villages into account at this stage of the development, the operations of these institutions can be standardized, because they are very limited if any need for individual client designed financing products exists. Standardization will reduce transaction costs and will require only limited banking skills of the staff employed.
- 5.10. High loan recovery rates are essential for the sustainability of these institutions. Factors that determine this are, apart from the normal evaluation and monitoring processes based on banking, that a community-based financial intermediary is better capable to evaluate the character of the borrower, his management skills etc than most commercial banks or D.F.I.s. Community peer pressure will have a positive effect on the attitude of the borrower towards loan repayment.
- 5.11. These institutions will need a second-tier structure in a relatively short time, which they jointly own for treasury activities, payment clearing systems, servicing larger clients, development of new banking products, training, etc. It is recommended that the D.F.I. be transformed into this function. Decision should be made soon on this subject including the expected timeframe, in order to enable the first-tier institutions to develop a relationship from the start with the D.F.I. knowing that they will jointly own this institution within the set time-frame. It is recommended that a maximum of a 5-year period be set.
- 5.12. The Mutual Banking Act appears to be the most appropriate legal structure that governs the operations of these institutions. However, it should be closely studied whether amendments are required to enable these institutions to operate on an allfinance concept as described earlier. In essence these institutions are co-operative banks.
- 5.13. It is recommended that the different currently operating rural financial intermediaries such as community banks, village banks etc operating on different concepts be transformed into institutions that operate according to the same concept, so that it can become part of a system.
- 5.14. The work done by the Financial Services Association regarding the establishment of Financial Services Co-operatives (village bank) should be considered a good starting point for the development of the envisaged rural banking system.

6. Rural Financial Institutions Development Council

- 6.1. The responsibility for a policy for rural development in general and rural financial institutions in particular is vested in different government departments.
- 6.2. Therefore it is recommended that a Rural Financial Institutions Development Council be established under the chairmanship of the Ministry of Finance.

Members of this council should include representatives from the Ministry of Agriculture, Ministry of Trade and Industry, Ministry of Housing, Reserve Bank etc. The council should, however, also include representatives of NGOs and farmers as well as medium and small enterprise organizations.

The role of the council is to:

- create the appropriate legal framework
 - develop the appropriate instruments such as transaction cost subsidy fund, etc. ensure that sufficient budgetary resources are made available to develop these institutions. It is recommended that 50/50 finance will be made available at national and provincial level.
 - supervise the activities of the National Implementation Unit for the development of rural financing institutions.
 - supervise the restructuring and repositioning of the D.F.I.s
- 6.6. Taking these factors into account an enlarged Co-ordinating D.F.I. Development Council as suggested in the Strauss Report could fulfil the role described.
 - 6.7. It is recommended that similar structures are formed at the provincial level, they have to concentrate mainly on the practical implementation, which should be carried out by the Provincial Implementation Unit.
 - 6.8. Until the restructuring process of the D.F.Ls as described earlier is well under way towards its second-tier function, it is recommended that the nationally and provincially based service organizations operate independently from an existing financial intermediary or government department. At a later stage (3 to 4 years) these functions can be taken over by the D.F.I. second-tier structure.

7. The National Implementation Unit

7.1 The main task of the W.U. should be to

- design and implement a publicity campaign;
- develop standardized manuals, operational guidelines, banking products, statutes, etc;
- design an easy loan evaluation point-scoring system;
- develop training programmes;
- give training courses to staff of the Provincial Implementation Units;
- assist in the creation and co-ordination of the work of the provincial credit inspectors;
- disseminate information received from the loan level and to make relevant policy recommendations and suggestions to the Board concerning the appropriate environment;
- co-ordinate (with the National Reserve Bank) the creation of the appropriate legal structures; and
- manage the created specific instruments such as transaction cost subsidy fund, savings, guarantees, etc.

7.2. The N.I.U. should be guided and directed by the board of directors. Staff numbers at the N.W. should be approximately six. Expertise required will be: rural banking

- institution building
- legal matters.

7.3. One of the staff members should be strongly affiliated to the N.G.O.s. The F.S.A. should be incorporated into the N.W. or it should be given the task of an N.W.

