



Prepared for the Bank of Uganda/GTZ//Sida Financial System Development Programme and KfW

# Agricultural Finance in Uganda

## The Way Forward

By  
Richard L. Meyer  
Richard Roberts  
Adam Mugume  
June 2004





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**Richard L. Meyer**  
**Richard Roberts**  
**Adam Mugume**

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37/43 Kampala Road

P.O. Box 27650

Kampala, Uganda

Email: [fsd@bou.or.ug](mailto:fsd@bou.or.ug)

Layout / Cover design:

Acha Graphics

P.O. Box 23363

Kampala, Uganda

Email: [acha@imul.com](mailto:acha@imul.com)

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Email: [qcprint@africaonline.co.ug](mailto:qcprint@africaonline.co.ug)

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## **ABBREVIATIONS AND ACRONYMS**

ACDI/VOCA	Agricultural Cooperation Development International/Voluntary Overseas Cooperative Assistance
ADB	Africa Development Bank
AFMIN	African Microfinance Network
AFRACA	Africa Rural and Agricultural Finance Association
AMFIU	Association of Microfinance Institutions in Uganda
ASCA	Accumulating Savings and Credit Associations
BoU	Bank of Uganda
CBA	Community Business Advisor
CBO	Community Based Organization
CDO	Cotton Development Organization
CERUDEB	Centenary Rural Development Bank
COMESA	Common Market for East and Southern Africa
CREAM	Consultancy for Rural Enterprise Activities and Management Ltd
DANIDA	Danish International Development Agency
DCA	Development Credit Authority
DFCU	Development Finance Company of Uganda
DFD	Development Finance Department of the Bank of Uganda
DFID	Department for International Development
EIB	European Investment Bank
EPTD	Environment and Production Technology Division of IFPRI
EU	European Union
FAO	Food and Agriculture Organization
FINCA	Foundation for International and Community Assistance
FSA	Financial Services Association
FSAIU	Financial Services Association International Uganda Ltd
FSD	Financial System Development Program
GoU	Government of Uganda
GTZ	German Technical Cooperation
HIPC	Heavily Indebted Poor Countries Initiative
ICRC	International Committee of the Red Cross
IFAD	International Fund for Agricultural Development
IFPRI	International Food Policy Research Institute
IITA	International Institute of Tropical Agriculture
JENGA	Joint Encouragement of New Gainful Activities (CARE project, West Africa)

KfW	German Development Bank
MAAIF	Ministry of Agriculture, Animal Industry and Fisheries
MCC	Microfinance Competence Centre
MDI	Microfinance Deposit-taking Institution
MFPEd	Ministry of Finance, Planning and Economic Development
MFI	Microfinance Institution
MMD	Mata Masu Dubara (program of CARE in Niger)
MSCL	MicroSupport Centre Ltd
MTCS	Medium Term Competitiveness Strategy
NAADS	National Agricultural Advisory Services
NARO	National Agricultural Research Organizations
NPA	Non-Performing Assets
PMA	Plan for Modernisation of Agriculture
PMT	Performance Monitoring Tool
PEAP	Poverty Eradication Action Plan
RMFSP	Rural Microfinance Support Program
ROSCA	Rotating Savings and Credit Association
SACCO	Savings and Credit Cooperative
Sida	Swedish International Development Agency
SLA	Savings and Loan Association
SME	Small and Medium Enterprise
SOE	State-Owned Enterprise
SPEED	Support for Private Enterprise Expansion and Development Project
SUFFICE	Support to Feasible Financial Institutions and Capacity-Building Program(EU)
TB	Treasury Bill
UCA	Uganda Cooperative Alliance
UCB	Uganda Commercial Bank
UCCA	Uganda Change Agents Association
UCDA	Uganda Coffee Development Authority
UCSCU	Uganda Cooperative Savings and Credit Union
UGT	Uganda Grain Traders
UIB	Uganda Institute of Bankers
UMU	Uganda Microfinance Union
UPE	Universal Primary Education

UNDP	United Nations Development Program
USAID	United States Agency for International Development
UWFT	Uganda Women's Finance Trust
WFP	World Food Program
WOCCU	World Council of Credit Unions

# Executive Summary

This report presents the findings of a study commissioned by the Bank of Uganda (BoU)/GTZ/Sida Financial System Development Program and KfW that was designed to investigate the development of self-sustainable agricultural finance in Uganda. The objective of the study is to identify the major bottlenecks and draft a medium-term strategy for the support of agricultural finance. It was undertaken against the backdrop of success that the government has achieved, working in conjunction with several international donors, in strengthening microfinance services for the poor.

## Macroeconomic and Financial Policies and Performance

Since 1987, Uganda has been undertaking major policy reforms designed to create a more liberal market-oriented economy and reverse the previous inward-looking, import substitution development strategy. Major policy measures have been taken to develop an effective, efficient and competitive financial system. The government has reduced its roles as owner of financial institutions and allocator of financial resources. The BoU (Bank of Uganda) has been given the mandate and the tools to play a more effective role in overseeing the development of the financial system, and to regulate and supervise the major financial institutions. The country is among the world's leaders in working through the complex issues of developing and regulating microfinance.

The economy responded well to the changes in development strategy during the 1990s when comparatively high levels of economic growth were recorded, inflationary pressures were contained, and good progress was made in reducing poverty. The country became an international showcase for economic reform and its efforts were recognized when it was selected as the first developing country to qualify for debt relief under the HIPC initiative in 1998. Concerns have emerged, however, that perhaps the relatively easy task of restoring economic growth has run its course and the more difficult task of developing institutions necessary to support a market-oriented economy must now be faced.

Some basic underlying structural problems can be seen in the financial system. In spite of several bank closures and the licensing of many new banks, financial sector deepening has not yet recovered to its mid-1970s level. A quarter of the commercial banks have been closed due to fraud and mismanagement, most having been registered between 1992 and 2002.

The ratio of customers to bank branches has risen sharply as the number of bank branches has been substantially reduced. Attractive rates paid on treasury bills and the underlying weakness of the banks to successfully screen clients and enforce loan contracts have led to high levels of excess reserves being held by banks and in banks heavily investing in risk-free assets rather than advancing loans. Real interest rates on loans are high so demand is limited to lightly leveraged firms realizing high rates of returns on investments. The four largest commercial banks are foreign-owned. They compete and engage in inter-bank transactions amongst themselves, are the market leaders and hold 70 percent of total commercial bank assets. The remaining smaller commercial banks, also mostly foreign-owned, compete for the remaining market niches. The commercial banks limit their exposure to agriculture and rural areas by making loans to the larger processing and export firms, some input supply companies and a few large farmers.

The emergence of microfinance has been a more positive development in the financial sector, especially for those concerned about access to formal financial services by small firms and households, which comprise most of the economy. Even here, however, agriculture and the rural economy have been largely unaffected up to now because most microfinance institutions (MFIs) have focused their operations in urban and peri-urban areas, their loan asset portfolios being heavily concentrated in short-term working capital loans for trading and commercial enterprises with frequent loan installments that are best suited to such enterprises. Member-owned SACCOs (Savings and Credit Cooperative Associations) and informal finance still largely serve the rural economy. Increased competition between commercial banks and MFIs has led both to experiment with new products and to attempt to serve new types of clients. This is seen most clearly in the competition for salary based loans. This development offers some hope that previously neglected small and micro businesses, small farmers, and rural areas may eventually be offered a better supply of more attractive financial products.

## Agriculture and Rural Areas – The Emerging Demand for Formal Financial Services

Uganda's economic reforms have provided fertile ground for private sector responses to economic opportunities in agricultural and fisheries production

and other associated downstream value-added activities. Indeed, success in these developments is crucial to the effectiveness of the Plan for Modernization of Agriculture (PAM), itself an important contributor to the aims of the Poverty Eradication Action Plan (PEAP).

The formal financial system is currently meeting some of the demand for financial services from the agricultural production and trading sectors, but access is generally limited to larger clients, both farmers and traders. Moreover, even for larger clients, there is unmet demand for less traditional financial products, such as term loans and price buffering mechanisms.

#### **Demand – Input Supply and Post Harvest Traders**

Of primary importance are the demand signals from destination markets (for exported commodities) and terminal markets (for other produce). The effectiveness by which the marketing chain can meet these market demands is dependent to some extent on the ability of actors in the chain to purchase volumes of commodities sufficiently large to achieve economies of scale in handling, processing and transport. Moreover, at some stages in the chain, a critical minimum volume is needed in order to attract buyers whose business would lead to advantageous sales.

Handling large volumes of commodities requires working capital. Only the largest traders currently benefit from bank advances secured by warehouse receipts. There is scope to improve the efficiency and lower the cost of managing stored products as collateral, so as to enable more traders to take advantage of the mechanism and the improved borrowing terms that result. Efficient trading also needs equipment, storage facilities and transport appropriate for larger volumes. The resulting benefits, in a well-informed chain, ultimately feed through to the farmer-producer, through formal market information services and informal signals passed along within the commodity chain. These requirements for output traders are mirrored in input markets, such as those for fertilizers, which are often served by the same traders.

Apart from conventional loans, there is clearly a demand in Uganda for improved marketing/financial mechanisms in order to reduce downside price risks. These mechanisms, for crops such as maize, would make a positive impact throughout the system, right down to the farmer producer, as well as to the suppliers of financial services. Possible strategic interventions include measures that will facilitate contract farming (which would convey price stability benefits for producers), and encouragement of forward selling to regular buyers. The mission has identified these interventions as warranting additional

study.

Along with the expansion in trading enterprises, future development in rural areas will include a natural growth in part-time farming and migration out of farming completely. This will spawn other non-farm enterprises in rural areas, which in turn will create an additional demand for rural financial services.

#### **Demand – At the Farm Level**

The agricultural sector is not homogenous. The PMA recognizes three broad groups of farmers (i.e. subsistence, semi-commercial and commercial). Because of substantial differences in the circumstances of these groups, their demand for financial services is outlined separately below.

##### **Commercial Farmers:**

There are an estimated 60,000 farmers and fishermen who operate on a commercial scale in Uganda. Some already enjoy access to short-term loans from commercial banks, MFIs and business firms that buy and/or process crops such as sugar cotton and tobacco. Term finance is much less common. Yet it is term finance for machinery, equipment and major farm improvements, such as livestock, that this group requires if a greater supply response to expanding market opportunities is to be engendered through productivity increases. Indeed, to date, access to term finance has been confined to a few borrowers who have benefited from special lines of credit for relatively large outlays for items, such as oil pressing machinery and cotton gins. In addition, some MFIs have made a few loans to rural individuals for machinery such as hammer mills and maize shellers.

There is a market for lease arrangements as demonstrated by several enterprises and individuals who currently lease machinery such as tractors and trucks. Demand for leasing is likely to expand, since about a third of current lessees receive tax benefits under lease arrangements and this proportion is expected to increase. Finally, a largely unexplored financial product for this group is life insurance, especially when linked to term loans as a way of mitigating the risks faced by lenders.

##### **Semi-commercial Farmers:**

The demand for financial services from this group of farmers is similar to that for commercial farmers with any difference being mainly one of scale. Some farmers in this category are linked to nucleus estates where there is significant management, input supply and product marketing support. Although many such

outgrower schemes include production loans extended by the central processor/buyer, there are many situations where a local MFI or other financial intermediary could provide better all-round service to the outgrowers. In addition, expanded financial services from financial institutions would help mitigate some of the exploitative tendencies that are inherent in financial dealings that see nucleus estates provide outgrowers with financial as well as other services.

### **Subsistence Farmers:**

Subsistence farmers are not only the most numerous (more than 3 million households), but by far the most challenging for the suppliers of financial services. Clearly it is vital to disaggregate the demand for services within this group. An important distinction needs to be made between “*villagers*” who do not actively strive to produce marketable surpluses, and “*farmers*” who set out to produce for the market, albeit on a small scale. If policy makers base policy formulation and support initiatives on the assumption that villagers will automatically respond to the same production incentives as farmers, then this will mean diversion (even waste) of effort and financial resources (e.g. under the Outreach Plan) from more productive and promising, but still poor, segments of the rural population.

It can be expected that a large number of villagers demand savings, deposit and money transfer services. Beyond this group, there are emergent subsistence farmers who actively try to earn a significant part of their livelihood from farming. They are oriented to serving the market, even though most in this category still use traditional farming technologies. There will only be a few in this group who can use loans for farming purposes effectively. Therefore financial intermediaries need efficient screening techniques to identify creditworthy borrowers of seasonal finance.

Lenders must identify suitable creditworthy borrowers by selecting only those who already have proven abilities to manage improved technologies or new crop/livestock enterprises by using their own financial resources. Loans can then be advanced to enable these proven entrepreneurs to expand the scale of their operations. A similar approach is needed for fishermen.

### **Supplying Financial Services to Agriculture and Rural Areas**

Supplying financial services to rural areas is more challenging than urban areas because of the higher costs and risks involved. Most of the savings and

loan transactions are fairly small with the result that financial institutions face high operating costs. Centenary Bank is the only commercial bank that has made a special effort to design a loan product and lending methodology for use in making individual loans to small commercial farmers. Its experience demonstrates both the promise and pitfalls of serving this clientele group.

The emergence of NGOs as specialized microfinance institutions and the new legislation authorizing some MFIs, the so-called Micro Deposit-taking Institutions (MDIs) to intermediate the public's savings, means that eventually there will be more regulated financial institutions committed to serving those in the lower income segment of the market. Increasing competition among the banks may also mean that some will actively search for new market niches in rural areas. Several banks have begun to offer unsecured salary loans and to use ATM machines to reduce the cost of handling small savings transactions. Some banks lend to NGOs, thereby indirectly serving the lower income market segments.

Hundreds of SACCOs and other member-owned financial organizations are the most important source of financial services for thousands of rural and farm households. However, they are among the weakest and least sustainable of the financial institutions. This is because SACCOs face inherent problems in having weaker governance structures compared to most other regulated financial institutions. The SACCO sector's lack of strong regulatory and supervisory mechanisms, compared to banks, contributes to its weakness. This situation is unfortunate because member-owned organizations have the potential to intermediate member savings in remote areas where commercial banks may find it too costly to establish branches. Moreover, member-owned organizations often engage in smaller size transactions that are desired by lower income people.

### **Expanding the Frontier of Formal Finance**

All financial institutions face constraints in trying to push the formal financial frontier deeper into rural areas. Commercial banks are best suited to make large term loans for agricultural transformation, but the current system of land titling, registration, and security of land tenure prevents the widespread use of land as collateral for loans. The lack of long-term savings also limits the supply of stable funds needed to make term loans. The reforms underway in the Justice, Law and Order Sector will be important for financial institutions as they will strengthen the legitimacy of written contracts and contract enforcement measures through the legal system.

The MDIs that will be licensed under the new law will face two major constraints in serving agriculture. One is the lack of resources (capital) and trained staff for expanding their branch networks. The other is a lack of appropriate rural savings and loan products given that these institutions have largely in the past served an urban and peri-urban clientele with loans and compulsory savings products. In addition, the remaining NGOs that will not be licensed to take deposits under the MDI bill will face constraints in accessing loanable funds, as donor funding for on-lending gradually declines. Moreover, many cannot be expected to be financially viable for some time to come to be able to access commercial bank loans.

The member-owned organizations face the greatest hurdles. Not only do they tend to be weak, they lack a strong regulatory framework that is so important for commercial banks. However, unlike some NGOs, even some of the best SACCOs have not been able to significantly improve their financial position in spite of heavy donor support. Thus, while some are now being reorganized as a condition for receiving additional external support, their prospects for efficiently managing such support remains weak. In addition, such external support can undermine incentives for self-help and thereby damage the SACCOs' most important attribute, namely their ability to intermediate local savings.

All financial institutions face common crosscutting problems. One is that neither they nor farmers have access to good sources of information about the nature of profitable investment opportunities in the market. Second, they all suffer because of the low level of profitability inherent in farming, which is further exacerbated by deficient infrastructure and markets, and by the low level of human capital found in agriculture. Third, trained bank staff is scarce and expensive. Fourth, it is costly to establish and operate bank branches in remote areas. Fifth, there are still gaps in donor coordination such that projects and activities undertaken by different donors are not always geared towards a coherent strategy of financial sector development.

## Recommendations

The Recommendations of the Mission are annotated in more detail in Chapter 5 in this report. They address direct and indirect ways in which the economic transformation of the rural sector can be encouraged through strengthening the financial system. The Recommendations are arranged in three clusters:

- ✎ Cluster One: Long Term Strategic Plan for Financial Services to the Agricultural Sector, and Related Issues

- ✎ Cluster Two: Issues for Attention by Legislators, Government Ministries and the BoU
- ✎ Cluster Three: Unfinished Business

### Cluster One: Long Term Strategic Plan for Financial Services to the Agricultural Sector and Related Issues

The issues concerning the improvement of financial services to the agricultural sector warrant special efforts to develop an overall *ongoing strategy*, which would provide guidance for policy development, and for the design and coordination of support programs and projects. The Mission proposes that a long-term strategic plan should be developed through dialogue between all concerned parties. Such a plan should include inputs from a range of experienced and resourceful stakeholders, including those from the commercial and trading sectors.

A High Level Workshop that would detail a work plan for the ongoing strategy on agricultural finance would initiate the Plan. The Mission believes that such a workshop could be held in the near future, contingent on the issuance of a policy paper that would focus deliberations, and on efforts to ensure that suitable participants attend the workshop and any follow-up workshops and/or deliberations. It is crucial for donors to be fully engaged in the workshop and contribute to the design of the long-term strategy so as to incorporate the workshop's outcome into their bilateral and multilateral programs of assistance to Uganda.

Particular issues to be dealt with under the Workshop and the Plan would include:

- ✎ Ongoing support for MFIs and the 'newly to be licensed' MDIs involved with the agricultural sector.
- ✎ Measures to strengthen business arrangements between the agricultural sector and the financial sector – for example in the area of contract farming.
- ✎ Specific attention to member-owned financial organizations, including:
  - ✎ Support measures other than the provision of funds for on-lending;
  - ✎ Separation of financial from other areas of business;
  - ✎ Rationalization of the roles of apex bodies; and identification and strengthening of the more promising governance models. Developing a standardized performance monitoring system would assist policy making for the member-owned bodies.

- ✘ Adequate finance of the marketing chain, and full incorporation of the interests of these businesses in policy-making on agricultural finance.
  - ✘ Identification of measures to increase farm gate price stability.<sup>1</sup> Measures could include facilitation of forward sale and forward contracting (including the possible use of put options); improved setting and enforcement of grading standards. Closely connected is the need to improve price/demand forecasting for key regional crops, such as maize, where Uganda has significant natural advantages as a producer in the Eastern/Southern Africa regions (bi-modal rainy season, high reliability of rainfall). It is the opinion of the Mission that there may also be an opportunity in Uganda to introduce a limited degree of price buffering through a price guarantee arrangement operating at the terminal market level. However, this would depend on improved levels of price/demand forecasting. The Mission stresses that this runs counter to what most observers would consider possible, but still feels it is at least worth investigating, given the special circumstances and advantages in Uganda - notably the bi-modal cropping pattern and existing excellent market information mechanism. (See also Cluster Three below.)
  - ✘ Provision of both seasonal and term finance for agricultural producers is currently meager, and measures to improve this situation should form a major part of the strategic plan for agricultural finance in Uganda. Given the diversity of intent and capability to productively use purchased inputs by Ugandan farmers, lenders must develop and implement careful procedures for seasonal loans. Information on investment opportunities in the sector needs to be collected, analyzed and made widely available in order to facilitate term lending (see Agricultural Enterprise Watchlist, paragraph 11 below). The special challenges involved in developing term finance, especially the limited supply of long-term savings, need to be addressed. The results of the European Investment Bank Apex Private Sector Loan Scheme should be evaluated to determine if and how it affected agricultural lending. There may be an opportunity for increased donor support for term lending, if such support can address underlying problems rather than simply supplying long-term funds to substitute for missing domestic savings.
- Government Ministries and the BoU**
- ✘ It is vital to implement macroeconomic and other reforms that will reduce Treasury bill interest rates.
  - ✘ A major effort is needed to unlock the real wealth that lies in the rural areas by addressing the land tenure issue. To begin with; a review of the current land records could be undertaken to establish those who have legitimate claims over land whilst weeding out those with illegitimate claims. A longer-term project could involve a more extensive evaluation of the magnitude of rural land conflicts, their impact on agricultural production, and the efficacy of the new land legislation and administrative procedures in minimizing and/or mitigating these problems. It goes without saying that several inter-related issues are at the heart of improving the security of land tenure and the ability of land users to mortgage such land as collateral for long-term loans.
  - ✘ Closely connected is the need to improve legal contract enforcement in regional and local courts. Specific warehouse receipt legislation, currently under consideration, is a step in the right direction, and clearly deserves serious attention by legislators.
  - ✘ Scope exists to forge linkages (through insurance product design) between life insurers and lenders, in order to improve the security of term loans. Donors could assist in the design of such products. On the other hand, MFIs will need assistance in developing the necessary business arrangements with insurers and in linking insurance products with loans.
  - ✘ Several fields of information management require attention. Firstly, policy makers need information on the performance (in a broad sense) of those providing financial services, in order to make and monitor supportive policies. Secondly, NAADS should start an Agricultural Enterprise Watchlist, giving information on investment opportunities. Thirdly, it is vital that the market information service (Foodnet) continues to be sufficiently well funded by government, given that it is a valuable public good.
  - ✘ Education is vital in many areas of financial services for agriculture, including improving the governance of member-owned institutions, and specialized knowledge and skills for bank and MFI staff, and for borrowers. Systems of knowledge management (incorporating presentation and dissemination of key material) are also required.

**Cluster Two: Issues for Attention by Legislators,**

<sup>1</sup> This will require the commissioning of specific studies

### **Cluster 3: Unfinished Business**

- ⌘ Carry out a more detailed investigation of possible strategic interventions by government to increase the level of stability of farm-gate prices for key crops such as maize.
- ⌘ Prepare an Issues Paper as preparation for a High Level Policy Workshop on Agricultural Finance in Uganda.
- ⌘ Collect and analyze information on the structure and performance of member-owned organizations in rural areas, with a view to facilitating stakeholder deliberations leading to the development of a long-term strategy for these organizations in the area of Agricultural Finance in Uganda.
- ⌘ Conduct a detailed analysis of the factors that impede or facilitate the expansion of bank branches in rural areas.
- ⌘ Prepare a support project to improve land titling, registration and security of tenure, and to facilitate and streamline the process of using land as collateral for agricultural lending.

# Chapter 1

## Introduction

### 1.1 Background

The Financial System Development Programme (FSD) of the Bank of Uganda (BoU)/ GTZ/KfW/Sida has been implementing a programme to develop and deepen the financial sector in Uganda. The overriding goal of the program is to contribute to the Ugandan Poverty Eradication Action Plan (PEAP) by enhancing economic growth. The aim is to increase the efficiency of the financial sector and the utilization of financial services by micro, small and medium enterprises, and low-income households.

One field of cooperation vital for financial sector deepening in Uganda is agricultural finance. In April 2002, the FSD Programme organized a dialogue seminar on agricultural finance in Uganda, which provided a forum for stakeholders to raise and discuss the key and pertinent issues of agricultural finance. The discussions stressed the need for an overall agricultural finance policy to contribute towards an enabling environment for self-sustainable finance in Uganda. In subsequent discussions, the Ministry of Finance, Planning and Economic Development (MFPED) and the BoU welcomed the suggestion by the FSD Programme to kick-start a policy initiative on agricultural finance via a study to identify the major bottlenecks. To this end, GTZ, KfW and Sida jointly supported the BoU in conducting such a study. The findings of this exercise are set out in this report.

### 1.2 Objectives of the Study

The study aims to identify the major bottlenecks for the emergence of sustainable agricultural finance in Uganda's current policy environment and to draft a medium-term strategy for the support of agricultural finance in Uganda. The results of the study should form a basis for future discussions with national and international stakeholders, including the assignment of roles and responsibilities for further action on the way forward for agricultural finance in Uganda.

The fieldwork for the study was undertaken in November 2003 by two international consultants, Richard L. Meyer and Richard Roberts, and one national consultant, Adam Mugume. They were assisted and advised by the able GTZ Program staff, among whom, Gabriela Braun provided general leadership and oversight, while Joseph Wasswa-Matovu contributed Annex 3, and advised on presentation and editing.

### 1.3 Approach and Organization of the Study

The study team recognized that a long-term strategy would be required to develop a sustainable system for agricultural finance. The team also recognized that financial services are needed for the entire rural economy, and as such it would be inappropriate to analyze finance for agriculture without considering how the demands for financial services by rural non-farm households and businesses might evolve along with the agricultural sector. To guide its thinking and analysis, the team approached the task by posing the question *"How will Ugandan agriculture change over the long term, and how will these changes influence the demand for financial services?"*

The agricultural sector assumes a dominant role in Uganda's economy in terms of numbers employed<sup>1</sup>. Thus, it accounts for over 80 percent of all employment and supports the livelihoods of the majority of rural inhabitants who constitute 85 percent of Uganda's population. Agriculture also accounts for 85 percent of Uganda's export earnings.

More importantly, agriculture has the potential to act as a base for the improvement of the livelihoods of both rural and urban populations. In rural areas such improvement would be achieved by enhancing productivity at the primary, i.e. production level. In rural towns and urban areas agricultural products constitute the base for the creation and expansion of value-adding processing industries catering to domestic and regional markets, and for packaging/marketing operations, both for domestic and export markets.

As part of its Poverty Eradication Action Plan, the Government of Uganda's Plan for the Modernization of Agriculture includes among its priority areas for action, measures that have direct relevance to this report. The first is research and the second is extension. There is much to be accomplished in these areas, however, before these measures will effectively raise agricultural and pastoral productivity in Uganda. For the vast bulk of Uganda's farmers and ranchers, the level of use of improved technology is very low, with concomitant low levels of investment.

Against this demand scenario, a number of challenges face all those involved in supplying financial services.