8. Provincial Implementation Unit

8.1. The main tasks of the PIU are:

- stimulating the establishment of the village banks;
- identifying the proper initiators in the rural areas, who can be the driving force behind an initiative to develop a village bank, where relevant in co-operation with N.G.O.s; carrying out formal and on-the-job training of staff and board members;
- assisting in the treasury aspects, especially in the negotiations with financial intermediaries (preferably the D.F.I.) on the open-end account for the village bank on the best possible terms;
- transforming existing rural banks or similar organizations into village banks;
- carrying out credit inspections;
- reporting to the Provincial Board and the N.I.U. on the financial data, progress and problems encountered.

8.2 It is proposed that the Board at Provincial level should consist of representatives of provincial organizations similar to the national organizations mentioned. It is anticipated that staff numbers at each P.I.U. should, initially, be approximately four.

9. Implementation and budget

9.1 After broad-based consensus has been reached on the concept, the N.I.U. should be established, or the F.S.A. should be transformed. The first task would be to refine the concept and to attend to all outstanding issues, such as legal aspects, etc. This should be done under close supervision and co-operation with the envisaged council.

9.2 This should be followed by the establishment of at least three P.LU.s in those provinces that already have some form of rural financial institutions.

9.3 At the end of year one all provinces should have a P.W.

9.4 The establishment costs of a village bank are estimated at R30 000. This includes the salary costs of the employees during the first year. In the subsequent year 50 % of the salary costs can be subsidized. After that the village banks can make use of the more generic instruments to broaden access to credit, such as a transaction cost subsidy fund etc.

9.5 It is estimated that a village bank with a total portfolio of R1 million can be profitable.

9.6 The proposed starting date is April 1997.

9.7. During the first year it is estimated that 20 village banks will be established.

9.8. In year two the aim is 100 village banks.

9.9. In year three the target should be 200 village banks.

Budget estimates

| | Year 1 | Year 2 | Year 3 |
|--|--------|--------|--------|
|--|--------|--------|--------|

| | | (R million) | |
|--|---|-------------|----|
| Operational cost N.W. | 4 | 5 | 6 |
| Operational cost P.I.U.s | 6 | 18 | 20 |
| Subsidy operational cost village banks | 1 | 4 | 8 |

10. Financial instruments

10.1 As stated earlier an important aspect of government policy is to improve access to credit, especially with regard to economic activities, to newly established enterprises, which currently have no access. Because of past policies, currently only a small sector of the South African population has access to a wide range of financial services. In order to stimulate economic growth, broad access is considered an essential element of overall government policy.

10.2. At the sectors] level the Department of Agriculture has as one of its policy objectives to broaden access to financial services, especially credit to new emerging farmers. For this purpose, it wants to put some policy instruments into the market to stimulate financial intermediaries to provide better financial services to the target group. At the same time the Department wants to end its direct involvement in providing credit to end-users or financial intermediaries.

10.3. In order to effectively design policy instruments that will improve access to credit, it is important to analyse the reasons for lack of access. The main perceived reasons given by financial intermediaries are:

- a) Lack of securities/collateral that can be offered by emerging farmers.
- b) Low rate of return in project financing because of the investment required for improving the agricultural infrastructure (this applies mainly to farm settlement schemes, etc).
- c) High transaction costs involved in providing credit to the target group. This involves . two elements:
 - high cost to manage a credit cycle for small loans
 - lack of banking network close to the beneficiaries (banks are mainly located in urban areas, far away from a large part of the targeted beneficiaries).
- d) High risk in the agricultural sector, which comprises three types:
 - market risk, mainly price
 - weather-related risks
 - management risk, low level of education/experience.

10.4. The Government can therefore bring some policy instruments into the market, which reduces the impact of these reasons on the access to credit for the intended target group. The following instruments are proposed:

- A. Credit guarantee scheme to reduce the impact of the lack of securities/collateral.
- B. Project finance fund which provides grants to partially finance projects which will increase the rate of return to acceptable levels for the financial intermediary that provides the loan.
- C. Transaction cost subsidy fund to reduce the transaction cost for the financial intermediary that provides loans to the target group.
- D. Crop Insurance Scheme to reduce weather risks and to replace *ad-hoc* drought relief schemes.