<sup>1</sup> GoU (2000), "Plan for the Modernization of Agriculture" Ministry of Agriculture, Animal Industry and Fisheries; Ministry of Finance, Planning and Economic Development, Entebbe/Kampala, August, 2000

It is widely recognized that supplying financial services in rural areas is usually more challenging than in urban areas for a number of reasons (see below). These reasons help explain the limited penetration of commercial banks into rural areas. While these reasons to a large measure exhibit the challenges financial institutions face in serving full-time farmers, many also apply in cases where financial institutions have to serve part-time farmers, rural traders and rural non-farm enterprises<sup>2</sup>. These reasons include:

- ⌘ Dispersed Clients: Population density is lower in rural areas than in urban or peri-urban areas. Coupled with the greater distances and poorer transportation and communications facilities found in rural areas, dramatic increases in the costs for both financial institutions and their clients can be expected.
- ⌘ Poverty: Farmers and rural people tend to be poorer than urban people, and have fewer assets to offer as loan collateral and to liquidate in the event of emergencies.
- ⌘ Seasonality and Loan Demand: Farmers tend to have similar seasonal patterns of cash deficits and surpluses. Such a pattern of cash flow is however not suited to agricultural loans, which generally are larger, stay outstanding for longer periods, and need to be repaid in one or only a few installments.
- ⌘ Heterogeneity of Farm-Level Activities: Farmhouseholds have diverse farming and non-farming activities and produce a variety of products. This reduces their production and marketing risks, but complicates the task of loan officers who need to understand their cash flows and predict their loan repayment capacity.
- ⌘ Risk of Lending: Farmers face many production, yield, marketing and price risks that can cause actual cash flows to deviate substantially from those projected at the time the loans are issued.
- ⌘ A Poor Debt Repayment Culture: Past efforts to provide loans to farmers were in a sense grants in disguise. These schemes and grants have left a poor debt repayment culture among farmers who have had access to cheap agricultural finance in the past.
- ⌘ Price Instability: Instability in the price regimes of agricultural products in both domestic and international markets can cause actual income to differ greatly from that that was originally projected.

For these reasons, formal financial institutions tend

to shy away from serving the agricultural and rural sectors as the low volume of agricultural loans in the financial institutions' asset portfolios show. When they lend to agriculture, financial institutions tend to make short-term seasonal loans that are secured by stringent collateral requirements, with the client shouldering the bulk of the interest rate risk in the form of variable interest rates. Where term loans are advanced to farmers, they are generally limited to those funded through donor programs.

#### **1.4 Structure of the Report**

Apart from the Executive Summary, this report is organized into five chapters. The annexes that accompany the body of the main report provide greater details on key issues in the main report. Chapter 2 describes the evolution of macroeconomic and financial policies and how this evolution has affected the structure and performance of the financial system and its ability to serve the agricultural and rural sectors. Chapter 3 analyzes demand conditions for financial services that will emerge as Uganda's economy undergoes structural transformation over the next twenty years. Chapter 4 contains an analysis of the structure of Uganda's current financial system, its products, and the segments of the agricultural and rural economy it currently serves. This chapter also analyzes the constraints that are likely to impede the financial system's ability to meet the demands that are expected to emerge, along with recommendations for improvements; including the recommendation for the development of a long-term strategy to develop financial services for the agricultural and rural sectors. Finally, Chapter 5 knits together the arguments in the preceding chapters into an annotated list of recommendations.

<sup>2</sup> A more detailed discussion of this topic can be found in Brigitte Klein, et.al., [Better Practices in Agricultural Lending](#), Agricultural Finance Revisited No. 3, FAO and GTZ, FAO, Rome, 1999.

# Chapter 2

## Macroeconomic Issues and Financial Sector Performance

This chapter briefly discusses the performance of the Ugandan economy, with special reference to the formal financial system. Section 2.1 gives a brief description of Uganda's economy in relation to its past poor performance and the policy reforms implemented to address past poor performance. In Section 2.2, we summarize current financial sector policies and identify some outstanding challenges facing the sector. Section 2.3 includes an analysis of the suppliers of financial services to the agricultural sector and to rural areas. Section 2.4 explains why land as loan collateral is an important issue that demands our attention. The current state of the banking sector and the supply of rural financial services are summarized in the last section.

### 2.1 General Description

The policy framework in Uganda until 1987 was an inward-looking economic development strategy, which emphasized the role of the state in economic development. It appeared self evident that an active state, pursuing interventionist economic policies in line with clearly articulated development plans, could within a short period of time eradicate poverty and underdevelopment, and ensure national control over strategic sectors of the economy. As a result of this thinking, the state undertook a major role in development by investing heavily in sectors seen as strategically important and by providing generous incentives (including interest rate and credit subsidies) to state-owned enterprises (SOEs), including agricultural marketing boards, and to private investors in priority sectors. Cognizant of vulnerabilities inherent in agriculture coupled with its elevated position in Uganda's economy ensured that government always underwrote the agricultural sector, more than any other sector, with highly subsidized loans.

In addition, the state made use of a complex system of trade and exchange controls to protect infant industries. However, this development strategy resulted, inter-alia, in the building up of a large and inefficient public enterprise sector, which later became a heavy burden on the treasury.

Consistent with these policies, the key function assigned to the financial sector was to collect savings at low cost and channel them to the government and

to identified priority sectors. Accordingly, the state held a dominant stake in the financial sector, which it tightly regulated through administered interest rates and directed credit. The role of market mechanisms was substantially limited. Under this policy regime<sup>3</sup>, private banks were part of the firms that were affected as the government took a majority stake and consequently gained exclusive control over the allocation of funds in the economy. This meant that the financial sector's key role in the economy; that of facilitating the mobilization and intermediation of savings was gradually undermined. In the early 1980s, as part of a proactive policy to improve financial depth, the government through the Uganda Commercial Bank (UCB) and the Cooperative Bank expanded the national branch network without consideration for whether the branches were profitable or not, or whether the branch managers had risk management know how. This consequently contributed to inadequate banking discipline and to insolvency for the two banks and further eroded public confidence in the financial system.

In a nutshell, consequent to government involvement in the financial sector, the balance sheets of the financial institutions deteriorated as their capital bases eroded in the face of large loan losses. Moreover, these policies had redistributive effects as they made subsidized credit available to politically favored classes. As a result the scope of financial institutions remained severely restricted, which in turn led to the concentration of financial services in the hands of a few commercial banks, the largest being the government-owned Uganda Commercial Bank (UCB).

This meant a vicious circle existed between the financial sector and the macro-economy whereby the insolvent financial system undermined confidence in the financial sector, resulting in a low savings rate, inflation hedges, and a lack of monetary depth. In turn, the lack of monetary depth and other inefficiencies in the financial system contributed to macro-

<sup>3</sup> This policy regime began in 1970 when the government sought a 60 percent participation in a number of private industrial, commercial, and financial undertakings. The military regime initially partially reversed this policy by reducing government participation to 49 percent. However, the nationalization drive was revived during the "Economic war" of 1972.

economic instability. This period also saw the politicization of commercial life and an undermining of professional and ethical standards. The result was that the credibility of financial institutions was severely impaired<sup>4</sup>. It was against this background that in 1987 the government, under the auspices of the Bretton Woods institutions, adopted its Economic Recovery Programme (ERP) with three reform pillars, namely; fiscal austerity, privatization, and market liberalization. These measures have helped to establish a truly liberal market economy in Uganda.

Since the adoption of the ERP in 1987, great advances have been recorded in the major macroeconomic indicators. Growth has been dramatic and averaged 6.5 percent over the last 15 years in spite of a difficult international environment with deteriorating terms of trade. Inflation has also been curbed and has averaged about five percent per year over the last decade. The solvency, transparency and liquidity of the banking sector have also all significantly improved. Thus, the ratio of non-performing assets to total assets that in the early 1990s stood at about 40 percent had fallen to about 3.5 percent in 2002, an impressive achievement even as such a rate is still high by international standards. Savings and time deposits that amounted to Ushs102.8 billions in 1993, stood at impressive Ushs 517.7 billions in 2002; an increase of over 400 percent. The rate of HIV/AIDS infection, which in the early 1990s was estimated at 25 percent, also fell to 6.1 percent in 2002 (Republic of Uganda, 2002). More importantly, solid growth has been accompanied by a substantial reduction in poverty, which has lifted more than 4 million people out of poverty in a decade. Thus, the percentage of individuals in absolute poverty, which in the late 1980s stood at about 56 percent, was reduced to about 35 percent in 2002<sup>5</sup>.

However, these aggregate data mask vast regional disparities. The central and western regions of the country have grown more rapidly than regions in the north and east. Thus, taking a clue from the Poverty Eradication Action Plan (PEAP), the right policy framework is needed to ensure that all citizens, particularly the poorest members of the community,

benefit from economic growth. High economic growth and poverty eradication, in the context of continued macroeconomic stability, which is underpinned by appropriate fiscal, monetary, and structural policies, will thus continue to be the government's principal economic and social policy framework. The government is committing its own and donor funds to increase public expenditures on growth-oriented and antipoverty programs and accelerate the implementation of the PEAP.

To summarize, most of the potential for rapid improvements in economic growth and poverty reduction through macroeconomic reforms has now been exhausted. Impetus for further growth will require deeper reforms to create an enabling environment for the private sector if growth rates of about 7 percent and government and millennium goals (e.g., of reducing poverty to 10 percent by 2017) are to be achieved. However, the private sector continues to raise a number of concerns. These range from corruption to inadequate infrastructure, poor public service provision, and limited access to financial services. This environment is also heightened by political uncertainty and insurgency in northern Uganda.

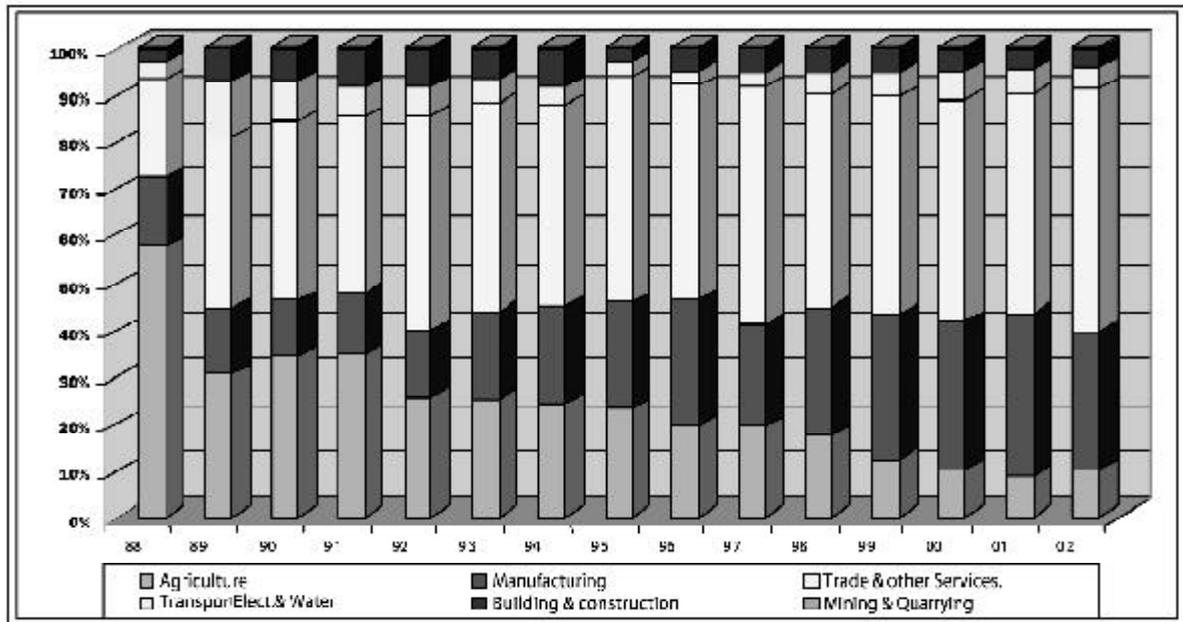
The demand for financial services by the agricultural and rural sectors is discussed at length in Chapter 3. Suffice to note that the policy support mechanism for meeting this demand needs to be well informed about the current situation, as discussed in Chapter 4. Regarding credit, there are no reliable objective standards of credit adequacy, but one feature evident in Figure 2.1 is that in the post financial sector reform period, a change in the composition of private sector credit from formal financial institutions is observable. An important feature to note is that two sectors, manufacturing and trade and other services, dominate credit allocation even as the share of credit going to agriculture has shrank. The agricultural sector that currently dominates the economy<sup>6</sup> receives only about 10 percent of all credit. The dependence on rain-fed agricultural production contributes to the general perception of formal lenders that agriculture based clients are high-risk. Moreover, the volatility of agricultural incomes implies higher transaction, enforcement, and supervision costs.

<sup>4</sup> The IMF studied the banking crises that occurred in Uganda and nine other Sub-Saharan African countries in the 1985-95 period and found they shared similar problems related to; government interference, poor banking supervisions and regulation, and shortcomings in management. See Roland Daumont, Françoise Le Gall, and François Leroux, "Banking in Sub-Saharan Africa: What Went Wrong?" IMF Working Paper WP/04/55, Washington, DC, April 2004.

<sup>5</sup> According to the latest PEAP review, poverty was estimated to have increased to 38 percent between 2000 and 2003.

<sup>6</sup> Agriculture had a 41 percent share of GDP in 2001/02, employed about 80 percent of the labor force and generated almost all of the country's exports

Figure 2.1: Loans and Advances of Commercial Banks to Economic Sectors (percentage)



## 2.2 Policies and Challenges in the Financial Sector

The liberalization of the financial sector in Uganda was part of the wide-ranging adjustment programs embarked upon in 1987. The key elements of financial sector reforms that were implemented are traceable to the Bank of Uganda Act of 1993 and the Financial Act amendment of 1993 and include:

- ⌘ The establishment of a legal basis for the independence of the BoU. This legal basis eroded the discretion of politicians in monetizing fiscal deficits and also restrained fiscal dominance in credit extension to the government.
- ⌘ The conferring to the BoU of wide-ranging powers over the financial sector with overall responsibility for supervising financial institutions and to serve as the sole monetary authority.
- ⌘ Institutional reforms, including new laws and regulations governing the financial sector,
- ⌘ Elimination of government intervention in the determination of interest rates,
- ⌘ Removal of the barriers to competition in the financial sector,
- ⌘ The scaling back of government ownership of financial institutions,
- ⌘ Allowing new financial products to appear, thereby increasing the diversity of financial services, reliability and efficiency,
- ⌘ Limiting excessive taxation of banks, (e.g. reserve ratios were substantially reduced to a maximum of 7 and 8 percent on time and saving deposits

and demand deposits, respectively, down from 10 percent in both cases), and

- ⌘ Complementary reforms like opening the capital market, reducing the corporate tax rate, legalizing foreign exchange deposits, etc.

The ultimate goal has been to enhance the development of an effective, efficient, and competitive financial system. More significantly, since 1987 the government has committed itself to pursuing appropriate domestic financial policies, to strengthening financial institutions, and to enhancing the mobilization of domestic financial resources and their efficient allocation. Monetary growth targets, as one of the means to control the inflation rate, have since replaced direct controls. With the approach of setting growth targets for M2 (currency plus demand, savings and time deposits), the monetary authorities have presumably been able to lower the inflation rate more than would have been possible using other approaches.

### 2.2.1 The Current Structure of the Formal Financial Sector

By the early 1990s, the banking sector consisted mainly of five foreign banks (Standard, Stanbic, Barclays, Libyan Arab Bank and Baroda), and two large locally owned banks (UCB and Cooperative) that together controlled 70 percent of all bank assets and liabilities even though they were insolvent. By the end of 2002, the system had substantially grown. The formal sector encompassed the Central Bank, 15 commercial banks, 8 credit institutions, about 18 insurance companies, 67 forex bureaux, 2

development banks and the stock exchange.

However, in recent years, the building societies that mushroomed in 1980s and early 1990s have disappeared while the commercial bank branch network has contracted from 290 offices in 1972, to 146 in 1996, and to 126 currently. This has resulted in a rapid deterioration in the ratio of customers per bank branch from 34,000 in 1972 to 80,000 and 100,000 in the 1980s and 1990s, respectively, and to about 190,000 in 2002. This compares very poorly with the average of 7,000 customers per bank branch for the COMESA region.<sup>7</sup> Uganda's ratio of M2 to GDP of 15 percent, in comparison to Kenya and Tanzania whose broad-money to GDP ratios, respectively, stand at 40 and 35 percent, suggests that the financial sector is still underdeveloped, although it has greatly improved compared to the situation in the 1980s. Consequently, only a limited number of financial instruments are available for savings mobilization, diversification of risk, and management of liquidity. The formal financial system is largely bank-centred and supplies mainly short-term working capital loans going to the non-agricultural sectors with less credit going to agriculture despite its dominant role in the economy. Also the rural banking presence has decreased because of branch closures.

## 2.2.2 Structure and Competitiveness of the Banking Sector

Uganda's financial sector has undergone considerable reforms to strengthen, broaden, and deepen the system and to encourage competition. A debate exists now about whether the few large international banks have an advantage, because of the scope of their business and their recourse to head office services, relative to new small banks that must set up such services. Table 2.1 below seems to suggest they do because the four major global international banks hold more than 70 percent of total bank assets. However, this position could be explained in part by the closure of the banks that used to dominate the market, which could have engendered a run on the remaining weaker banks and therefore resulting in the shifting of deposits to these safer global banks.

**Table 2.1: The Structure of the Banking Industry (as of 31 Dec. 2002)**

Bank	Ownership	Total Assets (billions)	Share in the Market	No. of Branches
Stanbic	Foreign	766.1	31.2 %	68
Standard	Foreign	606.8	24.7 %	6
Barclays	Foreign	228.4	9.3 %	2
City Bank	Foreign	186.7	7.6 %	1
Baroda	Foreign	122.8	5 %	6
CERUDEB	Local	116.2	4.7 %	18
Crane	Local	108.1	4.4 %	2
DFCU	Foreign	82.13	3.3 %	4
Orient	Local	68.3	2.8 %	6
Nile	Foreign	48	2 %	3
Allied	Foreign	40	1.6 %	3
Tropical	Foreign	36	1.5 %	3
Cairo	Foreign	20.3	0.8 %	1
Diamond	Foreign	16.1	0.7 %	1
National Bank of Commerce	Local	10	0.4 %	2

Source: BOU

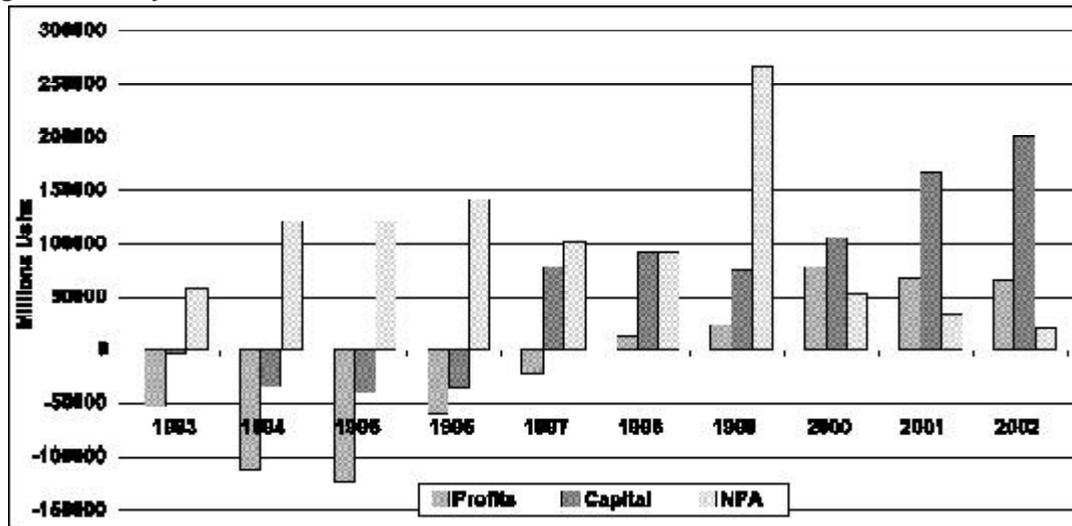
When international financial institutions dominate a country, they may enjoy competitive advantages that allow them to increase their market share relative to local smaller and weaker banks and attract depositors away from them. However, because international financial institutions have a larger propensity to make loans to large corporations, they are less likely to become a sustainable and reliable direct source of credit and other financial services for farmers or small businesses engaged in agriculture. With this market structure, new and small bank entrants cannot easily find a market niche and, at best, are market followers. In light of this, the BoU has placed a moratorium on licensing new banks based on the argument that the economy is over-banked and that new entrants could further weaken the small banks unless they provide new products. Moreover, it is possible to speculate that these few dominant banks took over the price-setting function when the government relinquished it.

## 2.2.3 Loan Portfolio Management

Since the mid 1990s, financial sector policies have focused on strengthening the system, increasing liquidity ratios, and tightening risk exposure. The BoU instituted a framework for more effective supervision and enforcement of prudential regulations that included increasing minimum capital requirements. This indeed has contributed to reducing the rate of non-performing assets (NPA) as well as enhancing the profitability of the sector as is evident in Figure 2.2.

<sup>7</sup> Mpuga, P., "Credit Demand and Small Scale Industrial Development in Uganda", Paper presented at 1<sup>st</sup> Industrialisation Workshop, 12<sup>th</sup> -13<sup>th</sup> August, Centre for Basic Research, Kampala, Uganda, 2003

Figure 2.2: Key Financial Sector Indicators, 1993-2002



Source: BOU

However, the dramatic decline in the NPA may not entirely suggest an improvement in the risk-return assessment on the part of commercial banks. Rather, it is largely due to the closure of the Cooperative and Greenland Banks and the restructuring of the UCB. The UCB and the Cooperative Bank were an important part of the inward-oriented economic policies of the pre-reform period and their existence could have hampered the development of the financial sector because other lenders could not compete with the subsidized terms they offered. Furthermore, they undermined the loan repayment ethic since loans advanced to important individuals in Uganda by these banks were generally never paid back. In addition, since the bulk of the loans these banks offered were agricultural, their closure meant that less total lending was available for the agricultural sector.

#### 2.2.4 Financial Sector Policy Challenges

Financial sector development is instrumental in not only fostering investment and growth, but also in mobilizing resources. Underdeveloped financial markets limit the efficient reallocation of resources especially in those sectors and enterprises that are less well linked to the financial system. That said, the government has credibly exhibited its commitment to stay the course of financial sector reform and to this end, some positive results have been recorded. Nevertheless, the financial sector still faces a number of challenges and problems whose mitigation goes beyond simple solutions.

As shown in Figure 2.3, under liberalization, credit extension has remained static despite the accumulation of excess reserves and minimal decline in intermediation costs. Instead, the commercial banks have concentrated their assets in Treasury Bills

(TBs). Large intermediation costs impede the expansion and development of financial intermediation because they discourage potential savers who face low returns paid on deposits. This limits the resources available to potential borrowers and constrains the growth of the economy.

High interest rates may impede the growth of fledgling enterprises. In particular, farmers find that they have to pay higher interest, making it more difficult for them to invest in more productive ventures, such as improved crop varieties necessary to improve agricultural productivity and raise incomes above subsistence for farmers. The necessary capital for more rapid growth becomes simply too costly. Moreover, World Bank surveys point to the cost, inadequacy and short-term nature of bank lending as major constraints in investment expansion.<sup>8</sup>

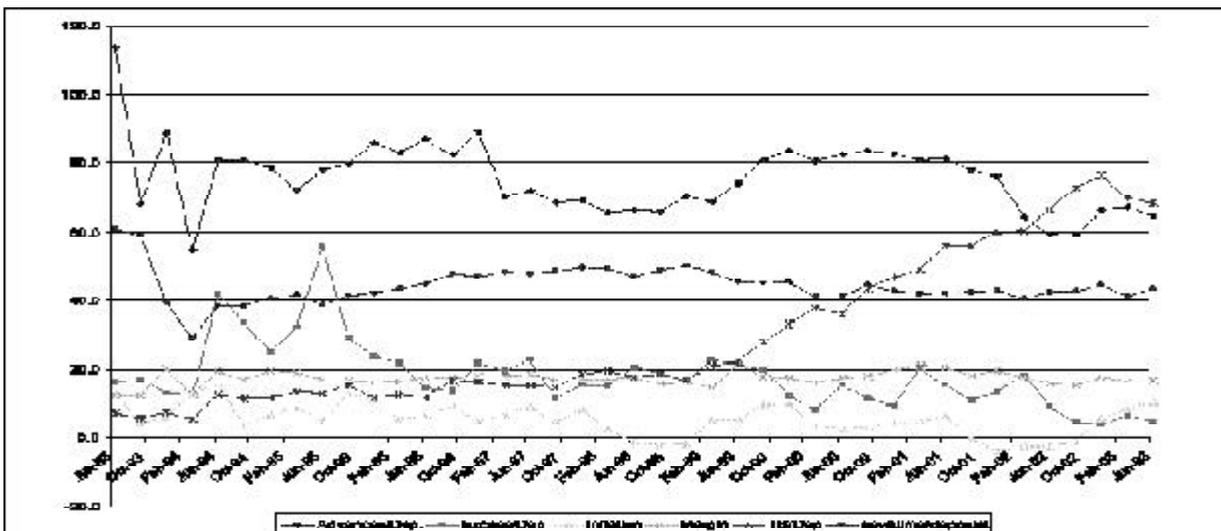
Several factors contribute to the high costs of intermediation. They include:

- ✗ Deficiencies in the system of commercial law for enforcing collateral liquidation in cases of loan default<sup>9</sup>;
- ✗ Adverse selection due to politically well-connected borrowers who in the past were responsible for a large number of non-performing loans.

<sup>8</sup> Reinikka, R., and J. Svensson, 2001, "Investment Response to Structural Reforms and Remaining Constraints: Firm Survey Evidence from Uganda", in Ritva Reinikka and Paul Collier, (eds.) *Uganda's Recovery: The Role of Farms, Firms and Government*, The World Bank, Washington D.C., 2001.

<sup>9</sup> The difficulties faced by financial institutions in liquidating collateral in the case of non-performing loans and advances are gradually being resolved with the recent strengthening of the Commercial Division of the High Court. Banks have been able to enforce recovery of bad debts with minimum difficulties. In addition, a Credit Reference Bureau is soon to be established; something that should reduce the risks financial institutions would face when advancing loans to their clients and in promoting a better loan repayment culture.