- E. Development of a rural financing system based on the village bank concept as described in Chapter 4.
- F. Extension services to reduce the management risk. For price risk no instrument should be developed, as this will lead to market distortion. Price risks are as in any other sector, normal market risks which have to be borne by the producers and/or financial intermediaries.

A. Credit Guarantee Scheme

10.5 Target groups:

- Emerging farmers, including farmers in settlement schemes
- Farmers mainly on leased land or communal land

10.6 A guarantee scheme can only eliminate the problem of lack of collateral and will not solve the problem of lack of payment capacity. Payment capacity for a family farmer should be calculated on the basis of total family income from all sources, minus production expenses and expenses involving the sustaining of the family. The positive balance gives the repayment capacity. The ratio is calculated by taking the payment capacity and dividing this by the liabilities resulting from the loan and possible liabilities from other loans (interest and yearly repayment on the principle). A ratio of 110 % should be regarded as a minimum for any loan that can qualify for the agricultural credit guarantee scheme.

10.7. Loans that will qualify:

- minimum 110 % calculated payment capacity ratio
- production loans to one farmer up to R10 000
- medium-term investment loans to one farmer up to R100 000.

10.8. Although production loans are eligible, this should be phased out over a three-year period, as production loan financing is not usually based on fixed assets but on crop and other types of pledges, which normally have to be adequate to qualify for the right amount of a production loan. Maximum guarantee given will be 40 to 60 % of the nonrecoverable part of the loan. The guarantee scheme will only cover the loan amount and not the interest payment.

10.9. Another condition for qualification under the guarantee scheme is that the farmer should have access to extension services and training. This should stimulate the extension services to concentrate on emerging farmers.

10.10. Financial intermediaries wishing to qualify for the scheme have to provide proof that their administrative procedures are in order. In other words, they have to keep adequate loan files containing: loan application form, loan approval form, loan document with the appropriate conditionality, proof of loan disbursement to ensure that the loan is used for the purpose it was intended for, documentation of actions undertaken during nonperformance of the loan.

10.11. The conditionality mentioned can be found in the loan file, which makes control and monitoring of the guarantee scheme relatively easy. Based on the eligibility criteria the financial intermediary can easily judge that a loan qualifies for the scheme. Therefore they can in most circumstances proceed to approve the loan and disburse the loan before official notification has been received that the loan has been accepted by the scheme.

10.12. Acceptance of a loan in the scheme is given by the Provincial Credit Guarantee Board, which consists of representatives from the Department of Agriculture and representatives from farmers' organizations (5 members). They will meet every two weeks and keep proper records of the procedures of their meetings.

- 10.13. Monitoring and control will be basically carried out by random sampling of 10 loan files at the financial intermediary, as all the criteria used are normally in the loan file, followed by a visit to 5 beneficiaries. The National Department of Agriculture is responsible for the control and monitoring function.
- 10.14. Claims that are made against the fund will be approved by the Provincial Board. Financial intermediaries that make the claim have to give ample proof that they have done everything possible to fully recover the loans. Records on visits to the farm etc have to be handed over, including notices given to the nonperforming borrower and proof of all payments received relating to the particular loan.
- 10.15. After a claim has been approved, the guarantee fund manager at national level will make the payment to the financial intermediary concerned.
- 10.16. At national level only a 40 % guarantee will be given, provinces have the option to increase this by a maximum of 20 % at their own risk.
- 10.17. It is proposed that as a start R20 million will be deposited in the fund. This should cover a loan portfolio of R250 million at a presumed recovery rate of 80 % with a 40 % guarantee. This is perceived to be sufficient for the coming years, although no detailed analyses have been made of the potential portfolio that could be covered taking into account credit demand from the target group.
- 10.18. The assets in the fund should have a return of at least 15 % on an annual basis.