Figure 2.3: Credit, TBs, Excess Reserves, Intermediation Margin and Inflation, 1993-2002



Source: BOU

- ⊘ Weak capacity of banks to assess commercial risks, especially of new entrepreneurs, hence their perception of new entrepreneurs as high risk and thus their reluctance to lend to them.
- ⊘ Sterilization measures through issuance of high-return treasury bills. High interest rates paid on TBs mean that banks can be assured of high and safe returns by simply investing a large proportion of their assets in TBs. Banks then have very little incentive to issue loans and advances to sectors such as agriculture where returns are low and investments risky. Moreover, as shown in Figure 2.4, there is high variability in the TB rates, which creates uncertainties for banks about future investments. This subsequently, could increase the option value for waiting and hence a build up of excess reserves.

Figures 2.3 and 2.5 show clearly that treasury bills have become a lucrative form of investment for the commercial banks. Banks in the main have shifted their assets and loan portfolios into TBs and short-term loans. This suggests that even creditworthy customers will have limited access to the formal financial sector. Moreover, agricultural based enterprises have been limited in their ability to borrow by high collateral requirements imposed by the banks and the fact that most land, particularly outside of greater Kampala, is unacceptable as collateral or is accepted only after being highly discounted.

Figure 2.4. Structure of Interest Rates, December 1994 - September 2003

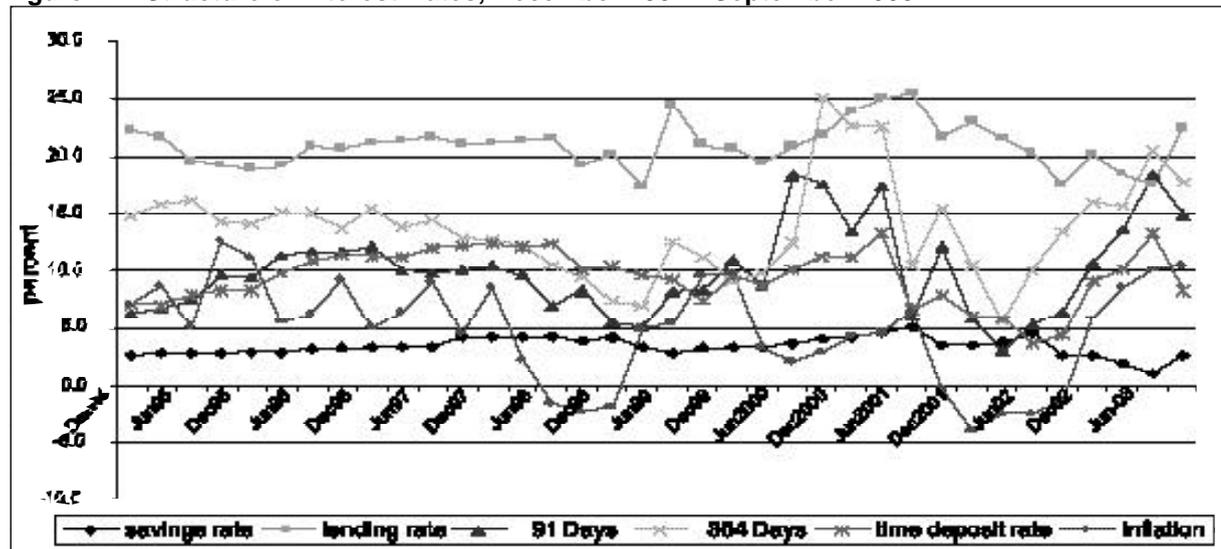
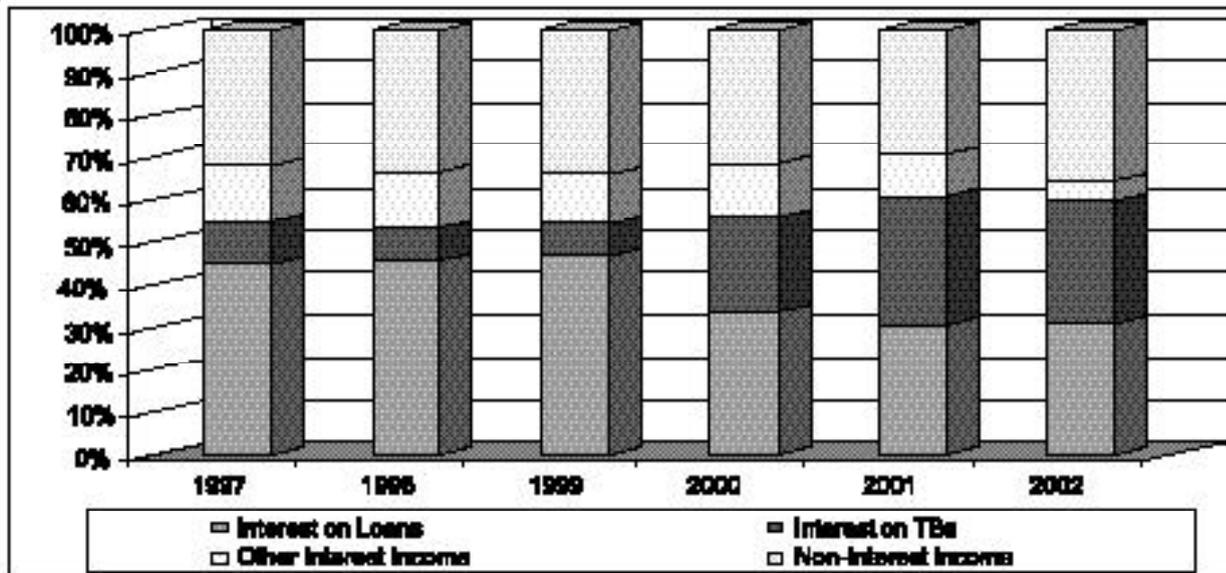


Figure 2.5. Structure of Commercial Bank Income, 1997-2002



Source: BOU, Bank Supervision

### 2.3 The Suppliers of Agricultural and Rural Financial Services

The structure of the current supply of rural financial services has evolved out of the interplay of spontaneous developments in the economy and responses to the policy changes discussed above. The main features of the rural financial system are outlined in this section. More detailed information together with an analysis of the implications of weaknesses in the current structure for the provision of improved services to the agricultural sector is presented in Chapter 4.

It is difficult to develop a clear understanding of the total volume and types of financial services available to and actually used by rural firms and households in Uganda. On the one hand as noted above, there is a general perception that the country is severely underbanked relative to its neighbors. This is reflected in a savings ratio of only 4.9 percent of GDP compared to the African average of 17.7 percent. In addition, only 77 percent of total GDP is supposedly monetized, and the ratio of broad money (M2) to GDP is only 10 percent compared to 40 and 35 percent in Kenya and Tanzania, respectively (PMA, p. 63). This view is bolstered by household survey data that suggests that banks provide only 2.4 percent of the total credit reported and that severe credit rationing exists<sup>10</sup>.

On the other hand, field surveys conducted in 107 communities during 1999 to 2001 give a somewhat different impression.<sup>11</sup> Over 95 percent of the households interviewed reported access to credit; about

one quarter reported access to formal credit in the village, and more than two thirds reported access to informal credit in the village. The average amount of formal credit reported as borrowed in cash was Ushs179,000 compared to Ushs129,000 from informal credit sources.

A related study analyzed the activities of NGOs (Non Governmental Organizations) and CBOs (Community Based Organizations) and found that relatively few communities reported a program in the village specifically related to credit, but over 40 percent of the households reported participating in such organizations.<sup>12</sup> The first number may be an underestimation considering that the persons interviewed might not have perceived that locally organized Savings and Cooperative Credit Organizations (SACCOs) were to be considered as organizations. Not surprisingly, the research found that the NGOs and CBOs tended to be located in areas with high population density and good market access, while government programs were more widely distributed.

The implications of improving access to financial services are likewise debatable. The PMA makes the logical argument that farmers need credit to manage the seasonality of their cash flows, to make

<sup>10</sup> Mpuga, P., "Credit Demand and Small Scale Industrial Development in Uganda", Paper presented at 1<sup>st</sup> Industrialisation Workshop, 12<sup>th</sup>-13<sup>th</sup> August, Centre for Basic Research, Kampala, Uganda, 2003.

<sup>11</sup> Ephraim Nkonya, John Pender, Pamela Jagger, Dick Sserunkuuma, Crammer Kaizzi, and Henry Ssali, "Strategies for Sustainable Rural Development in Uganda," Research Report Manuscript, International Food Policy Research Institute, Washington, DC, November 2003.

<sup>12</sup> Pamela Jagger and John Pender, "Impacts of Programs and Organizations on the Adoption of Sustainable Land Management Technologies in Uganda," EPTD Discussion Paper No. 101, International Food Policy Research Institute, Washington, DC, March 2003.

investments, and to cope with the vulnerabilities of farm production. Therefore, the establishment of a viable and sustainable rural financial system is considered to be one of the key interventions for the sustainable development of the agricultural sector (PMA, pp. 62-63). The measured impact of access to credit on production and productivity is ambiguous, however, as demonstrated by results from the 1999/2000 national household survey. The survey found that only 15 percent of the loans received by farmers in 1999 were used to purchase inputs, 7 percent were used for investments in land and livestock, and the largest share was used to establish non-agricultural enterprises, and for health and education expenditures.<sup>13</sup> These results suggest that the issue of profitability of investments must be evaluated relative to a farm-household's total financial demands. It will be argued in Chapter 3 that the demand for farm investment finance *per se* would come from just a portion of the farming community that is able to manage relatively larger and more complex enterprises.

The fragmentary data quoted above suggests that evidence concerning access to finance in rural areas varies with the definition of type of financial service, specific geographic location, and source of information. As in most countries, it is logical to expect that access to the formal financial system will be restricted to larger rural towns and cities, while the most distant and remote farming communities will be served mostly by informal sources and occasionally by NGOs. In addition, MFIs are also contributing to the expansion of financial services into the rural hinterland.

Notwithstanding the widespread perception of credit constraints, many types of formal and informal financial arrangements exist in rural areas. The system of suppliers of these services can be viewed as a triangle with a small number of formal financial institutions at the top, many MFIs serving the middle segment of the market, and numerous informal groups, moneylenders, and other informal arrangements serving the majority of the poor in rural areas.

The top segment corresponds to Tier 1 and 2 full-service regulated and supervised banks and credit institutions.<sup>14</sup> The MFIs can be divided into a few Tier 3 regulated microfinance deposit-taking institutions (MDIs) expected to be licensed under the new legislation<sup>15</sup>, and a large number of Tier 4 unregulated NGO – MFIs, SACCOs, CBOs, and other infor-

mal sources that do not qualify as Tiers 1, 2 or 3. This finance triangle corresponds to a triangle representing farm sizes that consists of a few large farmers and agribusinesses at the top and millions of subsistence farmers at the bottom.

Table 2.2 presents a stylized description of the sources of financial services and the respective segment of the market that each serves. It is an attempt to piece together fragmented information obtained from interviews and documents. It is impossible to quantify the total volume of transactions involved and it is possible that the number of firms and households that *potentially have access* to financial services is higher than those that choose to use them at any one time, i.e. *actually participate in financial transactions by taking loans or savings*. The table shows that at the top, formal financial institutions serve large farms and agribusinesses. Chapter 4 presents a discussion of each of the major categories of suppliers and the segments of the market they serve.

The supply of financial services is not stagnant or unchanging. Competition is increasing among the financial institutions, especially in the greater metropolitan area of Kampala. The pressures of competition, plus the successful experience of market leaders, have prompted institutions to look "down market" for new sources of business and revenue. For example, 20 banks, non-bank financial institutions and MFIs now make unsecured salary loans to low-income workers. Banks are working to improve their standard of service to clients. Many now offer the use of ATM machines. With its acquisition of UCB branches, Stanbic Bank may be in the best position to expand services into new retail markets with potentially important benefits for the agricultural and rural sectors.<sup>16</sup>

The competitive pressures between banks and NGO-MFIs have led to two important changes for NGO-MFIs that mirror those in Bolivia and Bangladesh, two countries at the forefront in microfinance. First, in locations where NGOs are heavily concentrated, the market is becoming saturated so they are forced to search for new market niches. Second, when given the opportunity, most customers choose individual rather than group liability loans. This preference is forcing some NGOs to rethink their lending technologies. Competition means that some NGOs will have to become more receptive to serving agriculture and rural areas if they are to survive. Yet the current loan

<sup>13</sup> Klaus Deininger and John Okidi, "Rural Households: Incomes, Productivity, and Nonfarm Enterprises," in Ritva Reinikka and Paul Collier, (eds.), Uganda's Recovery: The Role of Farms, Firms, and Government, World Bank, Washington, DC, 2001.

<sup>14</sup> Tier 1 institutions are commercial banks while Tier 2 institutions are credit institutions. Both Tier 1 and 2 institutions are licensed under the Financial Institutions Statute 1993.

<sup>15</sup> Micro Deposit-Taking Institutions Act, 2002.

<sup>16</sup> A recent report discusses the competition that is emerging in microfinance, the challenges it presents for financial service providers, and the benefits that may emerge for customers. See Graham A. N. Wright and Paul Rippey, "The Competitive Environment in Uganda: Implications for Microfinance Institutions and their Clients," MicroSave-Africa, Nairobi, September 2003.

products of most NGOs are not ideally suited for farming enterprises. Moreover, it is unclear how many farm and non-farm rural clients will be able to pay the high interest rates and fees required to cover the high operating costs of MFIs in rural areas. Nonetheless, with appropriate product development and cost containment, the new MDIs are likely to provide stiff competition for commercial banks in rural areas, and may become the leading players in the key semi-commercial farmer and trader niches of the rural market.

Suppliers	Financial Services Supplied
Moneylenders	≠ Any rural or urban firm or household needing quickly disbursed, emergency or business loans.
Money keepers	≠ Hold small amounts of savings for others.
Family and friends	≠ Loans for emergencies and start-up of business activities.

**Table 2.2: Suppliers of Financial Services and their Rural Clientele**

Suppliers	Financial Services Supplied
Commercial Banks	<ul style="list-style-type: none"> <li>≠ Large loans for commodity processing firms, trading companies, nucleus estates.</li> <li>≠ Letters of credit for importers and exporters.</li> <li>≠ A few loans for individual large farmers, horticultural and flower growers/exporters.</li> <li>≠ Use of warehouse receipts, bonded warehouses, chattel and real estate mortgages, third party guarantees.</li> <li>≠ Leasing of vehicles and equipment.</li> <li>≠ Checking, savings and deposit services for firms and households in rural towns.</li> <li>≠ Savings services for savings groups and richer farm households in close proximity to bank branches.</li> <li>≠ Remittance and money transfer services.</li> <li>≠ Banking services for MFIs and SACCOs.</li> </ul>
NGO - MFIs	<ul style="list-style-type: none"> <li>≠ Small group-guaranteed and individual loans largely granted to small-scale traders in urban and peri-urban areas.</li> <li>≠ Probably some lending for garden plots in peri-urban areas.</li> <li>≠ Compulsory savings for borrowers.</li> <li>≠ Experimental insurance linked to loans and remittance services.</li> <li>≠ Some financial services linked with other developmental activities promoted by NGOs.</li> </ul>
SACCOs, ROSCAs, CBOs, and other member-owned financial organizations	<ul style="list-style-type: none"> <li>≠ Small loans and savings services for farmers, rural traders, and non-farm firms and households in rural towns and villages.</li> <li>≠ Participation in pooling financial resources for purchasing lumpy assets (e.g. vehicles) or financing group investments.</li> </ul>
Processing companies, traders, input suppliers, nuclear estates	<ul style="list-style-type: none"> <li>≠ In-kind loans and suppliers' credits for buyers, sellers and farmers throughout the production/marketing chain.</li> </ul>

A key characteristic of SACCOs and other member-owned financial organizations is that theoretically they are member controlled and this fact introduces some governance issues that are not shared or shared to a less extent, by banks or NGOs.<sup>17</sup> Partly due to shortcomings in governance, most are assumed to be weak and poorly managed. Even among the stronger SACCOs, serious problems are to be encountered as reported in Annex 2. This situation is unfortunate because many of these organizations are located outside of Kampala, some in remote locations, and are the only type of financial institution that can serve sparsely populated areas where it is uneconomic for banks and the future MDIs to locate branches.

Unlike the banks, member-owned financial institutions lack a strong support system to nurture, regulate and supervise the sector. The Uganda Cooperative Alliance (UCA) Ltd., the Uganda Co-operative Savings and Credit Union (UCSCU) Ltd., and AMFIU (Association of Microfinance Institutions of Uganda) all provide support to the sector, although AMFIU has only a few SACCO members. However, all three are too weak and lack the mandate and resources to be significant sources of strength, let alone be the agents of transformation necessary to achieve the goal of effectively providing financial services to small subsistence farmers and the rural poor. Moreover, in the case of AMFIU, a conflict of interest would emerge where it to nurture and regulate its members concurrently.

There are many other unregulated informal financial institutions and arrangements that apparently provide a huge volume of financial services for participating households. The more geographically isolated the location, the more likely it will be that these sources offer the only financial services available. This category includes processing firms, traders and nucleus estates that make *in-kind* loans to farmers and others in the production/marketing chain. A number of informal group financial arrangements seem to have emerged mostly in the past ten years. There are Rotating Savings and Credit Associations

<sup>17</sup> A governance system can be defined as the interactions among shareholders, managers, boards of directors, and outside auditors, together with laws, regulations, and institutions that govern their interaction.

(ROSCAs) that are completely self-organized and autonomous that intermediate funds among their members. All members get loans during one full rotation. Accumulating Savings and Credit Associations (ASCAs) have also emerged that operate like savings clubs in which not everyone borrows and interest is explicitly paid to savers. Many moneylenders make short-term, quickly disbursed, usually high interest, emergency or business loans. Loans are also made among family members and friends at zero or low interest rates for emergencies and business start-ups. Businessmen and elderly relatives act as money-keepers by holding money for people who do not feel secure or disciplined enough to keep it themselves.

Finally, the Entandikwa Credit Scheme best represents the issue of failed government supported credit driven agricultural and rural finance schemes. This scheme was introduced in 1995 and sought to target that section of the population that could not obtain credit through traditional commercial lending. The Scheme was to benefit individuals and/or groups of the rural and urban poor, artisans, women, the disabled and the youth. Extension officers were supposed to offer routine technical services to the beneficiaries regarding the development and management of their micro-enterprises, and to monitor the utilization of the loan funds and advise on loan repayment. Although neither formal documentation nor evaluations are available, it is widely recognized that the scheme was a failure. In fact, the scheme was subject to massive rent seeking behavior as local elites received the lion's share of funds disbursed. In addition, the scheme's inauguration coincided with the 1996 presidential elections something that sent wrong signals to beneficiaries that loans under the scheme were essentially political grants. Consequently only about 40 percent of the loans were ever recovered and the *'revolving funds'* nature of the scheme was seriously compromised.

## 2.4 Using Land as Loan Collateral

An especially difficult problem in Uganda relates to land titling, registration, transfer, security of tenure, and operations of the land market. This problem exists in urban and peri-urban areas but is especially serious for agriculture because land is commonly used everywhere as collateral for agricultural lending. This requires record keeping and legal systems to identify the boundaries of properties, register the interests of claimants in a property (such as who holds a mortgage on it), and facilitate the seizure and liquidation of land pledged as collateral for loans. Although community or traditionally owned land can provide a degree of security of tenure so it will be used efficiently in the short term for farming, two problems can emerge in the long term.<sup>18</sup> First,

the users of such land may be discouraged from making investments in it because they may not have long-term use in order to enjoy the benefits from such investments. Second, lenders may refuse to accept it as collateral given fears that they would be unable to foreclose in the event of default. Thus, where lenders accept land as collateral, they have tended to demand a high ratio of land value relative to the loan to be advanced.

Annex 3 of this report contains a summary of key legal provisions concerning land in Uganda. Although the Land Act of 1998 is forward looking in the sense of recognizing the interests of both occupants and owners in land, the mechanisms that preserve and transfer these rights in the newly decentralized administrative system call into question the ability of people to effectively use their interests (in reality a form of equity) as collateral for loans. A complete analysis of this issue is beyond the scope of this study. However, as discussed in Annex 3, the potential problems seem serious from the perspective of financial contracts, and are especially serious outside of Buganda. They will likely prevent the full use of land as loan collateral for the foreseeable future.

If so, this is a critical problem that will constrain the ability of the formal financial system to make long-term loans for land acquisition and improvements since formal institutions normally rely on mortgaged land as collateral for these types of loans. This could lead MFIs and other financial institutions to look for collateral substitutes, and to secure their loans through multiple sources of collateral; a situation that should crowd out a number of potential borrowers with few alternative assets to present as collateral. Resolving the land issue is going to require a long-term and expensive commitment, but is necessary if land is to act as collateral and underpin the availability of sustainable amounts of term finance that are necessary to fundamentally transform the agricultural and rural sectors.

## 2.5 Conclusions

To summarize, the liberalization of Uganda's financial sector has been part of the success story of the whole economy. Much as financial reforms should be applauded for a gradual increase in the deepen-

<sup>18</sup> There is evidence of substantial insecurity in tenure arrangements. For example, a 2001 survey of peri-urban and rural households revealed that about a quarter of the respondents had plots involved in conflicts and that about a third have lost land through conflicts since 1994. In addition, productivity was found to be significantly affected on plots involved in conflict. See Klaus Deininger and Raffaella Castagnini, "Incidence and Impact of Land Conflict in Uganda," Policy Research Working Paper 3248, World Bank, Washington, DC, March 2004.

ing of financial intermediation, it is fair to conclude that financial deepening and development of the sector leaves much to be desired, particularly in relation to the flows and costs of credit to the agricultural sector.

Given the depth to which the financial sector had sunk by the mid 1980s, a more rapid rebound was expected when the reforms were implemented. Perhaps the reformers grossly underestimated the possibility that endogenous constraints, such as imperfect and incomplete credit markets, could be significant barriers to efficient and improved credit allocation to agriculture. Apart from these imperfections, the policy also disregarded peculiar structural features of Uganda's financial system, such as the dominance of a collusive commercial banking system and non-existent equity markets, and the problems that these pose for efficient credit market operation. Whilst experience has shown that imperfect government is not good at picking viable investments, there is little to suggest that a banking sector working under an inappropriate financial market structure would do any better. This situation has important implications for the possibility of developing viable rural financial markets that will contribute to pro-poor growth and to a dynamic rural economy.

The challenge is not just to create banks that do not lose money because of bad loans, but also to create sound banks that provide credit for growth, and more financial services to agriculture, which underpins this growth. In particular, whenever information is imperfect and markets incomplete, the invisible hand of the market works most imperfectly. Significantly, the development of appropriate institutional structures to reduce transaction and information costs, which inhibit financial sector development, have to be pioneered by active government programs and, in line with this, there is need to reconsider all elements of monetary and banking policies.

The current state of the banking sector and the supply of rural financial services can be characterized as follows:

⌘ Commercial banks: The commercial banking sector is dominated by a small number of foreign-owned banks, as locally-owned commercial banks account for little more than 12 percent of total bank assets. Banks are important in financing major export and import operations. They also provide services to major farm production units (i.e. large farms and estates), major fishing entities, processors and marketers. With the exception of the largest bank, the commercial bank branches are based in major urban centers, with a heavy concentration in the Kampala/Jinja/Entebbe area. Their direct relevance to small and dispersed agricultural production and marketing entities is

likely to continue to be very minor in the foreseeable future.

⌘ Two financial institutions, Centenary and DFCU Group, provide some financial services to farmers as discussed in more detail in Chapter 4. They have been heavily donor-driven and/or geared to larger operators. Both have demonstrated that success can be achieved in rural areas, but also sustainable operations require a strong governance system that maintains constant vigilance and assures adherence to sound banking practices. They remain potentially important for some segments of the agricultural sector.

⌘ Uganda has a vibrant microfinance sector, especially in urban and peri-urban areas. This development has blossomed under the liberalized economic policy environment of recent years. However, the relevance of microfinance for a rural clientele remains unclear in the minds of policy-makers who appear more concerned with raising objections to the high interest rates MFIs charge clients than to the issues of financial and operational self sustainability that underpin good practices in microfinance. Thus, where MFIs employ good practices and charge cost covering interest rates, such rates can prove unsuitable for the lower rates of return expected for most types of investments in the agricultural sector.

⌘ The member-owned financial institutions, largely comprised of SACCOs, are in a very unsatisfactory situation for continued, effective operations, let alone for growth, to realize their potential for expansion in rural areas. The SACCO segment of the financial sector has also seen numerous ad hoc measure of assistance implemented with little success. Thus, confusion and ambivalent on the part of policy-makers and SACCOs apex/support bodies, as to how to push SACCOs forward is still pervasive. Despite these problems, the SACCO sector cannot be ignored in future planning, since it offers a potential means of access to financial services for many who cannot have access to formal financial institutions. SACCOs come closest to being grass-roots institutions; something that presents them with both great advantages and disadvantages (see Chapter 4 for more details). An important step forward in improving the sustainability of farmer groups and member-based SACCOs would be to separate their financial and non financial operations.

⌘ Competition is increasing among banks and between banks and MFIs. This is resulting in some experimentation with new products and attempts to discover and serve new markets. This is a

hopeful sign that should herald more and better services for the agricultural and rural sectors.