B. Project Finance Fund

- 10.19. A project fund for special projects that grants assistance for small-farming development is already operational. The guidelines give a good overview of the target group.
- 10.20. These recommendations are to refine the operations of the fund.
- 10.21. Funding of the projects involves three elements: own contribution from the beneficiaries, credit from a financial intermediary and grant funding from the State.
- 10.22. It is essential that financial commitment from the three sources is obtained and guaranteed before a project is implemented. Disbursement of the credit and grant should be done in equal portions. For practical and transparency reasons the disbursement controls of both the grant and credit should be carried out by the financial intermediary and not by the implementation agency of the project, such as a development corporation.
- 10.23. The responsibility for project development and implementation lies with the Provincial Authorities. Therefore it is also advisable that the grant fund is provided on a 50/50 division between the province concerned and the National Project Fund.
- 10.24. Approval for a project is done by a Provincial Project Development Board consisting of representatives of the relevant provincial departments, D.F.I. and representatives of farmers' organizations.
- 10.25. The maximum grant set for a project should be 40 %, project implementation should be maximum 2 years and the maximum amount of grant funding per project is R2 million. Big projects with a large infrastructural component, should not be eligible for the fund, as decision making and preparation demands a much more elaborate process than foreseen in the guidelines.

10.26. In order to enhance the transparency of the decision-making process and in order to be able to monitor projects effectively a uniform point scoring system should be used according to the following parameters:

- sustainability and viability after grant financing is stopped from a financial, institutional and beneficiaries commitment point of view (max. score 3)
- cost per beneficiary, the lower the better (max. score 2)
- rate of introduction of new technologies or institutional structures (max. score 3)
- availability of support such as extension, training, design services etc (max. score 2)

10.27. It is recommended that these parameters be quantified further. Each project approved should have a minimum score of 7.

10.28. The National Fund will make its own evaluation of the projects approved once a year.

10.29. If major deviations occur during project implementation concerning impact and results from the projected figures, the Provincial Board will review the project and make recommendations on remedial action to be taken. This action has to be approved from the National Fund, before the project can continue.

10.30. Based on a 50/50 grant funding the National Project Fund should obtain R40 million from the Central Government budget.

C. Transaction Cost Subsidy Fund

10.31. Many emerging farmers and other rural entrepreneurs who could be using banking facilities have no access to formal credit because the loans they require are too small compared to the transaction costs of supplying these loans. Transaction costs involve loan application, evaluation, agreement, disbursement, monitoring and collection. The transaction costs of a small loan of R1 000 are nearly as high as those for a loan of R30 000. As normally the transaction costs should be covered by the interest rate spread (difference between interest on funding versus interest rate on the loan), this would mean that very high interest rates should be charged for small loans. This is making the development objective of improved access to credit for this target group neither feasible nor acceptable.

10.32. The problem of high transaction costs is further aggravated by the fact that most emerging farmers are relatively far from the offices of the financial intermediaries. This makes the proper assessment of loan and borrower more complicated and, therefore, costlier. The related institutional issue is dealt with under the proposal to develop a rural financial system.

10.33. It is proposed to establish a transaction cost subsidy fund in order to improve the accessibility to credit for farmers and other emerging entrepreneurs. This issue is related to emerging entrepreneurs in all sectors of the economy, therefore, the responsibility for the fund should be interdepartmental, with the Ministry of Finance as the manager of the fund. An alternative is to create the fund under the envisaged Development Council as foreseen in the Strauss Report.

10.34. Target group: Emerging entrepreneurs including farmers who have never received formal credit or only once before.

10.35. Eligibility criteria:

- payment capacity ratio should be a minimum of 110 % as calculated in the loan evaluation form
 - short-term loans such as production loans up to R10 000
 - medium-term loans up to R20 000

- production loans for one particular borrower can get a transaction cost subsidy for a maximum of three years
- a medium-term loan for one particular borrower can get a transaction cost subsidy only once.

10.36. Based on a preliminary estimate the following subsidy levels are envisaged:

- Short-term credit
 - Ø amount R500-R1 499, subsidy R200
 - Ø amount R1 500-R4 999, subsidy R150
 - Ø amount R5 000-R9 999, subsidy R100
- Medium-term loan
 - Ø amount R3 000-R9 999, subsidy R200
 - Ø amount R10 000-R20 000, subsidy R100

10.37. In order to establish the final subsidy levels it is recommended that precise calculations be carried out based on the most efficient form of credit delivery by a financial intermediary.

10.38. Financial intermediaries wishing to utilize the fund have to sign a contract that they will not split up loans and that they will follow the eligibility criteria as described. They can send in an invoice for the amount of subsidies once a month. The following information should appear on the invoice: the name of the borrower, amount of loan, loan type and loan file number.