- ⌘ No single type of institution can be identified as having a clear competitive advantage and thereby hold the key to improved financial services for the agricultural sector. Each type can play a role in the financial system, while the policy environment needs to recognize the need for varied expectations of the main institutional types, as well as distinct approaches to supporting policies and project/program initiatives.
- ⌘ The problems of land titling, registration, transfer, insecurity of tenure, and the operations of the land market pose significant constraints for the development of the rural financial system, especially for term lending to finance investments in agriculture. The effects of the recent legislation need to be evaluated and the time may be ripe to launch a fundamental review of the entire land issue.
- ⌘ The government and donors should work towards the development of a long-term strategic plan for developing the rural financial system rather than implement isolated reforms and programs. The coordination and planning activities that successfully paved the way for developing the microfinance sector are a good precedence, but this effort will need to be more ambitious and will require the involvement of a broader range of stakeholders. The need for a strategic plan is discussed in more detail in Chapter 4

# Chapter 3

## The Demand for Financial Services

### 3.1 Overview

As noted in Chapter 1, the agricultural sector provides a base for the improvement of the livelihoods of both rural and urban populations. In rural areas this is achieved through the enhancement of productivity at the primary, i.e. production, level. In rural towns and urban areas agricultural products constitute the base for the creation and expansion of value-adding processing industries for domestic and regional markets, and for packaging/marketing operations for both domestic and export markets. As part of the Government's Poverty Eradication Action Plan, the Plan for the Modernization of Agriculture (PMA) includes, among its priorities, areas for action that have direct relevance to this report. The first is research, through NARO (National Agricultural Research Organization). The second is extension, through NAADS (National Agricultural Advisory Service). Both organizations face stiff challenges. For the vast bulk of Uganda's farmers, the level of use of improved farming technology is very low, with 93 percent dependent on the hand hoe for cultivation, less than 30 percent use improved seeds, less than 10 percent use any form of plant protection, and the use of chemical fertilizers by subsistence farmers is negligible (GoJ 2000, page 47).

Financial services are essential at all stages in order to optimise the rate at which more efficient operations and adoption of improved technology can take place. This section of the report examines the nature of the demand for these services, starting with the premise that market-oriented financial services will follow genuine demand from clients. Financial services and products, especially loans, should not be used as tools to attempt to lead economic activity, as has been convincingly demonstrated in the disappointments with supply-led and targeted agricultural credit programs in many countries over the last 30 years. Rather, promising economic activities should lead to demand for such services.

In this brief look at the demand for financial services, a longer-term perspective has been taken. This time horizon is considered appropriate. The vast majority of farmers operate on a very small scale, which means that the bulk of the population of the country currently achieves very low productivity. Realism suggests that increases will come slowly in

this sector. Moreover, the major developments, which can be prompted by government and donor action, are generally those that take several years to impact positively on the economic well being of rural populations. Examples are initiatives in the fields of education, health, infrastructure improvements and institution building.

Naturally, as education and other developments proceed, increasing numbers of rural people will move away from total dependence on the land and the lakes for their livelihoods. The resulting migration – permanent, partial (part-time), seasonal – will in turn create demand for financial services in small towns and other rural centres. Much of this demand will be for services for which the MFI industry is already well equipped to supply in terms of technologies. However, a physical presence in rural centres, and staff to man these offices/branches, will be needed, together with the necessary internal information systems for supervision and control. Coupled with this will be a need for improvements in banking systems and technologies so that rural branches can be profitable.

This report takes the position that the Ugandan agricultural sector can only develop soundly if key actors receive signals concerning demand for products of the sector, and the likely profitability of meeting such demand. Such signals are generated in destination markets (for exported commodities and products) and in terminal markets – effectively Kampala (for other commodities and products). The process requires suitable information transmission mechanisms (see also Annex 4 Information Management). Meaningful marketing messages can then be effectively fed back along the marketing chain to the primary producer, and to the input suppliers upon whom he/she depends. In this connection it is interesting to note that in his report to Parliament for 2002/3, the Minister of Agriculture notes that

“Uncertainty of market availability for agricultural produce negatively affected farmers' drive to increase production”<sup>19</sup>.

<sup>19</sup> Parliament: The Republic of Uganda. “Report of the Sessional Committee on Agriculture, Animal Industry and Fisheries (MAAIF) on the Ministerial Budget Policy Statement for MAAIF for FY 2002/2003,” Kampala. (Section 5, Major Constraints Facing the Ministry as a Whole).

The case of cotton constitutes a useful example of information transfer. In Uganda the Cotton Development Organization (CDO) conveys a powerful message to growers, traders and ginners, and to their financiers, regarding the forward market for this commodity, by the pre-planting publishing of an *indicative price* for seed cotton at the gin. This action has other benefits, which are covered below in the section on price buffering.

The availability and efficiency of financial services impact on the agricultural sector through several phases of economic activity. For convenience these are differentiated below into the input/output market, and on-farm production stages. Some aspects of the likely demand for financial services for the production/processing/marketing chain for agricultural products and produce, in a longer-term perspective, are now examined. The discussion is divided into: first, the trading component, comprising the input and the output markets<sup>20</sup>, and second, the on-farm production component, i.e. farmers.

### 3.2 The Demand – Input and Output Trading Markets

#### 3.2.1 The Issue of Scale

The effectiveness by which the marketing chain can meet market demands is dependent to some extent on the ability of actors in the chain to purchase quantities of commodities in sufficiently large volumes to achieve economies of scale in handling, processing and transport. Moreover, at some stages in the chain, a critical minimum volume is required in order to attract those sellers (in the case of inputs) and buyers (in the case of outputs) whose business would lead to advantageous sales.

Given this need for scale, it is ironic that perhaps the biggest single impediment to improving the efficiency of both input and output markets is the small-scale nature of transactions, which characterizes dealings in the Ugandan agricultural sector. The numbers of traders operating is large, due at least in part to the lack of adequate road infrastructure, and the consequent use of the bicycle as a major means of transport. The bicycle often has a four gallon container (formerly for kerosene, the “debe” strapped on to the bicycle carrier. The debe acts both as a measure and as a transport container, hence one name for the small-scale traders, “debe boys”. The next step up the ladder from the bicycle-user is a petty trader who can transport a greater volume

<sup>20</sup> For many crops, e.g. coffee, tea, cotton, vanilla, as well as for fish, there is a strong element of processing undertaken within the marketing chain.

through the use of a “boda”. This is a light, usually 50cc, motorcycle, which represents a significant increase in investment and running costs over a standard pedal bicycle.

Table 3.1 sets out some estimates for the numbers of farmers and traders involved in various enterprise types. It illustrates the size of the potential pool of clients from among whom demand will be generated for financial services, as some actors increase their scale of operations. Anecdotal evidence suggests that the current net incomes of the majority of traders operating in rural areas are within the range Ushs1,000 (US\$0.50) to Ushs3,000 (US\$1.50) per day. This income level is comparable with the daily pay of laborers in construction in Kampala, which typically ranges from Ushs3,000 to Ushs4,000.

Given these low levels of remuneration from trade, coupled with the uncertainty of trade-related income; there is only a weak incentive for operatives to remain in the activity as and when other opportunities arise. Thus the numbers of debe boys and other petty traders will diminish over time, allowing the more efficient (or better funded) operators to expand. A second consequence of the low remuneration earned from trading is that any borrowing by petty traders for their business activities, initially, at least, would perforce be on a very small scale. One notes that this implies high costs for lenders, and consequently high interest rates.

**Table 3.1: Numbers of Farmers and Traders by Commodity \***

Commodity	Typical number of trading steps, or transactions (small scale producers)	Estimated number of producers	Number of exporters	Number of in-country traders
Coffee Robusta/ Arabica	Up to 5	500,000 10% of these Arabica	22	400 processors 400 “merchants” 4000 local traders 100,000 bicycle traders (debe boys)
Cotton	3 or 4	500,000	1 major (UGT)	6-7,000 “buyers”, 1,200 agents
Maize, Sorghum, Beans	3 or 5	2,500,000	56 gineries	1,500 rural buyers
Matoke	3 or 4	> 2 m	NA **	> 500,000

Commodity	Typical number of trading steps, or transactions (small scale producers)	Estimated number of producers	Number of exporters	Number of in-country traders
Vanilla	3	40,000	18 (15 registered)	70 traders, unknown numbers of petty traders
Fish	3	250,000	11 packing plants	750,000 processors / retailers, unknown no. of collectors, unknown no. of ice sellers

Notes:

\*A variety of sources have been used in constructing this table. Most numbers are broad estimates and the table must be regarded as incomplete.

\*\* Not applicable, though there is undoubtedly some minor border trade with immediate neighbors, especially to the south and west.

Fertilizer affords a good example of current scale difficulties in the inputs market. Annual consumption is just less than 20,000 tonnes, and large or highly intensive farming enterprises such as tea estates and flower farms directly import a third of this amount. The rest of the farming community has an extremely low rate of use of chemical fertilizer, as shown in Table 3.2. One notes that some growth in usage has been registered over the last two decades, albeit from a very low base.

**Table 3.2: Comparative Fertilizer Use in Uganda and in Neighbouring Countries (Kg fertilizer per cultivated ha per annum)**

Country/Region	1980 - 1989	1990-1995	1996 - 2000
Uganda	0.07	0.19	0.41
Kenya	21.39	23.24	31.58
Tanzania	8.42	9.02	6.13
Africa (South of Sahara)	7.54	8.14	7.92

Source: Compiled from FAO/AgriStat. data

Efforts to increase fertilizer use, which recent IFPRI studies have shown to be essential for some of the more intensively farmed parts of the country, must tackle the vicious circle of low demand/inefficient inputs markets/high prices. The cost of inputs is clearly a factor in Uganda's low rate of utilization, and this is particularly marked in the case of a high weight-to-value commodity like fertilizer, where the high transport costs experienced in the country impact heavily on the cost in the main and rural cen-

ters. A quick comparison of the landed cost in some selected cities of Uganda, Kenya and the United States is given in Table 3.3 below. The results show the very much higher cost faced by Ugandan farmers.

**Table 3.3: Cost of Delivered Fertilizer**

Delivered (CIF) to:	Cost of DAP per ton, US\$
Kampala, Uganda	325
Nairobi, Kenya	265
Tampa, USA	165

Source: Omano, Stephen "Fertilizer Trade and Marketing in Uganda" International Food Policy Research Institute, Kampala, Uganda, 2000.

Scale as an issue is also indicated by the current practice in Uganda of using the 50 kg. bag as the unit of sale at the wholesale level. Retailers commonly break down these units into 5kg. and even into 1kg. bags. There are few markets in the world in which the demand is focused on such small units.

Efficient trading also needs equipment, storage facilities and transport appropriate for larger volumes. These requirements for input traders, such as those dealing in fertilizer, are mirrored in output markets. Indeed, the same traders often serve the two markets. Table 3.4 below summarizes the possible effective demand for financial services that is understood to exist in the trading community, which deals directly with the agricultural sector. Product-by-product notes follow the table.

**Table 3.4: Traders' Demands for Financial Services**

Trader Group	Financial Services - Possible Effective Demand					
	Money transfer	De-posits	Short term loans	Term loans	Warehouse Receipts	Price Buffering Arrangements
Rural Traders - debe boys	Yes	Yes	Some	Some	No	No
Rural Traders - agents	Yes	Yes	Yes	Yes	Some	Some
Transporters	Yes	Yes	Yes	Yes	Some	No
Terminal market operators / input wholesalers	Yes	Yes	Yes	Yes	Yes	Yes
Exporter/ Importers	Yes	Yes	Yes	Yes	Yes	Yes

Notes:

\*\*Effective demand" means that the user of the service can have productive and profitable use for it, and would be expected to be in a position to meet obligations accordingly. The time period envisaged is still 20 years, but the judgements on which this table are based are largely subjective

### **3.2.2 Money Transfer & Deposits**

The demand for these financial services by traders at all levels will grow as scale increases. The challenge, which is addressed in the supply section of this report, is to manage the problem of cost in serving large numbers of small traders, who currently mainly work on a cash basis and far from any bank or MFI branches.

### **3.2.3 Seasonal Loans**

Addressing the issue of scale of transactions for both inputs and outputs is first and foremost an issue of the availability of working capital, both on-farm (for the inputs market) and in the trading sector (for both inputs and outputs markets). Handling larger volumes of commodities requires working capital, the demand for which will be determined in large part by developments in the road infrastructure, by the introduction and acceptance of grading standards, by the wider availability and use of market information and generally by the growing commercialisation of farmers themselves. Most traders (in terms of numbers) are used to working purely on a cash basis, or with trade credit. Access to institutional borrowing would enhance the ability of the more efficient traders to expand their scale of operations through giving them access to larger volumes of working capital.

### **3.2.4 Term Loans**

Since trading operations invariably involve storage, and sometimes also processing such as drying, washing, re-packaging etc., significant investments need to be made in buildings and equipment for any scale of operation other than the most basic. Some term lending in the sector, for items such as oil-pressing machinery, and cotton gins, is already being undertaken. There is understood to be scope for more investments in plant and equipment, especially in order to meet market demand for higher quality or value-added produce.

Robusta coffee provides a good example in this regard. Currently the destination market prices for standard Robusta coffee are at a 30-year low, with no likelihood of a significant improvement in the near future. The Uganda Coffee Development Authority (UCDA) has identified a market opportunity for higher quality Robusta, which results from careful grading combined with wet processing. The higher quality product can be expected to fetch a significantly higher price. The industry (through the UCDA) claims that it needs to increase the number of wet-processing plants from the current 16 to a total of 800 if it is to fully exploit the market opportunities wet processed robusta coffee present. However, each wet

processing plant costs US\$50,000. The potential new investment required is then close to US\$40m. This example indicates the type and scale of potential demand for term finance in Uganda's agricultural sector, even when one considers just one (albeit major) crop. In addition, the assumption is that prices in destination markets will be such that investments of this type continue to yield positive return.

### **3.2.5 Warehouse Receipts**

Only the largest traders currently receive bank advances secured by warehouse receipts. There is scope to improve the efficiency and lower the cost of managing stored products as collateral, so as to enable more traders to take advantage of the mechanism and the improved borrowing terms that this mode of collateral provides. These improved terms commonly mean a saving in interest charges of some three percent over loans secured with conventional collateral.<sup>21</sup> This differential is due to the greater ease with which such receipts can act as collateral. Against this saving there is the cost of collateral management, which is typically US\$2,000-US\$3,000 per warehouse per season. Clearly the greater the volume being secured, the lower will be the unit cost of using warehouse receipts as collateral.

Currently nearly half of all cotton and coffee is secured at some stage before leaving Uganda, by warehouse receipts. Under such arrangements exporters obtain funding that is secured by warehouse receipts from commercial banks with a quality control firm acting as collateral manager. At the level of charges quoted in the previous paragraph, the services of the collateral manager would be too expensive for all but larger warehoused volumes. There may also be an opportunity here for competition in the provision of warehouse management, competition that could result in lowered costs of collateral management.

Affordable warehouse receipt arrangements need standardized and readily implemented grading systems, so that commodities (notably grain) can be bulk handled, and ownership determined merely by weight and grade, rather than by organizing individually identified lots. Attention is needed to improve grading systems for many commodities. A start is being made with maize, with the introduction from 2004 of two grades, top grade (the only grade currently traded by major firms in the terminal market) and a lower grade for animal feed. Provided that the grading "message" is conveyed to farmers, and there is every reason to believe that this will happen, the new grading system will result in lower reject vol-

<sup>21</sup> Private communication from a major commercial bank in Kampala.

umes in the terminal market (Kampala) and overall a better appreciation by farmers of the importance of producing a quality product in order to realise a better price. It should also help expand the scope for the use of warehouse receipts.

It is understood that consideration is currently being given to improving the legislative framework for warehouse receipt operations, on the grounds that these involve three parties in a business relationship (i.e., the owner of the commodity, the financier and the collateral manager). Existing contract law is drafted with the more normal two party contracts in mind. It is understood that there is indeed a strong case for new legislation, given the expanded role that warehouse receipts can play in facilitating financing of trade in agricultural products. The current stalled position of the legislative proposals needs to be addressed.

### 3.2.6 Price Buffering/Marketing Measures

Apart from conventional loans, there is clearly a demand at this stage of Uganda's agricultural development for measures to bring an element of stability to farm gate prices. This demand is expected to grow as more producers become more dependent on income from crop sales. The difficulties of buffering prices are considerable. Indeed, this may be an area in which the GoU and its partners could do further work in order to design specific measures, which could eventually include strategic government interventions. This report sets out some approaches that might be considered.

The first of these is not a financial product, but rather improved price forecasting. Moreover, an example already operates in Uganda. Although not constructed as such, the Cotton Development Organization's indicative price mechanism has some of the effect of a price-buffering instrument. The *at-the-gin seed cotton indicative price* is based on futures prices in overseas markets for trades for Liverpool A grade lint. This indicative price is carefully and conservatively determined. It effectively acts as a psychological (though not actual) floor price for the commodity. As a reliable indicator<sup>22</sup> of price expectations, it provides an element of price certainty to growers, traders, ginners and their financiers. It is suggested here that there is a need to bring some of the benefits of this element of market certainty into the production and trading actions for other major crops in Uganda. While not directly reducing downside price risks, the indicative price does tend to set a benchmark, at least for cotton, where

the challenges of accurate forecasting are apparently being met with some success.

If a similar system would work in the maize market, then it would make a positive impact throughout the production/marketing chain. Those benefiting would include not only traders and farmers, but also the suppliers of financial services. It is further suggested that the feasibility of designing and implementing an indicative price for maize should be a subject of further investigation. Information used in determining the pre-planting maize price forecast would include:

- ✗ Likely purchases of the forthcoming crop by the World Food Program (WFP) and the International Committee of the Red Cross (ICRC);
- ✗ Stocks and forecasts of production compared with market demand in neighboring countries, especially Kenya; and
- ✗ The growth of the intensive livestock industry in Uganda (which is likely to continue to grow substantially, a trend which the introduction of a cheap livestock-feed grade for maize may well encourage).

The key opportunity for Uganda in this area is that the bi-modal rainfall pattern permits two maize crops per year, as opposed to a single crop in most of the maize producing areas of southern Africa. This makes the forecasting horizon shorter. If a shortfall is projected in countries such as Zambia, Zimbabwe or South Africa, Ugandan producers have time to respond by increasing the area planted for the next crop.

The second suggestion is also a marketing mechanism. Already mentioned is the fact that significant purchases of Ugandan maize are made by international relief agencies, notably by the WFP and the ICRC. Currently the destinations for this grain are understood to include: Congo, Ethiopia, Eritrea, Southern Sudan and Northern Uganda. Given that food shortages in these areas are likely to continue for the foreseeable future, forward purchasing contracts are an option which may convey benefits both for Kampala-based traders (giving security of return from sales of a future crop) and for the relief agency (providing security of supply – a policy which at least one of these agencies has already started to implement).

For the Ugandan farmer and rural trader, a greater degree of forward purchasing by these agencies would have a price stabilizing effect down the chain. Since two crops per year are possible in Uganda, such forward selling/purchasing is more feasible than in other markets, as the time and demand-forecasting horizon is shortened for both buyers and sellers.

<sup>22</sup> For the last two seasons it has proved conservatively reliable (personal communication from the CDO); earlier experience is unknown.

It is suggested that the feasibility of this mechanism be further explored, together with identification of any necessary actions by the financial sector in order to both accommodate this type of arrangements and, more importantly, take advantage of the improved price security in the maize chain (such as through bank-issued letters of credit, bonded warehouse receipts, and other types of guarantee).

The third mechanism relates to the purchase of put options, which convey a right (but not an obligation – it is an option, not a forward contract) to sell a specified quantity of a commodity, at a certain price, to a pre-identified buyer. Such an arrangement is made prior to or during the growing season. This is currently the subject of some attention internationally by a multi-agency group led by the World Bank. The mechanism has some attractions, but it is felt by the mission and by many other observers that given the present depressed state of the world coffee market, it would be inappropriate at this time to recommend adoption of this mechanism for achieving an element of price stability for coffee

The fourth possibility is to exploit the high potential for the contract growing of crops such as maize, and/or similar supply-based contracts by traders of maize grain. One current constraint to contract arrangements in rural areas is weakness in the ability of district courts to handle any subsequent contractual disputes, though the Kampala Commercial Court is well placed to handle larger cases. This weakness in the districts clearly needs to be addressed.

Apart from this, there are other strategic interventions by the government, which would facilitate contracting of this type. These could include, firstly, support for the more widespread use of grading standards. Secondly, work could be carried out on the design of financial instruments to assist maize chain actors to obtain finance, possibly using linkages to price projections derived from improved price forecasting. One such instrument could take the form of a guarantee to cover loans (to producers and marketers) in the event of a price slump to a level below that agreed for any forward contracts. A guarantee would be useful in maintaining the financial soundness of the commercial entities involved, because when the spot market price falls below an agreed indicative price, the value of the warehoused grain held in the terminal market would be less than what UGT (or other terminal market traders) would have to pay their contracted suppliers (big maize growers, and traders handling the grain from smaller producers).

The mission recognizes that there are important design issues in this difficult area of work. It is equally recognized that interventions of this type give the impression of running counter to free-market poli-

cies, and would therefore need to be presented in such a manner as to demonstrate their commercial worth. For both of these reasons a detailed investigation is needed.

Such an investigation, say for maize, would examine the likely production response from varying farm-gate price levels, the extent to which forward contracting could be enhanced in the Ugandan and regional context, and the financial implications of introducing a guarantee arrangement, together with the options for meeting the costs involved. This exercise is beyond the scope of the present study, but the mission strongly recommends that it be carefully undertaken before decision makers can be expected to give any consideration to interventions of this type.

### **3.3 The Demand – Production Stage (Farmers)**

The benefits of improved efficiency in the inputs and outputs markets can be expected to feed down to the farmer. Some of the required information on demand for products, and prices in various markets is currently available through the GoU/Foodnet Market Information Service, which recently started operations and is expanding its area of outreach across the country. The National Agricultural Advisory Service (NAADS) also conveys market demand information, along with technical, production advice to farmers. Other channels for transmitting demand information to farmers are the buyers of agricultural products and produce (see also Annex 4 Information Management). It is a matter of mutual interest that farmers and buyers have their sights set on the most profitable products, and on the most favorable presentation and timing of their entry into the marketing chain, in order to optimize their gains from market interactions.

The productivity of capital in farming is of fundamental importance to farmers and to their financiers. Whereas farmers can be expected to act rationally in investing in their operations when using their own funds, a history of easy credit may have blurred the focus of many to the key issues of the productivity and profitability of loan-financed use of purchased inputs and other farming investments. This has important policy and operational implications for financial institutions making farming loans (see below).

In terms of empirically determined returns to investment in farming, little information was available to the mission. Nonetheless, the results of one study undertaken on behalf of the Bank of Uganda shown in Table 3.5 shed some light on the issue. The 'benefit ratios' quoted in the table must be regarded as tentative, and are in any case highly sensitive to the crop prices obtained on sale. Perhaps the most ac-

curate position on the returns to farming investment is that they can be substantial, but that they are subject to wide swings, and include seasons in which losses are made. The reality is that in contrast to non-agricultural investments, farm production faces a different and usually more potent set of risks and uncertainties – the weather, commodity price fluctuations (often determined in far-off export markets), input supply difficulties, transport problems, poor roads, and praedial larceny (this was experienced in 2003 by some vanilla growers in Uganda, who reportedly lost substantial volumes of mature or nearly mature vanilla pods to thieves).

The agricultural sector is not homogenous, and the

**Table 3.5: Some Indicative Returns to Investment in Crops**

Crop	Input costs Ushs/ha	Benefit ratio
Coffee, improved	310,000	4.38
Coffee, clonal	409,000	2.98
Tea, outgrowers	193,000	1.32
Maize, using improved seeds	57,000	3.55
Beans	42,500	1.12

Source: Bank of Uganda

recognized three tiers of farmers outlined in the PMA provide a useful basis for suggesting differential approaches by providers of financial services. These differences will form the basis for policies that are suggested below for the various groups. Firstly a summary is given in Table 3.6 of the likely effective demand for financial services, again using a long term time horizon.

**Table 3.6: Farmers' Demands for Financial Services**

Economic Group	Financial Services - Possible Effective Demand *				
	Money transfer	Deposits	Seasonal loans	Term loans	Insurance Life/Agric.
Subsistence villagers	Yes	Yes	No	No	No
Subsistence farmers	Yes	Yes	Some	No	Life
Semi-commercial farmers	Yes	Yes	Yes	Some	Life
Commercial farmers	Yes	Yes	Yes	Yes	Life **

**Notes:**

\* "Effective demand" means that the user of the service can have productive and profitable use for it, and would be expected to be in a position to meet obligations accordingly.

### 3.3.1 Commercial Farmers

There are an estimated 60,000 farmers and fishermen operating on a commercial scale in this group. Many if not most commercial farmers and fishermen will doubtless already enjoy access to money transfer, deposit services and short-term loans. Some of these short-term advances will be from commercial banks; others will be from MFIs (especially for those commercial farmers who are urban or per-urban), while some financial services are obtained by farmers or fishermen as outgrowers or suppliers to a processing plant, e.g. a cotton gin, a tobacco curer, a sugar processing factory or a fish packing plant. For cotton, input supplies are commonly provided, in kind, through ginneries. There are reportedly 56 ginneries in the country, and on average each processes cotton from some 10,000 growers. Input costs are deducted from payments for seed cotton delivered. Cotton seed is handled by the Cotton Development Organization (CDO), which also imposes upon gins a levy of two percent on the ex-ginnery value of cotton lint. This levy covers the cost of the operations of the CDO, including the cost of processing and delivering seed at no further charge to farmers.

Tobacco is in a similar situation in that the main buyer, British American Tobacco, provides some inputs to growers under similar arrangements to those operated by some cotton gins. Sugar is another crop that lends itself to closed marketing arrangements – due to the high weight-to-value characteristics of harvested cane, and the need for processing to take place quickly after harvest. These inter-linked transactions carry advantages and disadvantages for farmers and processors. For the farmer/growers there is one big advantage. They are assured of a supply of the inputs in situations where input markets are unreliable because business volumes are low and demand uncertain. The processors also benefit as they are assured of a steady supply of farm output. Both parties also benefit from lower transaction costs.

On the other hand, there are disadvantages to inter-linked transactions of the type mentioned above. Although many of these arrangements include advances for production expenses, the involvement of a local MFI or other financial intermediary would provide a better all-round service to outgrowers/estate farmers, giving them also a degree of indepen-

\*\* If agricultural insurance were to be available, then there would be some effective demand from very large, heavily indebted farmers, for this service. This applies especially to mortality cover for livestock. Crop insurance is not likely to be available in Uganda within the long term horizon covered in this report, with the possible exception of specifically designed and brokered covers for intensive, high value crops, e.g. roses.

dence from the estate system. This independence could be useful in negotiating better business arrangements with the estate/buyer/processor. There is some anecdotal evidence in Uganda of exploitation of farmers in nucleus estate situations<sup>23</sup>.