10.39. After receiving the invoice the fund will pay the amount due to the financial intermediary within 30 days.

10.40. Each financial intermediary participating in the scheme will be random checked using the loan-file numbers; some visits will be made to borrowers to ensure that all criteria are met. A more thorough investigation will take place only in the case where misuse of the scheme is expected, based on the result of the random checking.

10.41. The financial intermediary will in cases of misuse have to refund the subsidies received and will be given a 200 % fine.

10.42. The fund will be managed at provincial level because only retail banking institutions are involved in lending to the target group.

10.43. The fund should be initially capitalized to the level of R20 million. Here a 50/50 split in contributions by National and Provincial Authorities is also recommended.

10.44. After further fine-tuning the eligibility criteria and the setting of the subsidy levels, the transaction cost subsidy fund should become operational by 1 May 1997. Eligible financial intermediaries should be informed about the establishment of the fund as soon as possible.

D. Crop Insurance Scheme

10.45. The past practices of relief schemes concerning drought and other weather related disasters, accompanied by writing off of debt have given wrong market signals, such as a negative effect on loan recovery. Because of political and other reasons, it is anticipated that the State will be inclined to intervene by means of different forms of relief measures when weather related disasters occur. It is recommended that measures be taken which are more related to the market. This makes it possible for farmers to take out an insurance against the effects of these disasters, in the form of a crop insurance scheme. This can also include the livestock

component. This scheme should only cover commercial farmers and emerging farmers producing for the market.

10.46. For household (basically subsistence) farmers traditional State funded social programmes will have to remain operational in the case of natural disasters.

10.47. As it is anticipated that it will not be feasible for the private sector alone to implement a crop insurance scheme with a wide coverage at an affordable rate, the State will have to partially sponsor the scheme.

10.48. Involvement of private-based insurance companies that will manage the scheme and collect the premiums, is essential.

10.49. As insufficient data are available to provide a blueprint for such a scheme, it is proposed that a task force be formed to work out the details for a crop insurance scheme. This force should include representatives from the Department of Agriculture, Ministry of Finance and representatives from insurance companies who might be interested to operate a crop insurance scheme. Consultants from the private sector could be also contracted for the development of the plan.

10.50. The task force should present its plan by 1 May 1997. If decision making takes place soon a comprehensive crop insurance scheme could be operational before the 1997/1998 season.

10.51. The following aspects could be included in defining the work of the task force:

- Zoning has to be closely studied and should result in excluding some agricultural practices from being covered by the insurance. This is particularly applicable to crop growing in drought-prone areas, where even in a good year only marginal returns can be obtained. This will result in the return of these marginal areas to extensive livestock production. From a soil conservation point of view this is also the preferred option.
- Extensive livestock production will be only covered when appropriate stocking rates are applied. Therefore zoning and establishment of appropriate stocking rates for each zone, which determine the eligibility of producers to receive coverage under the scheme have to be worked out in detail.
- A balance will have to be found between the risk involved and the return per unit area.
- The premium should not add more than between 2 to 4 % to the production cost for the crop involved. The balance will have to be subsidized, partly through cross-subsidization from the low risk areas and partly through the State budget.
- State budget subsidies should be concentrated in the first two years in order to capitalize the scheme sufficiently. After this period no or very limited subsidies should be given.
- In many cases of natural disasters resulting in a drop in production, market prices for these products will increase, which will partially offset the financial consequence of the disaster. Therefore, insurance coverage should not be related to yield but to financial return per unit, taking into account the production zone.

10.52. An important side-effect of a crop insurance scheme is that it will improve access to credit as it reduces the risk for financial intermediaries in agricultural financing. At the same time when such a scheme is available financial intermediaries will include their loan conditions that crop insurance coverage is taken out by the borrower.

10.53. Another important effect of the scheme is that appropriate agricultural management practices will be encouraged and in some cases rigorously enforced. This should be considered an important policy objective, that can be achieved through State fund contribution in the scheme.

- 10.54. After the system is in place the State should also exercise discipline, meaning that no bailouts will take place to farmers who can get insurance coverage, commercial farmers and emerging farmers involved in market-related production. Only subsistence farmers will still need direct State assistance in case of a serious natural disaster.
- 10.55. It is strongly urged that the task force which has to work out all the details for such a broad-based crop insurance scheme be formed as soon as possible.