Therefore independence in selecting partners for financial intermediation should be regarded as politically and socially desirable. For processors, there is a risk that farmers indebted to them will engage in extra-contractual marketing ('side selling') in order to evade repayment obligations; so these systems tend to work best when there is the reality of mutual benefit in developing a close working business relationship, and where fairness in dealing prevails. This requires good information flows and constant vigilance.

Much less common than access to seasonal finance, for the bulk of commercial farmers, is successful experience in obtaining term finance. To date the major agricultural term finance users have been those benefiting from the EIB line of credit through participating banks. These borrowers are generally large enterprises, and the loans, which in any case are very limited in number, have, in the main, been for processing equipment and similar purposes. Yet it is term finance that will be needed on commercial as well as on semi-commercial farms, in order to permit the expansion of cropped areas and/or larger livestock units. Much scope exists for development work on financing methodologies for such investments – including expansion of current leasing arrangements.

Encouragement for many types of term investment in farming would be given by greater certainty of land tenure. This applies particularly to various land improvement investments, such as fencing, water supplies, irrigation, and forestry. (See Annex 3 for a detailed discussion of land tenure issues that influence the demand for investments and access to finance.)

In effecting arrangements for term borrowing and investments, linkages between life insurance and term loans will be desirable in many instances since the productivity of the investment may depend greatly on one key individual (usually the family head). Health cover will also be in demand if premiums and benefits can be made sufficiently attractive. Insurance on farm assets such as farm buildings is already available in Uganda, and demand for this is expected to grow. Mortality cover for high

value livestock while no longer available in Uganda may well be offered again. Certainly there would be a demand for insurance for livestock enterprises, especially if such cover were to be made a condition of bank loans. Less likely over the foreseeable planning horizon is effective demand and indeed supply of crop insurance, though for highly intensive enterprises, such as flower production, some cover may be possible. (See Annex 5, Insurance as a Financial Service.)

### 3.3.2 Semi-Commercial Farmers

Because by definition semi-commercial farmers have progressed in the scale of their operations and use of technology, most in this category will have already demonstrated an ability to manage improved technology and/or larger enterprises. To this extent they are similar to farmers in the commercial farming category. It is also likely that many will be part-time farmers, perhaps working in rural towns, or operating small businesses, including trading in agricultural products and inputs. Many in this group would be candidates for client status with a local bank or MFI. This would also apply to those who are in outgrower situations with nucleus estates or other processors/buyers.

As with commercial farmers, as expansion of acreage becomes possible either because more land becomes available or management ability improves, investments in machinery/equipment and/or permanent improvements such as fencing, water supply, irrigation, storage become viable and lead to a demand for funding. Also as with commercial farmers, over the foreseeable time horizon there will be a growing market for life insurance (and in some instances health insurance) for this group. MFIs that lend significant sums as term loans may develop loan products that include a link to an insurance policy on the life of the borrower.

### 3.3.3 Subsistence Group: Villagers and Farmers

In Table 3.6 a distinction is made between 'subsistence villagers' and 'subsistence farmers'. This differentiation is important for financiers as well as for government policy makers. It is based on the observation that in rural areas there are persons, and indeed families, who do not actively strive to produce a saleable surplus from their farming activities. Indeed, they are the true subsistence cultivators, with their farming activities being in the nature of home gardening rather than a commercial activity. Therefore they are labeled as *villagers* rather than *farmers*.

<sup>23</sup> Eaton, Charles and Andrew Shepherd, Contract Farming: Partnerships for Growth, FAO, Rome 2001 (p. 14) list the following as among the disadvantages for farmers of inter-linked transactions, "manipulation of quotas and quality specifications; corruption; domination; indebtedness and over-reliance on advances".

If policy makers base policy formulation and support initiatives on the assumption that villagers are automatically susceptible to the same incentives for production as farmers, then this carries the risk of diversion of human and financial resources from more productive and promising sections of the rural population. This has important implications for initiatives such as the Outreach Plan, if financial institutions supported by the Plan eventually make loans to the rural poor. Since villagers have no intention of farming for profit, any external funding of their production decisions runs a considerable risk of failure. This is because this group lacks an orientation to farming as a commercial activity. Altering villagers' attitudes towards commercial farming cannot simply be achieved by making farming loans, or even grants, suddenly available to them. This situation would apply no matter the sources of funding, e.g. MFIs and/or other financial intermediaries.

Nevertheless, a large number of villagers have an effective demand for savings deposit and money transfer services. Financial intermediaries might be able to offer these services on a cost-covering basis, as an important part of their product range at the grassroots level. At present it is estimated that less than ten percent of the population in this category have access to formal savings facilities.<sup>24</sup> Given this situation it is hardly surprising that there is a very poor knowledge interface between the financial sector and the agricultural/fisheries sectors (see Annex 4 Information Management).

Emergent subsistence farmers, the *farmers* in the distinction made above, are a slightly different category. By contrast with villagers, those in this group actively try to earn a significant part of their income from farming. They are oriented to meeting market opportunities, even though most in this category still use traditional farming technology. The transition from the use of traditional farming technology to the use of improved technology involves an increase in management task. This can best be illustrated by the following simple equation.

$$T = f(C, S)$$

Where:

T = management risk

C = complexity

S = size of operations

It is evident that an increase in either C or S will increase the task of management, which involves: market-led enterprise planning, understanding the technology in relation to agro-climatic factors, organizing labor (the farmer's own, that of his family, and hired help), timing agricultural operations, recognizing pests and diseases and deciding on and imple-

<sup>24</sup> Estimate made by the mission, based on anecdotal evidence.

menting control measures – optimizing harvest timing in relation to the market, processing/ packaging needs, etc.

These are demanding requirements and carry implications for financiers, since the effect of introducing credit, if indeed it is used for farming, is to increase either *complexity* or *size* or both. It is important to be able to distinguish between those farmers who can use loans effectively from those who cannot do so. The most straightforward differentiating technique is to only consider for loans those who have already proven their ability to manage improved technology, or new crop/livestock enterprises, using their **own** financial resources. Loans can then be used to supplement savings in order to enable these proven operators to expand the scale of their operations.

Similar approaches are applicable for fishermen. Those wanting to upgrade their equipment using credit should first have shown their ability to manage improved technology and be integrated into a reliable marketing outlet for their catch, before a lender should consider their loan applications.

For the whole of the subsistence group, savings, deposit and money transfer facilities are important, both as valued services in their own right, and, in the case of deposits, as a means whereby the financial intermediary can develop a relationship as the basis for further business, in particular for meeting genuine, effective demand for loans.

### 3.4 Summary of Main Points on Demand

✗ Uganda has highly favorable natural conditions for agriculture and fisheries. However, production must be demand driven in order to realize optimum factor returns and, therefore, attractive profit levels from credit-financed investments.

✗ Effective transmission of demand signals is vital; fortunately in Uganda the rapidly developing FoodNet market information service performs this function for many agricultural products. Financial institutions working with the agricultural sector (farmers and/or traders) should be aware of and utilize this service, while the GoU and donors should ensure that it continues as an important public-good tool in the commercialization of agriculture.

✗ As out-migration from rural areas proceeds, the demand for term finance and the ability to service such finance should increase. Currently such finance is focused on the largest commercial farmers. Financial institutions need to design suitable products and procedures in order to profit from this business opportunity with smaller farmers

and fishermen.

- ⌘ Use of improved farming technology and/or producing on a larger scale requires a concomitant increase in managerial ability. Lenders need to distinguish between farmers who have proved that they have this ability, and those who do not. This is a particularly important issue for initiatives such as the Outreach Plan, which are intended to benefit the poorest among the rural population.
- ⌘ Currently the small volumes bought, sold and transported characterize the trading sector servicing agriculture. Rationalization of this sector will require investment in storage facilities and means of transport, and in some cases access to working and investment capital on the part of traders in agricultural produce, both those based in rural centers, and those in cities.
- ⌘ Much scope exists for improving marketing procedures, especially those which help reduce price uncertainty for both producers and traders. A start can be made by giving further attention to price/demand forecasting, and to the encouragement of forward purchases by large buyers, including international relief agencies. Other approaches could include facilitation of contract farming arrangements. Mechanisms for buffering prices for key crops, such as maize, could be considered in the light of the favourable situation in Uganda (notably the bi-modal cropping season, reliability of precipitation, coupled with the sound groundwork in forecasting by the Foodnet project). Some strategic interventions by government would be required for actual price buffering in the form of limited guarantees. The Mission is of the view that more developmental work is warranted in this area in order to provide a sound basis for consideration of possible interventions by decision-makers.
- ⌘ Development of insurance as a financial service to agriculture and fisheries will be chiefly and most usefully confined over the foreseeable planning horizon to the coverage of equipment, buildings and harvested crops, together with life cover. The latter type of product, if combined with term loans, could become a growth area for insurance and banking institutions (including MFIs). Crop insurance is not seen as becoming important within the next decade or two because of the likely low level of demand (at the high premium levels which would be required) in relation to the heavy cost of designing suitable products, and training and maintaining the specialist staff required to operate such programs. However, there will be growing demand (through loan conditions) for mortality cover on valuable, credit-financed livestock.
- ⌘ The information interface between the financial services sector on the one hand, and the agricultural and fisheries sectors on the other, in Uganda, is weak. Attention by all parties to improved information acquisition and management should assist in ensuring optimal mutual support, to the benefit of financiers, farmers and fishermen, and traders operating in these sectors.

# Chapter 4

## Supplying Financial Services to Agriculture and Rural Areas

### 4.1 Introduction

The previous chapter presented an analysis of how the demand for financial services in agriculture and the rural economy may evolve over the next several years. One of the characteristics of the economic development process in all countries is the relative decline of agriculture as per capita income rises. Therefore, it is likely that the proportion of the country's population living on farms and in rural areas (currently 85 percent) will decline sharply over the next decade. As economic growth occurs, some people will move off farms and migrate to rural towns and cities, and many will become engaged in economic activities with backward and forward linkages to agriculture. Some will continue to live on farms, but earn larger amounts of household income from non-farm enterprises. Some will specialize more in farming and utilize the land left behind by migrants to increase their farm sizes by employing animal and machine power. Some will become specialized in producing for nucleus estates.

The formal financial system is currently servicing a fairly small proportion of farmers and selected market niches within the rural economy. Economic transformation will increase the demand for financial services by farms and by households and firms in villages and rural towns. If some of the constraints identified in this chapter can be reduced or eliminated, the financial system will be able to respond better to these emerging opportunities and contribute more to the economic transformation process than it is doing today.

This chapter has three purposes: to summarize how the financial system is currently serving the rural economy, to identify how the supply of financial services will likely evolve in response to new demands for services, and to identify constraints that may affect its performance. The chapter ends with a listing of the key actions proposed to be taken to improve the likelihood that the financial system will contribute to and accompany the economic transformation rather than impede it.

### 4.2 The Suppliers of Agricultural and Rural Financial Services

Agriculture and rural areas are supplied financial services by formal financial institutions, NGO-MFIs, member-owned organizations, and informal sources. An overview of the sources, their products and the

clients served was presented in Chapter 2. This section provides important additional information about the suppliers and their services.

#### 4.2.1 Tier 1 and 2 Financial Institutions

Tier 1 and 2 financial institutions include 15 commercial banks and 8 credit institutions. About 10 percent of the total volume of loans and advances made by commercial banks reportedly go to agriculture. They could offer more financial services for agriculture and in rural areas but their limited branch networks, among other factors, constrain their outreach. They primarily make large short-term loans to commodity processing firms, trading companies, nucleus estates, and a few individual farmers, especially in the export sector. With donor support in the form of guarantees and incentives, some banks have started lending to MFIs so they indirectly finance rural firms and households. Some bank loans are undoubtedly made directly to smaller firms located in rural towns and cities. Bank loans typically are made for less than a year at prime rates of interest (currently about 15 percent) plus additional percentage points based on the perceived risk of the borrower. The banks offer a wide variety of other products and services to any firm, group or household that meets their requirements, and is located close enough to travel to their branches. However, the high minimum balances required and the formalities involved prevent most poor people from using commercial bank savings and deposit services.

Term loans are largely limited to those made by eight banks that participate in the European Investment Bank Apex Private Sector Loan Scheme. This scheme provides financing for loans of 5 to 12 years, with a one-year grace period. Loans can be made in either Ushs or foreign currency at below market rates and, unlike most short-term loans, the borrowers can choose fixed interest rate loans. Apparently, less than 20 percent of the 100 or so term loans granted under this Apex scheme have gone to agriculture.

Many banks have failed due to poor management and imprudent lending but, except for the Cooperative Bank, there is little evidence that agricultural lending has been the primary reason for failure. It is generally assumed that the granting of loans to people who were well-connected and refused to repay was the primary

cause for the Cooperative Bank's failure, not the inherent risk and cost of agricultural lending.<sup>25</sup>

Two financial institutions merit specific comment. The Centenary Rural Development Bank is recognized as being the pioneer bank in the country that began making individual loans to farmers in 1998 in its Mbale branch. It began this lending using a lending technology that analyzed the farm household's expected cash flow. Loans were made for 6-10 months at an interest rate of 1.8 percent per month plus other charges. The loans were collateralized and often carried a grace period followed by 3-4 monthly payments. Interest was charged at 1.8 percent per month on the declining balance, and an application fee of Ushs 5,000 (about \$3) was charged along with a monthly inspection fee of two percent, which was reduced to 0.5 percent for the fourth loan if the borrower made on-time payments for the previous three loans. As additional collateral, a special loan current account was also opened for the borrowers and post-dated checks were drawn against it for the loan installments.

The experience in the Mbale branch clearly shows that by employing an appropriate lending technology, using well-trained and motivated loan officers, and following prudent lending practices, many of which are similar to those successfully used in microfinance, it is possible to successfully serve agriculture. However, Centenary's high initial loan recovery deteriorated when it rapidly expanded agricultural lending into other branches in conjunction with a loan guarantee program. Recently it has been trying to collect from the guarantee an amount roughly equal to 29 percent of the loans guaranteed. It is unclear if its agricultural loan portfolio is as large today as it was in the peak guarantee period. This experience shows that government and donor incentives can induce financial institutions to imprudently expand into new markets where they have little experience, and/or when they have insufficient numbers of staff trained for new markets, coupled with insufficient control and monitoring by senior management.

The second financial institution is the DFCU Group that includes the DFCU Bank, DFCU Leasing, DFCU Limited (long-term lending), Housing Finance Company, and Rwenzori Properties. The Group reported that over eight percent of its loans and advances were made to agriculture and agro-processing at the end of 2002. The Leasing Company controls over 85 percent of the country's leasing market, with 16 percent of its net lease investments outstanding at the end of 2002 going to agriculture and agribusiness.<sup>26</sup> The transport sector represents about 40 percent of the total. By retaining ownership of the assets leased, it is expected

that leasing will be less risky than lending.

The agricultural items leased include new and used tractors, maize mills, coffee and millet processing equipment, and milk coolers. Under a DFID Challenge Fund Grant, a pilot beehive-leasing scheme is now operating in which the Uganda Honey Company is providing training and buys the honey. The bulk of the funding for all lease operations is borrowed from International Financial Institutions at an average cost of approximately 12 percent. Most leases are made for Ushs50 to 500 million, for 2 to 5 years, at leasing interest rates from 16 to 26 percent with an average of 18 percent. About 60 percent of the items leased are second hand when leased, which reduces the cost to lessees. Cash down payments of 10 to 15 percent are required, and the lessee can opt to purchase the equipment at the end of the lease for up to five percent of the value. To minimize default, lessees are required to prepare post-dated checks for the gross rentals over the lease period. It has opened four rural Leasing Centers with a grant from the SPEED Project that subsidized the start-up costs and training. This will broaden its geographic spread and facilitate more rural operations. The Leasing Company is an example of a financial institution that successfully participated in donor-funded schemes, but has not lost its commitment to efficiency and sustainable operations.

#### 4.2.2 NGO-MFIs

Nongovernmental organizations that specialize in finance number in the hundreds, but the exact number is unknown as neither the NGO Board nor the Registrar of Companies keep records of registered MFIs. Most are assumed to be quite weak; however, about a dozen are recognized as market leaders. Nine participate in the SPEED Project<sup>27</sup> designed to strengthen them for conversion into Tier 3 licensed deposit-taking MDIs. Even though they are among the best, it is likely that only 3 or 4 will be included in the first round of NGOs that apply for MDI licenses.

Most NGOs serve clients drawn from urban and peri-urban areas. The Uganda Microfinance Union is unique as it started in 1997 in a rural location and eventually opened urban branches. Some are "home grown" while others mimic international MFIs, such as the Grameen Bank or FINCA. Most make fairly

<sup>25</sup> Some delinquencies have been reported in agricultural loans guaranteed by the USAID/SPEED (Support for Private Enterprise Expansion and Development) Project.

<sup>26</sup> Much of this material was extracted from Juma Kisaame, "Case Study of DFCU Leasing Company—Uganda," Paper presented at the Paving the Way Forward for Rural Finance International Conference Sponsored by the Agency for International Development, Washington, DC, June 2-4, 2003.

<sup>27</sup> The mission is especially grateful for the assistance of several SPEED project staff members who so graciously provided their time, data and facilities during our work. Any misinterpretations of these data are our responsibility and the SPEED project staff may not share the conclusions presented here.

short-term loans, often with group guarantees and frequent payment schedules. These types of arrangements are better suited to trading enterprises with high turnover than to farming enterprises with more irregular and seasonal cash flows. The interest rates and fees charged for small loans can total the equivalent of a 50-100 percent nominal interest rate calculated on an annual basis, in order to cover high operating costs.

Some MFIs experience rapid growth and high loan recovery rates. For example, six MFIs in the Speed Project grew from serving a total of 42,000 clients in 1998 to over 150,000 by 2002 with over Ushs32 billion in loans outstanding. Moreover by 2002, the number of savers exceeded 227,000, surpassing the number of borrowers by more than 50,000, and the total volume of savings was Ushs15 billion, roughly half the loans outstanding. This demonstrates the demand for savings that exists among poor people. Their portfolio at risk (defined as loans more than 30 days overdue) ranged from a low of zero to a high of 8.4 percent. Four of the six had an index of financial self-sufficiency above 100 percent indicating they could cover all operating and financial costs.

The NGO sector receives considerable assistance. Some comes through donor projects, like SPEED, that target one or a few NGOs for large amounts of assistance. The EU provides broader support to the sector through SUFFICE (Support to Feasible Financial Institutions and Capacity-Building Efforts). It provides credit lines, bank guarantees, matching grants for MFIs and providers of capacity building services, and research and field-testing of new products. Other donors support AMFIU that was established to serve as an advocate and capacity builder of the sector. Still other NGOs obtain assistance directly from network organizations, such as the links between FINCA Uganda and FINCA International and between the Uganda Women's Finance Trust and Women's World Banking. Both of these NGOs are actively working towards transformation into MDIs. An important development has been the growth of commercial bank lending to NGOs now totaling several billions Ushs in outstanding loans. The interest rates on some of these loans are strictly commercial while others are subsidized directly by donors and indirectly by loan guarantees. These wholesale-retail relationships permit the banks to utilize their comparative advantage in mobilizing savings, while the NGOs utilize their comparative advantage in making loans to lower income customers.

#### **4.2.3 Member-Owned and Managed Organizations**

The number of cooperatives and other member-owned organizations supplying financial services is even larger than the number of NGO-MFIs. As of October 2002, 6,580 cooperatives were registered with the Registrar of Cooperatives, of which 680 were SACCOs.<sup>28</sup> It was estimated that at least 60 percent of Tier 4 MFIs, excluding moneylenders, are SACCOs. It is a heterogeneous group that includes credit unions, community based village banks, Financial Service Associations (FSAs)<sup>29</sup> and Savings and Loan Associations (SLAs)<sup>30</sup>. Some are savings-first self-help oriented organizations, but many groups or SACCOs are reportedly being created in rural areas because of the expectation they will receive external assistance.<sup>31</sup>

Member-owned financial institutions generally face governance problems because they are member controlled. Partly due to shortcomings in governance, most are assumed to be weak and poorly managed. Even the WOCCU-assisted SACCOs that were expected to be stronger face serious problems as reported in Annex 2. Unlike banks, this market segment suffers due to the lack of a strong support system to nurture, regulate and supervise it. This is unfortunate because they may be the only type of financial institution that can economically serve sparsely populated remote areas where it is too costly for banks and the future MDIs to locate branches.

Member-owned organizations normally provide only savings services and loans. Credit unions and FSAs collect member shares as the primary source of loan capital and are weak in mobilizing savings. Members often save just the minimum required to get loans, as occurs in many NGOs. Loans are made in various sizes and terms and, except for SLAs, loan delinquencies are often high. Poor lending and collection practices, aggravated by a bad debt repayment culture and numerous supply-led government credit schemes in the past, have caused this problem. Poor loan recovery and limited savings mobili-

<sup>28</sup> Stefan Staschen, Possible Mechanism to Regulate Tier 4 MFIs in Uganda, Financial System Development Program, GTZ, Kampala, May 2003.

<sup>29</sup> A financial service association (FSA) is a small locally managed microfinance institution providing savings and loan services to its shareholders. The model was developed by Ahmad Jazayeri who is organizing them in Uganda and Tanzania as a means to provide financial services to low-income people. A total of 31 FSAs are operating in Kampala and southern Uganda and, as of September 30, 2003, they reported a total of 13,079 shareholders.

<sup>30</sup> CARE has created almost 600 SLAs, each with about 22 members, in the West Nile with a total membership close to 13,000 members.

<sup>31</sup> See Leonard K. Mutesasia and Nthenya R. Mule, "Understanding the West Nile SLAs and Charting a Path for the Future," Final Draft Report presented to the DFID Financial Sector Deepening Project, Kampala, October 2003.

zation produce liquidity problems, which discourage growth in membership and loan repayment, as borrowers fear they will not get new loans if they pay off current ones. Some SLAs operate as savings clubs and make loans to nonmembers, and others make loans to members for group enterprises.

#### 4.2.4 Informal Finance<sup>32</sup>

There are many other unregulated informal financial institutions and arrangements that provide a huge volume of financial services for participating households. They are often the only source of financial services in the most geographically isolated locations. These informal arrangements are built on trust, social and family relations, and reciprocity rather than written contracts. They exist among people who know each other and this knowledge is used to screen the transactions that are undertaken and to enforce informal agreements. They have stood the test of time, so expanding the formal financial frontier into rural areas will likely involve harnessing these traditional practices rather than trying to replace them. There are, however, some disquieting reports about these traditional mechanisms. For example, it was reported that trustworthiness is declining in rural areas leading to a reduction in informal lending and an increase in collateral requirements. A decline in levels of trustworthiness would signal the need to introduce more formal systems, while retaining the advantages of the traditional practices. A worsening of economic conditions, considerable rural unrest and insecurity, and deaths due to HIV/AIDS could all contribute to a breakdown in these traditional financial methods of coping with problems and obtaining financial services in areas located far from formal finance.

### 4.3 Expanding the Frontier of Formal Finance

We now turn to the question of how to push the frontier of formal finance deeper into agriculture and rural areas. What policies, programs, initiatives, and investments should be implemented so the supply of financial services expands to meet the changes in future demand identified in Chapter 3?

#### 4.3.1 Objectives of the Financial System

There are three important objectives that the Ugandan formal financial system should strive to achieve in its efforts to serve more agricultural and rural clients in the future.

<sup>32</sup> A description of informal financial services in rural areas can be found in Grace Sebageni, Steven Kaagwa, and Leonard Mutesisira, "Where There is No Banker: Financial Systems in Remote Rural Uganda," MicroSave Africa, Nairobi, February - May, 2002.

- ⌘ Outreach – The financial system should attempt to reach as many households and firms as possible, including many of the poor, but not necessarily the poorest most indigent members of the rural society whose serious needs cannot be met solely by financial services. A larger variety of services are preferred to a fewer number, and making services available on a continuous and repeated basis is preferable to a one-time event such as providing someone a grant.
- ⌘ Sustainability – The financial system should be sustainable so it can continue to offer its services over time without interruption and be self-financing so the financial institutions generate the revenues necessary to cover their costs. In this way they will be less dependent on the whims and priorities of the government and donors for subsidies.
- ⌘ Efficiency – The financial system should consume as few of the nation's resources as possible to produce products and services and offer them to clients as cheaply as possible. Competition should be encouraged as an important driver of efficiency.

If the financial system meets these objectives, it will make a significant impact on the country by assisting the largest possible number of people realize their direct economic objectives of increased employment and income, and reduced poverty. Other indirect benefits such as improved consumption, nutrition, empowerment and welfare may also follow.

Several ways to assist the financial system meet these objectives are outlined in this section. Some of them are crosscutting in that they affect all segments of the market, while others are specific to particular types of financial institutions.

Key topics to be considered in this analysis include:

- ⌘ General environment. Financial institutions operate within a framework of policies and institutions that condition their activities, and facilitate or constrain them in meeting their objectives.
- ⌘ Supply of resources. All financial institutions consume financial and human resources and all lenders must have access to funds to lend.
- ⌘ Internal operations. All financial institutions employ resources and technologies to produce their financial products and services. Some are market leaders in discovering and introducing innovations, while others lag behind and eventually follow the leaders.
- ⌘ Governance system. The internal and external "rules of the game" and the interplay among agents (boards of directors, managers, staff) determine how well an institution performs. Some types of financial institutions tend to have stronger

governance systems than others.

- ✘ Comparative advantage. Some types of financial institutions may have a comparative advantage in supplying certain products and services in some market segments compared to others.
- ✘ External support. Providers of financial services vary in their dependence upon and ability to effectively use external support without damaging their financial discipline.

#### 4.3.2 Matching Demand and Supply: At What Price?

The task of efficiently producing financial services is challenging. Table 4.1 provides some sketchy data compiled from documents and interviews to demonstrate some features of the current supply of loans. It lists categories of suppliers, estimates of loan sizes, and ranges of nominal interest rates that have been reported. This is a crude approximation since it is necessary to analyze all fees, compensatory savings balance requirements, and other transaction costs to accurately determine the full cost of borrowing. The last column reports the level of operating costs for two sources which provide some clues about the cost of supplying loans. Of course, estimating full costs requires a careful analysis of the cost of funds including reserve requirements, loan losses, and many other detailed accounting issues.

As expected, large banks make the largest loans at the lowest explicit interest rates often set at the prime rate plus a margin depending on type of loan and perceived riskiness of the borrower. The size of the DFCU leases can also be quite large with implicit interest rates roughly in the same range. The operating costs of these two categories are unknown but clearly personnel and facility costs must be relatively high. They mobilize funds at a rather low interest rate from savers or at mildly subsidized rates from international financial institutions. Centenary Bank makes much smaller loans to individual farmers, although some small DFCU equipment leases may be granted to a similar class of customer. Centenary's interest rates are roughly in the same range as the banks, but it also charges several other types of fees that raise total borrowing costs. It raises funds from the public and has also received large amounts of donor funds in the past.

The NGO-MFIs and credit unions tend to serve a different market segment compared to banks. Loan sizes are much smaller on average and interest rates are significantly higher. Thanks to the efforts of supporting institutions, estimates of operating costs are available, and they tend to be very high because of small loan sizes and other reasons. On the one hand,

the cost of funds for NGOs is high because some

**Table 4.1: Loan Sizes, Interest Rates, and Operating Costs by Category of Supplier**

Suppliers	Loan size (Ushs)	Interest Rate (%)	Operating Costs* (%)
Large banks	Millions	Prime (15)plus X % annual	Unknown
DFCU Leasing	50 - 500 million	16 - 26 % annual	Unknown
Centenary Bank	Ave. 300,000	2 % per month declining	Unknown
NGO-MFIs	50,000 - 4 million	2-3% per month flat or 4% declining balance	40 - 85 %
Credit Unions	50,000 - 4 million	20 - 48 % annual	4 - 45 %
FSA	50,000 - 2 million	8 % per month declining	Unknown
SLAs	5 - 50,000	5 - 20 % monthly flat	Unknown
Rural money lenders	50,000 and above	5 - 20 % monthly flat	Unknown

Notes: \* Operating costs are defined as operating expenses/ average assets.

borrow from banks. On the other hand, some also receive concessional funds. Credit unions tend to have lower operating costs because their salaries are often lower, sometimes their facilities are subsidized, and members donate labor for management and governance. The FSAs serve a similar market segment with interest rates that are significantly higher. However, they are still in an experimental phase so it is unclear what rates they might charge in the future. Their operating costs are unknown.

The SLAs appear to serve yet another market segment. They represent the most rural of all categories as they operate in a region where few other financial institutions are located. Their loan sizes are much smaller. Interest rates are surprisingly high perhaps because the members use moneylender rates as their reference and assume that is the competition "to beat." It may also be the case that they want to compensate themselves for the savings they put at risk and for the time spent in governance. By comparison, the credit unions in the WOCCU project pay two to eight percent per annum on savings and no profits are paid on shares owned.

How will the rural financial markets evolve, what will be the probable costs of advancing small rural loans, and what levels of interest rates will prevail in the future? First, although the nominal interest rates reported above appear very high, they are less so when adjusted for inflation. For example, farmers in developed countries today pay between 6 to 10 percent annual interest rates on seasonal farm loans but

their current inflation rates may be only 2-3 percent compared to 5-10 percent in Uganda. The more striking difference is that developed country farmers face less interest rate risk as they can also obtain fixed interest rate term loans at roughly the same rate as seasonal loans. Even for seasonal loans, most bank loans in Uganda are made at variable rates. Therefore, the Ugandan agricultural sector is at a comparative disadvantage in using borrowed funds to finance longer-term investments.

Treasury bill rates establish a floor for the interest rates charged by banks, and influence the rates charged by other lenders that borrow from them. Therefore, the interest rates charged borrowers by many lenders must be several percentage points above the T-bill rate. For this reason, the single most important action that Uganda can take to lower interest rates for all borrowers, including those in agriculture and rural areas, is to implement macroeconomic and other reforms that will stabilize and reduce the Treasury bill rate.

Second, the future cost of funds for the MDIs will be influenced by their success in mobilizing savings and deposits from their borrowers and the general public. They will probably have to pay savings rates at least as high as those offered by banks, and their cost of administering such savings may be high in the early stages until they attain economies of scale. Therefore, the future interest rates for MDI loans may be determined as much by their efficiency in savings mobilization as by their efficiency in lending.

Third, the future rates that non-deposit-taking NGOs will have to charge for loans will be determined partly by their access to subsidized sources of funds, but there is evidence that such funds are drying up except for social investors who target the strongest and most sustainable MFIs. Most NGOs have little experience in serving agriculture and rural areas so it is difficult to estimate their future operating costs and interest rates if they expanded more aggressively into this market.

Fourth, the member-owned organizations have the greatest ability to offer lower rates for loans. They rely heavily on member savings and shares that sometimes can be mobilized at low cost. Some use subsidized facilities and donated time from members for governance purposes. They also tend to pay lower salaries. Despite these advantages, many, if not most, SACCOs are extremely weak. Moreover, since their loan recovery is frequently poor, they need to charge high interest rates to cover loan losses even if they mobilize cheap savings. Since many SACCOs and other types of member-owned organizations are unsustainable, it is unclear what their costs and interest rates would be if they were sustainable entities. The problems of the SACCOs, coupled with the failure

of the Cooperative Bank, suggest that the old paradigm for developing the cooperative sector has been and will likely continue to be a failure.

Fifth, although moneylender rates are reportedly high in rural areas, it is not clear how much their rates would fall if sustainable MFIs attempted to serve their clients with the same size loans for the same purposes.

Sixth, the rural economy is heterogeneous. For example, large banks are needed to serve large processing firms, but they are too costly and don't have the appropriate lending technology to make small loans to individual farmers. Small and medium size banks and MDIs may be ideal to serve small and medium businesses in rural towns.

There does not appear to be strong evidence that shows that a particular type of supplier has a clear comparative advantage in efficiently mobilizing savings, making and recovering loans, and supplying other services for the heterogeneous demands of rural areas. This being the case, the most prudent government policy will be to encourage a competitive environment in which all types can experiment, evolve, and compete with each other over time.

#### **4.3.3 The Future for Commercial Banks**

The increasing competition that is observed among the commercial banks will have important consequences for both microfinance and rural finance. First, there may be further restructuring of the banking sector through acquisitions and mergers. Although the country may be under banked in terms of branches outside of Kampala, it is possible that it is over banked in terms of number of different financial institutions appropriate for the existing market. If true, the licensing of MDIs will exacerbate the situation. The banks and MDIs that survive will be the ones that adapt and find profitable new markets.

Second, when Treasury bills cease to be so attractive, banks will have to look for new sources of revenue. Those currently servicing large agribusinesses will be able to grow along with the successes realized by their clients. The magnitude of the financial resources involved and associated risks mean that only the biggest banks have the capacity to serve the largest businesses. Those banks with the largest branch networks will be in the best position to serve emerging business opportunities in rural towns and towns. The first NGOs that successfully complete the transformation process into MDIs and become adept at mobilizing savings and deposits will be obvious candidates to expand their branch networks into under banked regions.

Third, some banks may decide to increase their farm

lending, while others may specialize in retail banking. Some may even create specialized agricultural departments. Centenary Bank may return to its original prudent individual farm-lending model and slowly extend it into new areas. Other smaller banks may follow the Centenary example and make the institutional commitment needed to serve this market. It is logical to expect that favorable geographic areas will be reached first, where farmers have the best production possibilities and access to the best markets.<sup>33</sup>

As the banks learn from their experiences in lending to MFIs, more wholesale-retail relationships may develop. Banks may use their comparative advantage in mobilizing savings, and lend to MDIs and NGOs, while these entities utilize their comparative advantage in on-lending to the agricultural and low-income market segment.

Four sets of constraints will influence the future performance of commercial banks in agriculture.

- ✘ First, commercial banks are best suited to make term loans because of their capacity to transform short-term savings into long-term loans. However, as noted in Annex 3, there are many impediments in the current landholding system that will prevent the widespread use of land as collateral for long-term loans in the near future.
- ✘ Second, the absence of long-term savings in the country will impede the ability of financial institutions to make substantial numbers of loans with maturities longer than a few years.
- ✘ Third, unlike MFIs, commercial banks depend on written contracts and contract enforcement through the legal system. The reforms under way in the Justice Law and Order Sector will be crucial for streamlining the procedures used to enforce loan contracts, resolve disputes and reduce intermediation costs.
- ✘ Fourth, financial intermediation is an information-intensive activity. As noted in Chapter 3, there are no good easily accessible sources of information about economic opportunities in agriculture for use by either farmers or bankers. This problem will have to be rectified through the reforms underway in NARO and NAADS if farmers are to discover and respond to market opportunities, and if bankers are going to correctly assess the creditworthiness of potential borrowers. Eventually, the volume of

credit transactions in the economy will require the creation of a credit reference bureau system to facilitate the exchange of information and reduce the cost of information sharing among creditors.

#### **4.3.4 The Future for MDIs and NGOs**

The Micro Finance Deposit-Taking Institutions Act represents an important step forward in resolving the problem of how to legally mobilize deposits from the public for use in making small loans to microenterprises. Now it is up to the NGOs to meet the minimum capital and other requirements specified for Tier 3 status as deposit-taking MDIs, and for the BoU to develop the capacity to efficiently license, regulate and supervise them. Experience in other countries suggests that NGO transformation is not a simple task. The SPEED Project is discovering some of the costs and difficulties that MFIs face in this process. Even if the first few MFIs smoothly transform themselves into MDIs, there will be a need for additional resources to screen and assist the next round of potential candidates for transformation. More importantly, the new MDIs will need considerable assistance in designing savings instruments that appeal to the general public, not just the poor who have been their traditional clientele. Also, if they are going to penetrate rural markets, they will need additional capital and staff to expand their branch networks. Their existing lending technologies will likely be appropriate for use in lending to small businesses rural towns, but they will need to develop new loan products for crop and livestock enterprises.

The remaining Tier 4 non-deposit-taking NGOs will face problems as they will be limited to taking compulsory savings as a kind of loan insurance from their clients, but they will not be allowed to on-lend these resources. Therefore, they will have to rely on donations and concessional funds from donors, or become strong and credible enough to borrow from other financial institutions, or expand slowly through retained earnings from grant-based lending. The best option for some may be to try to develop long-term wholesale-retail partnerships with banks. In any case, they will have to develop more transparent accounting systems that reflect their true financial health, and good lending technologies to efficiently make and recover loans.

#### **4.3.5 The Future for Member-Owned Financial Organizations**

The future role of member-owned and managed financial institutions is the most problematic segment of the financial system. Much additional thought and analysis is needed to design a comprehensive strat-

<sup>33</sup> There is some evidence indicating that better access to infrastructure is also associated with lower levels of civil strife. This in turn can be expected to influence where financial institutions choose to locate. See Klaus Deininger, "Causes and Consequences of Civil Strife: Micro-Level Evidence from Uganda." Policy Research Working Paper 3045, World Bank, Washington, DC, May 2003.

egy for these organizations. On the one hand, they present the best potential solution for reaching poor households in the remotest locations. On the other, they tend to be the weakest in achieving long-term sustainability. This segment of the market seems most susceptible to manipulation by politicians and local elites eager for votes and influence. Moreover, member-owned institutions have been particularly vulnerable to having their financial discipline undermined with external funding.

The failure of the Cooperative Bank with the loss of millions in donor funds, the weaknesses that persist in some of the best SACCOs even after months of assistance from the WOCCU project, and the lack of an effective national support and regulatory system, even after considerable donor assistance, are evidence of the fundamental problems of this entire sector and the great challenge in finding effective ways to develop it. Therefore, although member-owned organizations number in the hundreds and provide limited financial services to thousands of members, there is no clear way forward for developing them into a dynamic sustainable segment of the financial sector. The experiments underway with community-based village banks and the creation of FSAs and SLAs, together with the WOCCU attempt to strengthen a few SACCOs, may eventually reveal strategies to overcome the weaknesses inherent in these organizations.

The experiences of the recent past clearly suggest what not to do. First, the government and donors should not distort the internal incentive and governance systems of member-owned organizations by providing them with funds for on-lending. This tends to destroy their most important strength – intermediation of member savings. Frequently, external funds provided to revolving funds tend to get disbursed, but not repaid so they revolve only once or twice then collapse. Only financial organizations with strong governance structures can avoid the temptations for malfeasance that such funds produce. The mission strongly supports the current thinking of the Outreach Plan to not provide funds for on-lending to SACCOs, and believes that this should be the policy for all government and donor programs.

Second, new SACCOs should not be promoted with the promise that this is the way for the members to obtain outside financial assistance. The muddled message now being delivered to people in some rural areas must be clarified. This represents a delicate problem because the delivery of information and technology is done most cheaply through groups, so it is logical that the reforms of the research and extension systems include promoting the creation of groups. Moreover, local self-help groups are one of the traditional ways to solve problems at the village

level. However, the frequent poor management and governance in SACCOs makes them most vulnerable when they attempt to manage external resources. The mission strongly believes it is essential that a commitment be made at the highest levels to develop a clear message regarding the separation of financial activities from other functions that farmer groups are encouraged to undertake. A similar explicit separation of the functions of the apex organizations, UCA and UCSU, should be explored.

Several things should be done by the government, donors and the member-owned organizations themselves that will contribute to the formulation of a much-needed long-term strategic development strategy. In this regard:

⌘ Basic information is needed. The development of a strategy requires a better understanding of several basic issues than exists today. Basic data collection and some field survey work are needed to answer questions such as: How many SACCOs are registered? How many are effective members of UCA and UCSCU? How many names and addresses of members can actually be retrieved? How many SACCOs are really functioning? How many provide financial services? How good are their financial records? How many have the capacity to maintain accurate accounts and records? How many are lending outside resources? How many are essentially defunct because of unrecovered loans? How many active members are there? How many are active savers? How many members have lost savings? What are the characteristics of the most successful SACCOs?

⌘ Strategic planning is needed concerning the appropriate support structure. Some questions here include: What legal, regulatory and supervisory framework is needed for the sector? Are there logical reasons to support three separate organizations – UCA, UCSCU, and AMFIU? What should be their respective roles and responsibilities? What powers should each have? What role should the BoU have relative to the three organizations? What about the Registrar of Cooperatives? How much of this framework can be self-financed? Are there public goods components of the system that justify public support and can be clearly identified and appropriately funded? Are there any proposals for changes in organization and legislation? Are they comprehensive and inclusive in their approach? Is a temporary administrative system needed to provide leadership and guide the development of this entire support framework? Should this framework be set in place before additional resources are spent in developing grassroots organizations?

✎ A better understanding is required concerning the impacts of the past support that was provided to this sector and the lessons to be learned from it. For example, what are the primary factors that contributed to the collapse of the Cooperative Bank? Why has the support provided to UCA and UCSCU not produced stronger organizations? Why have some of the SACCOs supported by the WOCCU project performed better than others? Is support more effective when it is targeted at just a few SACCOs rather using a broad sector-wide approach? Have some SACCOs been able to efficiently manage external resources? What are their characteristics? Are most successful SACCOs utilizing only their own resources? Can a set of best practices be established to guide the support provided to the sector? What performance standards should be established for organizations receiving support?

Several decisions might come out of a strategic planning exercise. For example, it might be concluded that it is a waste of resources to assist SACCOs at the grassroots until the support system is overhauled. Several legislative and organizational changes might be proposed. Powers and responsibilities might be given to an organization to close poorly performing SACCOs. Perhaps a few could be identified that would benefit from a low-budget intensive strengthening program with the objective of converting them into regulated financial institutions that collect savings from nonmembers. Some type of self-regulatory organization might be created for smaller SACCOs with powers delegated to it by the BoU. Small SACCOs might be trained to use a set of simple standardized accounts. Another category of simple organizations, such as MMDs,<sup>34</sup> might be nurtured to operate on self-auditing principles that are highly transparent and understandable for the members. Strong educational programs on governance might be designed for all levels in the sector. Most importantly, strong commitments might be made at the highest levels in the public administration to not use these organizations as conduits to disburse public funds.

If most of this is accomplished, it is possible to envision sustainable SACCOs of various sizes offering competitive services at the local level to intermediate member savings. Larger ones might evolve in towns and cities and effectively compete as regulated full-service financial institutions. Others might be formed to offer services for paid employees in commodity

<sup>34</sup> The Mata Masu Dubara (MMD) Program was pioneered by CARE in Niger. The MMDs consist of a small group of savers, some of whom also borrow, that are organized into groups with an explicit termination date at which time the interest earnings are distributed to the savers. The original model used no written accounts, but relied entirely on the members to recall who contributed what, who owed what, and what amount of funds are stored in the group's moneybox at any time.

processing plants, while others might offer services to producers for nucleus estates. A strong regulatory system would likely be developed, and a second tier federation might be created eventually to intermediate savings among member SACCOs and to manage emergency and savings insurance funds.

If a systematic approach is not taken, it is likely that additional resources will be spent in this sector but most SACCOs will continue to be weak, vulnerable to political promises of bailouts and cheap money, lethargic in mobilizing savings, and uncompetitive in locations served by banks, MDIs, and dynamic NGOs. The support institutions will provide few services of real value to their members and will be more active in advocacy than in genuine development of the sector. For this reason, the mission recommends that the government and donors agree to support the development of a comprehensive long-term strategic plan for this sector rather than implement isolated reforms and programs.

#### **4.3.6 The Future for Informal Finance**

The informal financial system will continue to provide financial services in the foreseeable future. Sometimes it has a comparative advantage compared to formal finance. For example, the trading sector and nucleus estates acquire information about the traders and farmers with whom they do business. This information is useful in screening potential clients for in-kind loans and these interlinked transactions give them good opportunities to recover loans. However, contract enforcement is more difficult for some commodities, such as cotton, where farmer-borrowers can engage in side selling to traders other than the ones from whom they borrow. Once trading patterns become more settled, these problems may be self-correcting. Traders may begin to realize that if they want their contracts respected, they must respect the contracts of their competitors, and farmers may learn they will be denied access to future loans if they fail to repay current obligations.

Moneylenders often thrive even where formal financial services exist because they offer quick, low transaction-cost loans for any purpose. By necessity, formal financial suppliers follow procedures that require more time, and they prefer to lend for productive activities that are expected to increase borrower income.

As noted in Chapter 3, interlinked contracts can be exploitative, and so can moneylenders. This situation sometimes leads decision-makers to propose controls to avoid these abuses. Usually these controls are ineffective so the expansion of formal finance tends to be the most effective way to reduce this problem because it provides alternatives to the informal sources. Moreover, the expansion of formal finance

may reduce the costs of informal finance and permit the users to avoid the reciprocal obligations that accompany borrowing from friends and relatives. The mission believes that expansion of the formal financial system is the most effective way to control abuses that may occur with informal finance rather than trying to mitigate abuses through rules and regulations that are effectively unenforceable.

#### 4.3.7 Crosscutting Issues

There are five crosscutting issues that affect most or all segments of the rural financial system, which will have a crucial influence on its future performance. They include:

- ⌘ Access to information. This topic was introduced in Chapter 3 and discussed in detail in Annex 4. Suffice to emphasize here that all agents in the agricultural sector - farmers, traders, and processors – need information about profitable production and marketing opportunities to serve domestic and foreign markets. Entrepreneurs often do not have sufficient resources to bear the cost of acquiring good information. Moreover, they may not be able to recover the costs through returns on investments because innovators tend to quickly lose their competitive advantage when others learn from their example. Financial institutions need this same type of information in order to evaluate applications for loans. They also help to disseminate information to their clients. Eventually a credit bureau may be useful to facilitate the sharing of information. Some types of information generation activities, such as agricultural extension, have strong public goods features that justify the use of public funds.
- ⌘ Human capital in rural areas. The limited managerial capability of subsistence farmers is well known. This affects their ability to efficiently operate their enterprises and the member-owned organizations in which they participate. This is a particularly serious problem for women who make up a large share of the rural workforce and do much of the farming. Public investments in improving human capital will contribute to improved agricultural productivity, to creating clients for financial institutions who are better prepared to use their products and services, and to rural people better prepared to manage their member-owned organizations.
- ⌘ Trained banking employees. Financial institutions need personnel trained in agriculture, finance, accounting, management information systems and other fields. These skills are scarce and salary levels are high in Uganda compared to the size of small loans that are best suited to poor people.

This situation contributes to high interest rates on loans. Moreover, it is expensive for financial institutions to handle the small savings and deposit accounts of poor people. It would be useful to analyze the future demand for bank personnel by skill level and evaluate if the projected evolution in supply will be adequate, or if special programs should be created to train the needed personnel. The financial sector also needs an information system to search for and disseminate information about training materials and opportunities, such as those identified in Annex 4.

⌘ Establishing branches of financial institutions. Increasing rural outreach will depend importantly on the ability of financial institutions to profitably expand their branch networks. Careful analysis is needed to identify barriers that impede branching and make it expensive. For example, these might include banking regulations that are more appropriate to urban than to rural operations. The poor quality of rural infrastructure and the insecurity and civil strife that occur outside the major cities represent additional problems. Recent major improvements in the cellular phone system may pave the way for cost-reducing innovations in transferring information and data between branches and head offices, thus permitting improved managerial oversight. One important benefit that this would convey is the possibility of lowering the costs of operating rural branches, since good communication permits these offices to be staffed by more junior staff.

⌘ Donor support and coordination. Donor coordination in supporting microfinance has been outstanding in the Microfinance Forum, in the creation of AMFIU, and in the development and adoption of the Performance Monitoring Tool (PMT). A similar approach is needed for rural finance, but a more ambitious effort encompassing a broader range of stakeholders is needed compared to those involved in the current coordination mechanisms. One achievement of microfinance coordination is that a remarkable consensus has emerged to support a market-oriented approach to developing the financial system. However, there is an incomplete flow of information about individual projects so that all stakeholders can learn from successes and failures. The mission found reluctance by some organizations to share information and this attitude slows the speed of learning within the sector. There are obvious incentives for donors to implement individual projects and pursue objectives that don't necessarily add up to a coherent strategy. This is evident in the long history of support to an individual institution, such as the Centenary Bank, and in the multiple projects that have supported

financial development in rural areas. Further efforts are needed to develop a coherent framework so that individual activities make a greater contribution to an overall strategy. Greater consensus is needed about what works and what doesn't work, what should be done and what shouldn't be done.

#### **4.4 Summary of Main Points About the Supply of Financial Services**

This section presents a summary of the main points discussed in this chapter and the recommendations that logically flow from them and from Chapters 2 and 3. It concludes with a discussion about the need for developing a long-term strategy for creating a dynamic and sustainable rural financial system.

##### **4.4.1 Main Ideas Discussed and Actions Required**

- ✘ Implement macroeconomic and other reforms to stabilize and reduce the interest rates on Treasury bills.
- ✘ Begin to build a data base of information on financial service providers, the nature of services they provide and the costs they incur in supplying the services.
- ✘ Conduct analysis to develop a better understanding about the number and distribution of smaller NGOs and SACCOs that currently supply financial services, their strengths and weaknesses, and their potential for expanding sustainable services into rural areas.
- ✘ Conduct analysis to determine the mix of formal and informal financial services used by rural farm and non-farm households and firms.
- ✘ Evaluate the adequacy of financial services to the trading sector, especially with a view to identification of strategic interventions to increase price certainty.
- ✘ Conduct an in-depth study of the possibilities of offering new financial services in rural areas, especially insurance as noted in Chapter 3.
- ✘ Adopt policies that will stimulate the expansion of different types of formal financial service suppliers and encourage competition between formal and informal finance.
- ✘ Develop a policy for the government and donors to support the suppliers of financial services in ways other than providing funds for on-lending.
- ✘ Evaluate the adequacy of the sources of information available to entrepreneurs and the financial system regarding economic opportunities, and

identify possible areas for publicly funding information generation and dissemination.

- ✘ Support policies and programs to raise the level of human capital in rural areas and especially of people engaged in farming.
- ✘ Project the future demand for trained manpower by financial institutions, and determine how to improve the supply if that is needed.
- ✘ Develop a long-term strategic plan for expanding the formal financial system that involves all major stakeholders so there is a greater probability that individual future projects and programs will contribute to it.

##### **4.4.2 A Process for Developing a Long-Term Strategic Plan for Developing an Agricultural and Rural Financial System**

A long-term perspective is required when thinking about an agricultural and rural finance system, and a development strategy for the entire rural financial system is needed to guide specific activities. This strategy will need to involve many public and private organizations. It will require a better understanding than is available today of the services currently provided by each segment of the market and the users of these services. Much more empirically based information is needed so good decisions can be made.

A framework involving analysis and discussion among stakeholders is needed to guide the process of developing this strategy. It will have to include an administrative mechanism to provide leadership, to identify key issues to be analyzed, to set a timetable for activities, to develop a budget to finance preparatory work, and to develop procedures for consultations, discussions, and the exchange of ideas. One alternative would be to identify a future date for a two-three day conference at which presentations would be made on predetermined topics. Another alternative would be to organize a series of half-day seminars spread over a year, each one to cover a specific topic. For the latter, a relatively small group of representatives from the relevant constituencies could be organized as a working group to provide leadership over the life of the process. It would generate information; critique research, documents and presentations prepared for it; and prepare a draft strategy. The whole process would need to be given a mandate from the highest level (perhaps the office of the President or the BoU). This would allow it to command respect and be successful in obtaining access to information and data. The objective would be to produce a plan with specific proposals for actions, policies, legislation, and investments for pushing out the frontier of the formal financial system.

A list of the potential topics to be addressed should include:

- ⌘ Macroeconomic and financial policies and their effect on the level and volatility of interest rates.
- ⌘ A review of the legal issues concerning land, land titling, and land transfers and possibilities for reforms to facilitate the granting of long-term investment loans using land as collateral.
- ⌘ The comparative advantage of Ugandan agriculture and projected rates of return for rural on-farm and off-farm investments.
- ⌘ The future demand for loans, savings, insurance and other financial services in rural areas.
- ⌘ The current outreach (geographic distribution, types of clients) of the supply of financial services by the formal financial system (including the microfinance system).
- ⌘ The operating and financial costs for different types of financial institutions supplying financial services.
- ⌘ Experiences with alternative designs and models for delivering products and services for agricultural and rural clients.
- ⌘ The financial status and performance of NGO-MFIs and SACCOs.
- ⌘ The status of the existing support system for member-owned organizations and alternatives ways to organize apex bodies to support such organizations.
- ⌘ Opportunities for and pitfalls in the use of warehouse receipts, loan guarantees, matching grants, subsidies and other methods to augment the supply of rural financial services.
- ⌘ Changes in the financial infrastructure needed to enhance financial transactions, such as a credit reference bureau, a collateral registration system, and changes in legislation affecting borrower and creditor rights.

# Chapter 5

## Conclusions and Recommendations

### 5.1 Introduction to Conclusions and Recommendations

This report has been commissioned by the Bank of Uganda. Accordingly the conclusions and recommendations it contains are directed primarily to the central bank. Many of the actions discussed, particularly with respect to issues directly connected with member-owned organizations, fall outside of the responsibilities of the BoU. Nevertheless, the mission considers that the BoU is in a good position to ensure appropriate consideration of the issues identified, and is similarly well-placed to prompt or to suggest action, as required.

Most of the Recommendations which follow are directed, at least in part, to policy makers. And most will involve more than one ministry or institution. The issues surrounding financial services for agriculture necessitate a multi-agency approach to policy making in this area. For this reason, the major recommendation of the Mission concerns development of a Long Term Strategic Plan for Agricultural Finance.

More detail is given below on this Plan, and the Workshop which it is suggested should be held in the near future, as a means of ensuring participation in the Plan of key ministries, public and private sector entities, and donors. All of these can and should contribute to policy-making for improving financial services to the agricultural sector.

For convenience, the material which follows has been arranged in clusters which reflect the priority sequencing and responsibilities as seen by the Mission.

### 5.2 Cluster One: Long-Term Strategic Plan for Financial Services to the Agricultural Sector, and Related Issues

#### 5.2.1 Long-Term Rural and Agricultural Finance Strategy/High Level Policy Workshop

A clear long-term strategy for expanding the formal financial system into rural areas would convey many benefits. It would need to be broadly based, with all key stakeholders involved in the overall objective of

contributing ideas and resources. Such a strategy should provide a favourable environment for improved financial services to the agricultural sector and the rural economy. It would facilitate mutual support between individual projects and programs, and also assist in ensuring that the necessary public good inputs, such as policy direction, education, training and information dissemination, are optimally designed and implemented.

The strategy would need to be dynamic, adjusting to changing needs and circumstances. It would, therefore, require an operational base, with a work plan, and the resources to implement the work plan. The Mission envisions it in terms of an ongoing Plan, and suggests that the responsibility for steering this initiative would be determined through a dialogue of all concerned parties. This dialogue would also be responsible for allocating responsibility for implementation. An ongoing working group would give continuity to this dialogue. Such a working group would be drawn from farming and marketing firms and organizations, government ministries and donors. This working group would effectively be an expanded (i.e. more broadly-based) version of the existing Rural Finance Group under the PMA.

Careful attention would need to be given to the initiation of the Plan, in order to avoid problems, which arise so easily with multi-sector and multi-agency exercises of this sort. The Mission believes that the appropriate mechanism to start the initiative would be a High-Level Policy Workshop. This would be specifically designed to introduce the concept of the Plan, to highlight the required components, to encourage maximum participation by stakeholders, and to identify future responsibilities. The outputs of this workshop would lay a good foundation for ongoing policy-making and support efforts, for all businesses interfacing with the agricultural sector; this would include SACCOs and other member-owned organizations, as well as other financial and marketing/supply entities operating in the market.

The mission further believes that future operations of the Plan could be conducted through a project, or better, a program encompassing multiple projects. Such a program could, inter alia, consider implementing many of the recommendations set out in the present report.

Thus, concerned ministries, financial institutions, marketing bodies and commodity organizations should combine efforts to initiate and develop an ongoing Long-Term Strategic Plan for the Provision of Financial Services to the Agricultural Sector. To ensure optimum effectiveness, three requirements would need to be met. First, it would require management by a prominent organ in the public sector in order to facilitate information gathering and analysis. Second, it would need to enjoy a high degree of independence, so that the outputs of its work would command respect, and carry weight for a large number of stakeholders. Third, it would need to be triggered by a carefully prepared High-Level Policy Workshop.

Inputs for the Policy Workshop would include:

- ✎ A specially commissioned report which would assess past government and donor efforts (technical assistance, matching grants, funds for on-lending, etc.) and projects, together with operations of current lenders focusing on their strengths and weaknesses in strengthening financial services provision in rural areas; and
- ✎ An Issues Paper that would provide the basis for focused discussion and decision-making during the Workshop.

The outputs of the Workshop would be guided by the Issues Paper and should include:

- ✎ An agreed work plan for establishing and operating the Long-Term Rural and Agricultural Finance Strategic Plan. This would focus on policy formulation and project design to guide future efforts to strengthen the provision of financial services in rural areas, for farmers and for other entrepreneurs; and focus government and donor attention on activities that contribute systematically to the overall strategy.
- ✎ An agreed mechanism for monitoring the effectiveness of financial sector business linkages with the agricultural sector (including input and output marketing entities), and the manner by which the results can be fed back to policy-makers on an ongoing basis.

### 5.2.2 Institutional Changes MFIs - MDIs: Need for Support and Action

As with other sectors of the economy, servicing the agricultural sector sustainably is a matter of controlling financial risks and costs, in order to offer loan

finance on terms that facilitate investment. Much hope rests in the idea that MDIs will be licensed and will be able to efficiently mobilize savings deposits, and that this will increase the supply of funds for small-scale lending (including rural lending) and also lower the cost of such funds. As stated in Chapter 4, in the future, interest rates for MDI loans may be determined as much by their efficiency in savings mobilization as by their efficiency in lending. Therefore:

Non-deposit-taking NGOs, in general, have little

Much support, including from donors, will need to be continued for these MDIs to take full advantage of their new status.

experience in serving agriculture and rural areas. If they are to make significant inroads into the sector, then other NGO-MFIs will need support in areas such as financial product design, and assistance with information management and communication systems in order to provide the basis for effective and efficient operations.

### 5.2.3 Informal Finance - MFI Interface

The mission believes that expansion of the formal financial system is the most effective way to control abuses that may occur with informal finance, rather than trying to control the latter through unenforceable rules and regulations. This applies both to informal transactions among relatives and friends, as well as to moneylenders, traders, and the more formal interlinked transactions of the type used in contract farming arrangements. In the case of interlinked transactions, financial institution development is needed in order to provide the necessary competition and the ability to compare costs of loans and other services being provided by sugar mills, cotton gins and other crop buyers.

Financial service provision in the context of other business arrangements with the agricultural sector works best when it operates in a competitive context. The existence of contract farming and/or other interlinked transactions involving loans should be an encouragement to the establishment of specialized institutional arrangements. It should not be a deterrent to such efforts.

### 5.2.4 Member-owned Organizations

Nearly every aspect of the situation of member-owned organizations is muddled. This includes the way in which they are promoted in rural areas, in their status and operational procedures in rural communities, the manner in which they interact with other financial intermediaries, and even their interface with the apex bodies which are meant to support them. A number of problem areas contribute to this situation.

Firstly, although member-owned organizations have the greatest ability among financial intermediaries to offer lower rates for loans, they are highly vulnerable to manipulation by individuals and/or small-group interests. Until the general level of education is raised in rural areas, the scope for SACCOs and other member-owned organizations to realize the potential of this institutional model will be limited. It is understood that a few SACCOs have managed to improve their governance/management situation and survive as intermediaries working for the benefit of their broader memberships.

Donor support may help those SACCOs committed to reform by graduating them into a stronger financial model, perhaps by assisting them to develop suitable governance structures, coupled to specific training efforts.

Secondly, SACCOs have received much attention in some political and development circles because of the large numbers of people they are believed to represent. This has led to many projects and programs designed to assist them. But even with the best of intentions these efforts are doomed to failure because of the scarcity of solid data on the SACCO movement and its performance. Without such data (more detail as to requirements is given in Chapter 4), it is not possible to formulate the policy changes that are needed, let alone deliver the policy-based outcomes which are desired, nor is it feasible to design and implement effective support projects and other initiatives.

***A performance monitoring system is needed for the SACCO sector. This would focus firstly on the collection of data on the structure and performance of these organizations, identifying, among other things, the more promising types of governance structure.***

Four further points relating to SACCOs and other member-owned organizations are already clear.

Firstly, the mission strongly supports the current thinking of the Outreach Plan to not provide funds for on-lending to SACCOs, and believes that this should be the policy for all other government and donor programs.

Secondly, the mission strongly believes it is essential that a commitment be made at the highest levels to develop a clear message regarding the separation of financial activities from other functions that farmer groups are encouraged to undertake.

Thirdly, the mission believes that the separation of financial activities from other areas of business should be reflected in the policies and support actions of all apex bodies

***Finally, the respective roles and responsibilities of the various apex bodies needs to be clarified, so that their scope of operations is clear for their memberships and for donors from whom they receive support.***

### 5.2.5 The Key Role of Marketing in Financing Agricultural Production

Adequate financing of the marketing chain will facilitate individual operators to handle larger volumes, and permit investments leading to a reduction in post-harvest losses. Both of these help build efficiency and lower marketing margins.

Access to suitable financial products can also have a positive feedback effect on farm gate prices, through forward selling, "put" options, contract growing and other marketing mechanisms which provide some price security to those in the commodity chain who assume ownership of farm produce – all the way back to the farmer/producer. (See Chapter 3 for more details.)

Apart from efforts to increase the use of the marketing methods mentioned above, the area of farm product price buffering is one where the mission feels valuable developmental work could be done on possible strategic interventions by the public sector, interventions which would reinforce and build on forward selling and the other means to stabilize price levels (see Section 5.4.1 below).

### 5.2.6 Term Finance

Increasing labor productivity in farming – the key to improving rural incomes – depends on increased capital investments and eventually on the availability of term finance. Uganda has a long way to go in this field. Many constraints exist, including the issue of land tenure, but it is already clear that further investigative and developmental work is warranted to explore ways of improving term finance availability, even within the current environment (see Chapter 3). On the supply side, commercial banks will be the main providers, and the requirement for donor involvement has been highlighted above in Chapters 3 and 4. MFIs and even MDIs are likely to have very limited ability to enter this market, especially to serve commercial farmers, who in the main constitute the main source of effective demand for this type of finance. Nevertheless, demand for term investment finance is bound to grow from smaller farmers, who will generally need to demonstrate successful experience with seasonal loans in order to access term loans.

The mission believes that better information about investment opportunities in the agricultural sector is needed, in the first instance, if banks are to make significant inroads into this area of lending. The Agricultural Enterprise Watchlist, suggested in Annex 4, would be a useful support measure (see also 5.3.4 below). The special challenges involved in developing term finance, especially the limited supply of long-term savings, need to be addressed. The results of the European Investment Bank Apex Private Sector Loan Scheme should be evaluated to determine if and how it affected agricultural lending. There may be an opportunity for increased donor support for term lending, if such support can address underlying problems rather than simply supplying long-term funds to substitute for the missing domestic savings.

sale of surplus products (i.e. villagers). This is an important issue for programs intended to benefit the poorest among the rural population (see Chapter 3 where villagers are distinguished from farmers).

Lenders should identify the twin triggers of eligibility for seasonal borrowing by small farmers: first the intention to produce for the market; second the managerial ability to cope with the increased managerial task that the use of production finance and purchased inputs involves.

### 5.2.8 Donor Support and Coordination.

Systems of coordination are required not only between ministries and local financial institutions. They are also required within the donor community, where the current score card may well read, "Good, but could do better" (see Chapter 4). Further efforts are needed to develop a coherent approach to financial sector development so that individual activities and projects make a greater contribution to an overall strategy. Greater consensus is needed as to what works and what does not work, what should be done and what should not be done. Thought should also be given to establishing a suitable, ongoing forum for the exchange of information, with the focus on ministries rather than donors, but with donor participation.

The mission has suggested several initiatives where consultation is the key to effective planning and implementation. The High Level Policy Workshop provides the first of such exercises, one that should lead to better coordination between key ministries, other concerned public and private sector entities, and donors. It is crucial for donors to be fully engaged in the Workshop so they contribute to the design of a long-term strategy and incorporate the outcome into their bilateral and multilateral programs of assistance to Uganda.

### 5.2.7 Seasonal Production Finance

The use of improved farming technology and/or producing on a larger scale requires a concomitant increase in the managerial abilities of farmers. Lenders need to distinguish between farmers who have proved that they have this ability, and those who have not. A second requirement is that lenders extend production finance only to those cultivators who deliberately strive to earn cash income from farming activity (i.e. farmers) rather than those whose focus is subsistence production with the occasional

## 5.3 Cluster Two: Issues for Attention by Legislators, Government Ministries and the BoU

### 5.3.1 Macro-economic Management: Treasury Bills

The Treasury bill rates establish a floor for the interest rates charged by banks. In the interests of increased investment, every avenue should be explored to lower the high cost of borrowed funds for

the benefit of all borrowers, including those in agriculture and rural areas. Accordingly...

***it is vital to implement macroeconomic and other reforms that will stabilize and reduce the Treasury bill interest rates.***

### 5.3.2 Legislative Issues: Land and Contract Enforcement

An important impediment to the greater involvement of lenders, especially longer term lenders in agriculture, is the current landholding and tenure system, which in most areas of the country does not facilitate the use of land as collateral, despite the legislative attempt to clarify the situation by providing Certificates of Occupancy for customary tenants (see Annex 3). The mission recognizes that tackling this issue is a potential minefield for any government, but wishes to make two observations. First, there is little doubt that this situation, common in Africa, is a major constraint to rural development, and will therefore have to be addressed at some stage in the future. Issues of short-term conflict reduction as well as long-term rural development are involved. Second, given the momentum behind Uganda's economic reform efforts and the public support these reforms have garnered, this might be a good time to accelerate efforts to fundamentally address the land issue in its several dimensions.

**The mission is bound to join those who see the land tenure issue as being an area for urgent and bold attention, at the highest levels. A practical start could be a renewed push to clean up the existing land records, and the system by which these are created and stored. This could then lead to more fundamental changes, permitting greater security/certainty of ownership, thus facilitating investment and unlocking the real wealth that exists in the land in the country.**

The current situation for settling smaller legal issues in the commercial sector is unsatisfactory, and is a deterrent, especially for transactions of commercial banks. The reforms under way in the Justice Law and Order Sector will be crucial for streamlining the procedures used to enforce loan contracts, resolve disputes and reduce intermediation costs.

***More resources may have to be identified and committed to introduce reforms in and streamline the procedures of district courts.***

As a special field of contract law, financing in the marketing chain will be facilitated by greater clarity in the legal status of warehouse receipts. In this regard.....

specific warehouse receipt legislation, currently under consideration, is a step in the right direction, and clearly deserves attention by legislators.

### 5.3.3 Insurance as a Financial Service for the Agricultural Sector

Insurance products for the agricultural sector over the 20-year horizon will be confined to cover for equipment, buildings and harvested crops, together with life cover. Crop insurance is not seen as becoming important within this time period. However, there will be a growing demand (through loan conditions) for mortality cover on valuable, credit-financed livestock. MFIs and other lenders may similarly require cover on the life of a borrower for term loans (see Chapter 3 and Annex 5). Thus there is some potential for designing useful insurance products, especially to support term finance, by assisting both lenders and borrowers in managing risk.

Product design assistance for insurers may be required here, while MFIs may need assistance in developing the necessary business arrangements with insurers and linkages between insurance products and loans.

### 5.3.4 Information Management

The information interface between the financial services sector, on the one hand, and the agricultural and fisheries sectors, on the other, is weak in Uganda. Attention by all parties to improved information management should assist in ensuring optimal mutual support, to the benefit of financiers, farmers and fishermen, and traders operating in these sectors (see Chapters 3 and 4, and Annex 4).

Policy makers need information on the performance (in a broad sense) of those providing financial services, in order to make and monitor supportive policies. An institutional mechanism should be established in order to effect this.

A two-way flow of information is needed. Financial institutions need information on enterprise opportunities in Uganda such as could be provided by the Agricultural Enterprise Watchlist suggested in Annex 4. Such a Watchlist could be a means of outreach for NAADS, while at the same time constituting a useful interface point between the government

extension services and the banking sector. It would include information on typical rates of return for investments in the agricultural production sector, and downstream in the processing/marketing chain.

NAADS should start an Agricultural Enterprise Watchlist, possibly as a collaborative exercise with the DFD Department of the BoU and/or the Uganda Institute of Bankers.

Agricultural production must be demand driven in order to realize optimum factor returns, and therefore produce attractive profits from credit-financed investments in the sector. Uganda's excellent market information system, Foodnet, needs to be more widely used by the production sector, and to be more widely known by the financial sector. It is a basic decision-making tool for producers and those in the marketing chain.

It is vital that the market information service (Foodnet) continues to be sufficiently well-funded, as a valuable public good.

### 5.3.5 Education and Training

Education has already been noted as an essential requirement for improving the key governance issue for member-owned institutions in Uganda. Other areas are within financial intermediaries, as well as among borrowers themselves (see Chapter 4). But it is not only general education and skills training that are important. Systems of knowledge management (incorporating presentation and dissemination of key material) are also required. International attention in rural finance circles is now beginning to focus on this potentially fruitful field, and Uganda could be well placed to benefit. (See Annex 4; approaches for information and assistance could also be made to the FAO-coordinated, multi-donor initiative, Rural Finance Learning Centre – ref. [jennifer.heney@fao.org](mailto:jennifer.heney@fao.org) or [doyle.baker@fao.org](mailto:doyle.baker@fao.org))

Information on the support for improved training currently and potentially available deserves to be more widely known so that managers in financial institutions can draw on the resources as an important part of building capacity among their staff and their clientele.

## 5.4 ClusterThree: Unfinished Business

### 5.4.1 Further Actions and Developments

The present mission has been unable to complete work in areas where it is clear that further efforts are needed. Among the more pressing are the following:

- ✎ Carry out a more detailed investigation of possible strategic interventions by government to reduce the magnitude of farm-gate price-level uncertainty for key crops, e.g. maize (see Chapter 3).
- ✎ Prepare an Issues Paper as preparation for a High Level Policy Workshop (see Chapter 4).
- ✎ Collect and analyze information on the structure and performance of member-owned organizations in rural areas, with a view to facilitating stakeholder deliberations leading to development of a long-term strategy for this sector (see Chapter 4).
- ✎ Conduct a detailed analysis of the factors that impede and facilitate the expansion of branches of financial institutions into rural areas. This should include an analysis of banking regulations, the impact of poor rural infrastructure and insecurity outside of major urban centers, and the efficacy of incentives, such as matching grants, in encouraging more branching. It should also include information on business opportunities for financial intermediaries in the rural non-farm economy.
- ✎ Preparation of a support project to improve land titling and security of tenure (see Chapter 2 and Recommendation 5.3.2 above). Long-term issues surrounding land titling, registration, transfer, and its use as loan collateral require careful study.

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# Annex 1

## Agricultural Finance in Uganda - The Way Forward

### Terms of Reference

#### Background

The overriding goal of both the Ugandan/German and the Ugandan/Swedish co-operation is to contribute to the Ugandan Poverty Eradication Action Plan by enhancing economic growth. It aims to increase the efficiency of the financial sector and the utilisation of financial services by micro, small and medium enterprises and low-income households. Both co operations systematically support the Bank of Uganda and other partners in important fields of the deepening of the financial system such as banking supervision, development of the payment system, promotion of innovative financial products, capital market development etc.

The development and deepening of the financial system is one of the key areas of co-operation between the Governments of Uganda (GoU), Germany and Sweden. Therefore, the German/Swedish support is not only limited to the current fields of intervention but constantly strives to identify areas for possible further co-operation.

One of the fields which are vital for financial sector deepening in Uganda is Agricultural Finance. In April 2002, the German/Swedish Financial System Development Programme (FSD) organised the dialogue seminar on "Agricultural Finance in Uganda – a Debate on the Way Forward" which provided a forum for discussion on the pertinent issues in agricultural finance. The participants of the widely-attended seminar came up with the following conclusions:

- ✍ The market alone will not ensure the emergence of Agricultural Finance
- ✍ Government has a role to play in providing incentives for the development of an agricultural finance market
- ✍ There are market opportunities proving that a positive combination of increased outreach and financial sustainability of financial services providers interested in agricultural finance is feasible
- ✍ Setting the right policies is an essential pre-condition for the development of an agricultural finance market
- ✍ Building up an agricultural finance system can be a fragile and long-term process

✍ The Central Bank in charge of regulating and supervising financial institutions, the overall stability of the financial system and the protection of the interests of depositors, has a direct interest in the deepening of the financial sector which includes the expansion of financial services to the rural population.

✍ External incentives, including well-designed specific subsidies, can help to correct market failures without distorting the private sector-led market development process

✍ An agricultural finance Apex body, a "bank for agricultural banks and agricultural finance institutions" as well as a capacity builder and policy advocate, appears to be an interesting option for supporting the complex, gradual and time-consuming process of building up self-sustainable agricultural finance providers that are fully integrated in the national financial sector

The discussions held at the seminar stressed the need for an overall agricultural finance policy to contribute towards an enabling environment for self-sustainable agricultural finance in Uganda. During the following discussions, MFPED (Ministry of Finance, Planning and Economic Development) and BoU (Bank of Uganda) welcomed the suggestion by FSD to kick-start a policy initiative on agricultural finance via a study to identify the major pertinent bottlenecks.

It is to that effect, that GTZ, KfW and Sida are jointly supporting the BoU in conducting the present study.

#### 1 The Policy Framework

In Uganda, a comprehensive political framework which provides the basic principles for designing a more specific framework for agricultural finance is already in place. The Poverty Eradication Action Plan (PEAP) outlines the government's strategy to transform the country into a modern economy where agents in all sectors can participate in economic growth. The pre-requisites for this include the modernisation of agriculture and the development of industries, which build on demand and supply link-

ages from agriculture. One of the fields of intervention mentioned as strategic area for promotion of economic growth and transformation is “financial sector reform”.

In May 2001 GoU launched the Plan for Modernisation of Agriculture (PMA) as a strategic framework to eradicate poverty by improving the natural resource-based livelihoods of the rural poor in a sustainable manner. It lays out a set of principles and prescribes the role of GoU in assisting the development of the rural sector. It also describes the new institutional framework by which sustainable rural livelihood will be promoted. The PMA includes the development of a viable and sustainable rural financial system as an important element for the development of the agricultural sector.

As a response to the need of the low-income population especially in rural areas the Cabinet recently passed the Outreach Plan, which was developed under the auspices of the PMA and the Microfinance Forum (MFF). The Outreach Plan seeks to further strengthen the outreach of microfinance institutions to rural areas. However, empirical evidence shows that many of the obstacles to the delivery of sustainable financial services lie in the real sector (e.g. deficient infrastructure, lack of support services for farmers and non-availability of efficient markets) and cannot be overcome by strengthening financial institutions alone. Further, the microfinance sector in Uganda still has limitations given that only few institutions achieve large number of clients in a sustainable manner, whereas most of the institutions remain weak. The expansion of financial services especially when supported by external donors and concessionary funds hold risks for reaching self-sustainability in a market environment. The Outreach Plan shows that it is widely recognised that microfinance can play a vital role in expanding outreach and alleviating poverty. However, microfinance alone cannot address the challenge of agricultural finance. A consistent and comprehensive policy framework as a basis for strengthening financial institutions as well as for addressing the real sector problems is needed.

In Uganda, the design and implementation of such a policy framework by all stakeholders involved remain a major challenge on the agenda of the Ugandan government. Setting appropriate policies and guiding the development of an agricultural finance market are imperative for Uganda, where 80% of the population depends on agriculture.

## 2 Objective of the Study

The study aims at the identification of the major bottlenecks in the current policy framework and the draft of a medium-term strategy for the support of

agricultural finance in Uganda. The results of the study will provide the basis for further discussions with the national and international stakeholders including the assignment of roles and responsibilities for further action to be taken.

## 3. Specific tasks of the Consultants

Specifically the consultants will carry out the following tasks:

- ✕ Review past policy initiatives on agricultural finance and their impact and sustainability.
- ✕ Review the policies and strategies on financial sector development and on rural/agricultural development outlined in the PEAP and the PMA. To effectively do this, the consultants will make the necessary consultations with all relevant organisations and stakeholders and establish the current position on all issues contained in the strategy document.
- ✕ Undertake consultations with public, private and civil society sector representatives on past agricultural finance initiatives and their relative impact on the agricultural sector. Define stakeholders, group them and identify representatives (focal groups) of the groupings for discussions. This activity should include consultations with GoU officials.
- ✕ Suggest criteria for classification of agricultural producers (e.g. export orientation, commercial farming, subsistence production) and identify the major bottlenecks for agricultural finance for each class of producers. The analysis should include constraints found in the real sector (e.g. roads, irrigation, markets, agricultural research and extension, taxation, agricultural trade policy and development of product prices).
- ✕ Review the supply side of agricultural finance (Bank of Uganda – Development Finance Department, commercial banks, development finance institutions, micro finance institutions, informal providers of loans and different government, NGO and donor programmes). The review of the supply side shall include the financial products currently offered to farmers of the different sub-groups focusing on terms and conditions. The study shall also provide an overview on typical contractual arrangements in crop deals such as interlinked transactions and briefly discuss their strengths and weaknesses.
- ✕ Availability and design of crop insurance schemes.
- ✕ Review the state of implementation and the activities of the Outreach Plan and make an assessment of its potential to expand the provision of

financial services to small farmers.

- ⌘ Identify the major bottlenecks of the current policy framework for agricultural finance.
- ⌘ Formulate proposals for a medium-term strategy for the support for agricultural finance in Uganda including potential roles of national stakeholders and international donor agencies. The proposals shall build on the existing policy framework such as the financial sector policy, the PEAP, the PMA and the Outreach Plan.
- ⌘ Discuss the proposals with all relevant stakeholders in a seminar that will take place in the last week of the mission.

#### **4. Team of Consultants**

The team of consultants comprises two international experts with a strong background in agricultural finance and a local consultant experienced in the topic. The mission will be sponsored by KfW and the FSD Programme.

#### **5. Timing**

The assignment will be carried out between . . . . . In the last week of their assignment a seminar will be held where the consultants present their proposals to the stakeholders. The recommendations of the consultants will include the discussions of the seminar.

#### **6. Output**

Based on the seminar and the findings of the mission, the consultants will draft and submit a comprehensive draft report within 14 days of completion of the onsite visit to Uganda. The final report shall be submitted to KfW and FSD by 11<sup>th</sup> of July.

# Annex 2

## Savings and Credit Cooperative Societies (SACCOs)

One of the potentially most important types of financial institutions for serving rural areas are member-owned and managed SACCOs. By volunteering their time to govern the organization and sometimes to staff day-to-day operations, the members can reduce operating costs and supply financial services to some remote and sparsely populated areas that would be too costly for branches of banks or MFIs using paid staff.

As of October 2002, 6,580 cooperatives were reportedly registered with the Registrar of Cooperatives, of which 680 were supposedly SACCOs.<sup>1</sup> Relatively little systematic information is available about them. It is generally believed that most are weak and many exist in name only. The Commissioner of Cooperatives has the responsibility for registering cooperatives but has little capacity to regulate or supervise them. The Uganda Cooperative Alliance (UCA) Ltd. is an apex institution with responsibilities to promote and defend the entire cooperative sector, but it also has little capacity to either strengthen or regulate it. The Uganda Co-operative Savings and Credit Union (UCSCU) Ltd. is the federation or league with SACCOs as members. It claims to have 300 members but for a recent training activity was able to produce names and addresses for only a small fraction of this number. Rather surprisingly, the UCA rather than UCSCU is implementing a project funded by the Swedish Co-operative Center and the Canadian Co-operative Association to create and strengthen so-called village banks, which are community-based SACCOs.<sup>2</sup>

### 1 The USAID/WOCCU Project

The World Council of Credit Unions (WOCCU) has implemented several projects in developing countries to rehabilitate credit unions. Its approach involves improving human resources, introducing dis-

cipline in the management of financial resources, and improving governance by introducing modern management tools and programs that generate information needed by managers, boards of directors and members to understand the performance of their organizations. For managers and members who are committed to reforms, the adoption of this approach has succeeded in turning many moribund credit unions into dynamic competitive financial institutions.<sup>3</sup> WOCCU had an USAID-financed SACCO rehabilitation project in Uganda that made some progress, but failed to meet performance standards so was terminated early at the end of 2003. The goal of the project was to build strong financial discipline, introduce transparent accounting systems, reform policies, and develop competitive products. The project worked initially with 19 SACCOs but five were dropped because of failure to implement the project's technical advice, high delinquency of board members, dishonesty, financial insolvency and inappropriate financial practices. The project provided technical advisors, paid the salaries for some credit union managers, conducted training, introduced management and computer systems, and supported the cost of stationery, furniture, renovations, and other operational expenses of the participating SACCOs. It also attempted to strengthen UCSCU and recently helped to overhaul its bylaws.

The data in the table below present some comparative statistics for the 14 SACCOs remaining in the project as of September 30, 2003. At that time, most of them had been participating in the project for 30 months. They were selected to participate because they were considered to be among the largest and best in the country and, therefore, were expected to benefit from this type of assistance. They were concentrated in the central part of the country. Three were classified as urban, one as peri-urban and the rest were rural. The rural ones include some farmer members. Ten are open to anyone in the community while the others are tied to a particular place or type of employment. The data provide insights into

<sup>1</sup> Stefan Staschen, Possible Mechanisms to Regulate Tier 4 MFIs in Uganda, Financial System Development Programme, GTZ, Kampala, May 2003.

<sup>2</sup> The use of the term village banks is a bit confusing here because in most countries that term is used for some type of finance programs patterned after FINCA International that is credited with coining the term. However, these village banks do not seem to be created to follow an explicit FINCA model.

<sup>3</sup> A description of the methodology and the results obtained in rehabilitation projects can be found in Glenn D. Westley and Brian Branch, (eds.), Safe Money: Building Effective Credit Unions in Latin America, InterAmerican Development Bank, Washington, DC, 2000.

the nature and severity of the problems faced by this segment of the financial markets.

The 14 SACCOs have a total membership of over 18,000 but they are heterogeneous in many characteristics. The smallest has only 259 members while the largest has over 4,500 members. Total consolidated savings were Ushs4.0 billion (over US\$2.0 million) with an average of almost Ushs220,000 per member (US\$110). The largest (I) reported over Ushs1.2 billion (about US\$600,000) in savings, about 30 percent of all savings reported. In addition, the 14 reported over Ushs547 million (US\$280,000) in consolidated share capital. The largest amount of average savings per member was reported by the fairly small SACCO labeled as M with close to Ushs1.8 million (US\$900). There are exceptions, but some of the largest amounts of average savings per member are found in SACCOs with the fewest members.

Credit unions have a strong history of mobilizing savings and as a group these 14 are net savers.

Total savings 2.4 billion (US\$1.3 million), or Ushs133,544 (US\$68) per member. The largest SACCO, I, also has the largest amount of total loans outstanding of Ushs626 million, but the largest amount outstanding per member is found in the smallest (G) with only 259 members, each owing an average of Ushs805,710 (over US\$400). On the one hand, some SACCOs are fairly cautious in lending. For example, the amount of loans outstanding in B is equal to only 17 percent of its savings, and it has 57 percent of its total assets in financial assets, much of it in T bills. On the other hand, others are more aggressive. For example, the amount of loans outstanding in D was 125 percent of savings and it has the largest external debt amounting to one third of total assets.

All of these SACCOs have bank accounts and some have deposits in other SACCOs and in UCSCU. Two have made investments in T bills. The minimum size of loan made is usually Ushs50,000 and the maximum of Ushs1 to 8 million. The annual nominal interest rates on loans range from about 18 to 48

#### Membership and Performance of 14 SACCOs, as of September 30, 2003

SACCO	Number of Members	Total Savings (000 Ushs)	Average Savings per Member(s)	Total Loan Outstanding (000 Ushs)	Average Loan Outstanding per member	Portfolio at Risk (% Over 30 days)	Operating Expense Ratio (%)
A	1,450	48,342	33,339	55,927	38,570	58.2	11.0
B	1,033	403,821	390,920	68,214	180,853	26.9	12.2
C	691	18,273	26,444	18,539	26,829	58.0	23.8
D	580	49,819	85,895	62,535	107,819	62.8	23.6
E	789	56,949	72,179	26,230	33,245	14.8	44.9
F	1,380	183,839	133,217	167,712	121,530	30.6	92.8
G	259	190,248	734,548	208,679	805,710	25.4	27.1
H	755	64,514	85,449	52,658	69,746	62.0	45.2
I	4,549	1,207,853	265,521	626,600	137,745	60.1	23.0
J	1,408	126,404	89,776	113,129	80,347	57.3	13.8
K	3,212	106,921	33,288	94,914	29,550	51.5	41.9
L	787	670,362	851,794	609,373	787,005	5.6	1.1
M	491	873,927	1,779,892	326,545	665,061	76.1	4.2
N	973	22,069	22,681	10,424	10,713	63.3	20.2
Consolidated	18,357	4,023,341	219,172	2,451,479	133,544	41.7	9.8

Notes: \*For reasons of confidentiality, the names of the SACCOs are suppressed.  
Source: WOCCU

percent. They tend to link loan sizes to existing share capital rather than to an analysis of the member's debt repayment capacity. The nominal annual interest rate paid on savings ranges from 2 to 8 percent.

Lack of financial discipline and inability to cover costs are two of the biggest problems faced by these SACCOs. For example, only one (L) had single digit levels of portfolio at risk that are similar to the strongest NGO – MFIs. Nine had 50 percent or more of their portfolio in arrears 30 days or more and the overall average was over 40 percent. This high rate of arrears can be attributed to poor lending practices and collection policies. If a significant amount of these loans are never repaid, member savings will be lost.

Operating cost ratios are highly variable among these SACCOs. They range from a low of 1.1 percent to a high of 92.8 percent, but this latter figure is distorted because of accounting adjustments. Eleven of the 14 fall in the 10-45 percent range, which is lower than the best MFIs. The salaries of the staff members paid by WOCCU are included in these cost estimates, which elevates the numbers. Even so, these costs seem high. Credit union operating costs frequently are relatively low because the members, who are often poor, resist paying what they perceive to be high salaries to managers and other employees. This contributes to low operating costs, but often the managers and employees do not have strong financial and management skills.

The project discovered several long-term management problems in these SACCOs. Often there was a lack of commitment on the part of boards and/or managers to make necessary changes. The data presented in the form of averages above mask some of the problems that emerge with closer examination. Many loans have been delinquent for a long time, and there is a resistance to adopt adequate loan loss provisioning because of the damage that would do to reported earnings. As a result, the actual provisioning is only about 40 percent of recommended levels. The reported profits, therefore, tend to be exaggerated. The proportion of non-earning assets is high because of these nonperforming loans and large investments in fixed assets. This saps their liquidity so they frequently don't have the funds needed to make new loans. This problem, in turn, has a negative impact on willingness to repay because the borrowers fear they will not be able to access new loans if they pay existing ones. The lack of profits means the SACCOs cannot pay dividends on share capital, stunts the growth in new members, and prevents the accumulation of reserves needed for future investments, modernization and growth.

## **2. Termination of the Project**

The decision to end the project was made because of its failure to achieve performance targets agreed to with USAID. The SACCOs were slow to improve and there was a reluctance to adopt modern bylaws and management techniques, design new products, follow prudent policies, elect responsible board members and hold them accountable, and hire competent staff. If this is the situation for some of the best SACCOs in the country, one can only guess at the sorry state of most others.

The problems encountered with these SACCOs, coupled with the millions of dollars in donor and government funds lost in the failed effort to develop the Cooperative Bank, suggest that the cooperative or member-owned and managed segment of the financial markets has experienced grave difficulties, albeit for different reasons. This segment seems to have great difficulty in modernizing and following sound policies and practices required for sustainable and dynamic financial intermediaries. Therefore, it seems clear that it would be a mistake to channel more funds into SACCOs until fundamental changes are made starting at the highest levels. An appropriate legislative, regulatory, and supervisory framework is essential before money can be prudently spent on strengthening the sector at the grassroots level. There appear to be too many incentives and opportunities for members and leaders to engage in opportunistic behavior, and not enough effective controls to stop it, a situation that frequently leads to undesirable outcomes and wasted resources. The sector lacks a strong commitment to implement reforms needed to improve governance. Therefore, its ability to be an effective leader in the search for ways to push out the frontier of formal finance is seriously constrained.

# Annex 3

## A Note on the Use of Land as Collateral for Agricultural Lending in Uganda

Land is the most commonly used asset as collateral for agricultural lending in most countries. However, for land to effectively act as collateral for agricultural loans, a system of public recordkeeping is required that identifies and outlines the dimensions and/or boundaries of individual properties, registers claimants' interests in land (such as who holds a mortgage on it, which mortgages have been paid off, who owns the mineral rights, etc), establishes the value of land, and contains clear legal procedures that specify creditor and debtor rights, procedures for foreclosure, seizure and liquidation of property pledged as collateral for a loan, etc., has to exist. For Uganda the question is whether such a system exists, which would allow and facilitate using land as collateral for loans advanced to the agricultural sector.

The Ugandan Constitution vests land in the people. The Land Act of 1998 (LA98) operationalises this constitutional provision and stipulates the Act's implementation modalities in the context of a decentralized public administration and politics consistent with the Local Government Act 1997. Government position papers link the LA98 with increased productivity and development. Thus, in the government's view:

A good land tenure system should support agricultural development and overall economic development through the functioning of a land market, which permits those who have rights in land to voluntarily sell their land and for producers and investors to gain access to land (Position Paper of Department of Lands, Housing and Physical Planning, 1997).

A key objective of the LA98 is individualization of land through certificates of occupation, certificates of customary ownership, and registerable interests that can be bought and sold. Underlying this view is the idea that identifiable land rights provide for security of tenure. In turn, identifiable land rights lead to the development of efficient land markets that enhance landowners' access to finance and credit markets and to investments in land and land improvements. In a sense, the LA98 should nurture a progressive outlook that allows one to individually own land and to be able

to use it as collateral for loans for a variety of purposes including making improvements to the land. But what exactly does the Act offer to individuals with a claim to land that can permit it to be used as acceptable collateral for agricultural loans?

In Uganda, the first expression of de jure land law was the 1900 Agreement. It imported to the country the customary law of England in the form of freehold, for a select group, and customary tenure on what was now 'Crown Land', for the majority. Subsequent land legislation of 1928, 1962, 1969, and 1975 altered the legal expression of land arrangements and relations between the owners (state and title holders), on the one hand, and occupants (*bibanja* holders, leaseholders and customary tenants), on the other. Moreover, the whole realm of extra-legal social, cultural and political-economic relations in which these laws operated shaped their effects and meanings and, thus, the de-facto modes available to individuals to access and secure land. (Ribot, 1999: 26).

The Ugandan legal system recognizes four types of land tenure: customary, mailo, leasehold and freehold (see table below). In addition, the sub-tenure of occupancy is recognized under specific legal conditions. Two other sub-tenures, known as renting and borrowing, operate widely but without legal recognition.

Unlike earlier land laws vested land to the State and abolished freehold and *mailo* tenures; the 1995 Constitution restores freehold and *mailo* tenures and vests land in the people of Uganda. Under the new constitution, provisions were made to enable customary tenants on public land to become freehold owners. Lawful and bonafide occupants on registered land (i.e., freehold and mailo land) were recognized and the constitution stipulated that within two years of its promulgation, a law (i.e., the LA98) to regulate the relationship between the 'occupants' and the 'owners' of land would be enacted. Finally, the Constitution anticipated that land management would be decentralized to the districts.

The LA98 provides for certificates of ownership for customary tenants on what was formerly public land. On mailo land, the LA98 attempts to resolve conflicts between owners and occupants (i.e., lawful and

**Types of Land Tenure, Features and Incidence**

<b>Tenure</b>	<b>Key features</b>	<b>Geographical incidence</b>
Customary	"Traditional" land tenure, varying in different areas. More individualized in south and west; more communal in north and east.	Countrywide
Leasehold	49 or 99 year leases, with development conditions. Land rent and premium payable. Leasehold title issued.	Countrywide, especially in urban areas
Freehold	Registered ownership in perpetuity. Freehold title issued.	Predominantly in south and west
Mailo	Limited form of freehold, which recognizes tenants' rights. Mailo title issued.	Central region
Occupancy	Right to occupy land under specific conditions based on occupation prior to 1983.	Countrywide on any registered land
Renting	Use rights to land for a defined period subject to payment of rent	Varies countrywide
Borrowing	Use rights to land for a defined period subject to payment of part harvest	Various countrywide

Source: Land Sector Strategic Plan, 2001-2011

bonafide) through the provision of certificates of ownership and occupancy. However, the LA98 does not vest absolute land rights in the hands of either group. Rather, it has enforced 'bundles of rights' for owners and occupiers respectively. Thus, the LA98 leaves ample room for conflicts over the allocation of rights.

Overall, it appears that the LA98 establishes a regulated relationship between lawful and bonafide occupants and mailo registered owners that to some extent provides security of tenure to all the parties concerned. Thus, the LA98 restores the mailo tenure but subjects registered owners to the rights of lawful and bona fide occupants. Section 30 describes a 'lawful occupant' as:

- (a) a person occupying land by virtue of the repealed
  - (i) Busuulu and Envujjo Law of 1928;
  - (ii) Toro Landlord and Tenant Act of 1937;
  - (iii) Ankole Landlord and Tenant Law of 1937; or
- (b) a person who entered the land with the consent of the registered owner, and includes a purchaser;
- (c) a person who had occupied land as a customary tenant but whose tenancy was not disclosed or

compensated for by the registered owner at the time of acquiring the leasehold certificate of title.

Under the LA98, lawful occupants or 'tenants by occupancy' can be issued a Certificate of Occupancy after verification of the claim and the boundaries of the land. With this Certificate and the owner's consent, the tenant may assign/sell, sub-let, pledge or bequeath his/her right of occupancy.

To the extent that a Certificate of Occupancy legitimizes a tenant's occupancy, it constitutes an important document that lenders could consider as collateral in extending seasonal loans to tenants. For example, such a certificate could serve as evidence that a standing crop really belonged to the person(s) who claimed to be the tenant(s) and offered it as collateral for a short-term loan. However, because the process of issuing Certificates of Occupancy is in its infancy and is presently being undertaken under the Land Sector Strategic Plan (LSSP) only on a pilot basis in some districts, it is expected that Certificates of Occupancy will only become credible collateral on a wide scale in the distant future.

Section 30 (b) of the LA98 recognizes the land rights of people that gained occupancy with the consent of the registered owner, but it is silent on whether those who gained occupancy with the consent of the occupant (*bibanja* holder) can also claim to be lawful occupants. In other words, Section 30 (a) (i) does not

appear to cover all those who occupy the land by virtue of arrangements with the *bibanja* holder. Yet this is an important question as a large number of transactions involving usufruct rights have occurred since 1975, particularly in Kampala District. However, it is generally held that occupants that purchased land from a *bibanja* holder (now considered the lawful occupant) are 'lawful occupants' under the Act. Any interpretation of Section 30, therefore, ought to legitimize transactions that have occurred in the informal land use market. Consequently, under the LA98 the *bibanja* holder and anyone acquiring use rights from the *bibanja* holder through purchase or other means can be deemed to have security of tenure. Less fortunate and secure are those who occupied land through license, rental, borrowing, or leasing arrangements, since these arrangements are not 'regulated' by law.

Section 30 (2) defines a bonafide occupant as a person who before the coming into force of the Constitution:

- (a) Had occupied and utilized or developed any land unchallenged by the registered owner or agent of the registered owner for twelve years or more; or
- (b) Had been settled on the land by the Government.

The twelve-year period specified above is referred to in the Limitation Act. This Act provides that no action for the recovery of land shall be brought after twelve years from the time such right of action arose. Further, Article 30 (5) states: any person who has purchased or otherwise acquired the interest of the person qualified to be a bona fide occupant shall be taken to be a bona fide occupant. This means that land transacted by squatters (before the Act made them bona fide occupants) will be honored. It is unclear whether or not the twelve-year qualifying period applies to those who acquired land interests from the person qualified to be a bona fide occupant. Section 31 states that a person who has occupied land unchallenged by the registered owner for *less* than twelve years *does not* qualify to be a bona fide occupant. The provision for squatters to become bona fide occupants is controversial because, by granting squatters inheritable occupancy on registered land, the LA98 effectively deprives registered owners interest in their land.

The Government's position on these issues is that the Constitution both guarantees a qualified right to own property and provides for security of occupancy. These arrangements suggest a potential impasse between owners who, on the one hand 'own' but do not 'control' the land and lawful and bona fide occupants, on the other hand, exercise control by virtue of occupancy. Legal title is further denied its economic

content by the provision that all tenants by occupancy are required to pay Ushs1000 (currently about US\$1) per year in rent to the owner, regardless of the size or location of the land. It seems to be more reasonable to apply a different rent on urban land, compared to rural land, because of the wider range of commercial activities and land values that urban lands command. Moreover, it would be expected that there would be a correlation between the plot sizes of rural land and rental charges, especially where commercial farming is practiced.

Government expects that the outcome that may emerge will be commercial, that is, it hopes that owners and occupants will sort out any land ownership disputes commercially. Under this line of thinking, freehold and/or mailo landlords would sell their rights to tenants thereby allowing the latter to enjoy full use of the land. However, far from making it possible for the parties to sort things out commercially, Section 32 (9) stipulates that the security of tenure of a lawful or bona fide occupant is not prejudiced by reason that he or she does not possess a certificate of occupancy. In other words, occupants do not have to acquire a certificate of occupancy, as their security of tenure exists with or without this formality. Needless to say, this ambiguity would appear to complicate occupants' land ownership claims or rights vis-à-vis lenders. Lenders might be more willing to extend seasonal and short-term credit to occupants with Certificates of Occupancy compared to those without.

In a nutshell, the LA98 does not create absolute rights in land, comparable to western notions of private property. What it does is to legitimize 'bundles of rights' for owners and occupiers. This can be seen as an attempt to incorporate or formalize land transactions that occurred alongside (but not outside) the officially sanctioned registered land market. However, rather than exclusively defining these 'bundles of rights' in a way that would allow the owner of a 'bundle' to exclude others, the Act leaves ample room for conflicts over the allocation of rights. This implies that it would be almost impossible to expect that land titles held by land owners or Certificates of Occupancy could act as credible forms of collateral acceptable to lenders in the agricultural sector.

The difficulty of this situation can be recognized when one considers what would have to occur if an occupant wished to have a Certificate of Occupancy, which would require him/her to apply to the owner. The owner would inform the Parish Land Committee and a date would be set to verify and adjudicate the boundaries. The Committee's determination would be sent to both parties and, as long as there are no rental arrears, the owner must grant consent in the prescribed form to the occupant(s). The Re-

Recorder could then issue the Certificate of Occupancy. The Recorder would also notify the District Registrar of Titles who would note the Certificate as an encumbrance on the title of the land. While the owner possesses the 'right' to sell the land title, it is an encumbered title and will only be bought by someone willing to accept the encumbrance(s). In fact Section 37 requires that an owner 'who wishes to sell the reversionary interest in the land' must give the first option of purchase to the occupant. Likewise an occupant, who "wishes to assign the tenancy" must give the first option to the owner of the land.

In addition, under the LA98, an occupant may "assign, sub-let, or pledge, create third party rights in, sub-divide and undertake any lawful transaction in the respect of the occupancy." Before doing so, however, the occupant must have the owner's consent to the transaction. The owner may grant consent, grant consent with conditions, or refuse consent. In the case of the latter two responses, the occupant may appeal the decision to the District Land Tribunal. A copy of every consent form is sent to the Recorder. No transaction 'to pass any interest in land' will be 'valid and effective' without consent. Thus the decisions and actions of owners and occupiers are inextricably linked. Their respective 'bundles of rights' cannot be exercised without the acquiescence of both parties. This has led some to argue that the provisions relating to the tenant by occupancy may have rendered registered land totally unmarketable in perpetuity (e.g. Okoth-Ogendo, 1998:9)

The Land Act provides for the institutional articulation of the rights highlighted above in a decentralized environment. However, since its enactment, implementation of the Land Act has proven to be difficult. Donors and many in government blame this on a shortage of financial and human resources to create the necessary decentralized administrative structures. Moreover, decentralization increases the number of sites of formal adjudication of rights and exposes the adjudication process to local predispositions. In Buganda, the complex "bundles of rights" that can be applied to the same piece of land further amplify points of conflict.

A major hurdle of implementation is setting up the decentralized structures specified in the Act. Administration of the Act implies a large bureaucracy. Land Committees will be established in each Parish, each gazetted urban area and each division in the case of a city, to determine, verify and adjudicate the boundaries to land and provide this advice to the District Land Boards. Each District shall have a District Land Board of a minimum number of five people. In addition each Sub-county, each gazetted urban area and each division in the case of a city will have a

Recorder responsible for keeping records relating to certificates of customary ownership and certificates of occupancy. Each District shall have a District Land Tribunal to determine disputes of higher value and in each Sub county there shall be a Land Tribunal to judge disputes of a lesser nature.

The Act also expects each District to create and maintain a District Land Office to perform registration, surveying, valuation and planning functions. Clearly these demands place financial and management pressures on institutions in an early stage of their development. Equally daunting are the costs of maintaining the structures for decentralized land administration. In short, it would be an incredible achievement for one statute to successfully 'vest land in the people', resolve the competing interests of landowners and occupants, and create a system of competent and consistent recording and monitoring at local and central levels.

Fortunately, the Land Act does not stand alone because there are multi-strands of legislation that support decentralizing land administration. The Local Resistance Councils Act 1993, the Local Government Act 1997, and the Constitution of 1995 transfer real powers to local governments and thereby appear to provide important supports for decentralization. Recently, however, inconsistencies between the governance statutes and the Land Act have been revealed. For example, on the question of financing:

Local governments are desperately short of funds and it is highly unlikely that they can raise resources to finance the institutions specified in the Act.

The Land Act provides that all expenses of the District Land Boards and Parish Land Committees shall be charged on the District Administration funds. However, two sections in the Local Governments Act 1997 could be read as being in conflict with this. Section 81 specifies that any extra obligation transferred to a Local Government by the Government shall be fully financed by the Government, yet the Land Act makes no such provision. Section 83 reinforces this by stating that no financial obligation shall be placed on local Government by the Government after the enactment of the Appropriation Act without provision of funds (Land Act Implementation Study, Annex 7: Institutional and Capacity Building Appraisal Draft Report, August 1999: 4-5).

Ambiguity is also evident in land policy. The Constitution states that land matters fall exclusively under the jurisdiction of the central government. District Land Boards are given land administration functions such as allocation, registration, and attendance to land issues in accordance with the laws made by Parliament. The Local Governments Act is consistent with the Constitution on this matter. The Land Act, however, suggests that Districts have a land policy role. This ambiguity notwithstanding, if Districts are empowered to make land policy and interpret the Land Act in accordance with local circumstances, then it is possible that decentralization of land management to the parish level will democratize land management systems and bring services nearer to the people. On the other hand, without a central government monitoring and supervisory framework to keep the Act “nationally intact and locally articulated” in a consistent way, local implementation and discretion will likely lead to manifold, unanticipated outcomes.

It is obvious, therefore, that although land administration and adjudication is to be implemented within a decentralized environment, financial and other logistical constraints make it unlikely that landowners and occupiers will be able to expeditiously obtain a formal certification of ownership or a certificate of occupancy with which to mortgage land as collateral for agricultural loans. This problem represents an important constraint to the establishment of a market-oriented formal financial system to serve agriculture and rural areas.

# Annex 4

## Information Management

### 1. Introduction

The interface between the financial services sector, on the one hand, and the agricultural and fisheries sectors, on the other, is weak in Uganda. It is weak in terms of numbers from these primary production sectors who are clients of financial institutions; it is weak in terms of the mechanisms in place for key information generation, transfer and sharing; and with a few exceptions it is weak in terms of the knowledge that financial institutions have of the agricultural and fisheries sectors.

This annex explores some relevant information fields, and suggests initiatives, through which the information interface could be strengthened, to the benefit of producers, traders and financiers.

Three broad information fields are relevant.

- a. Information clients have about financial service availability and conditions, about management of their own financial affairs, and information needed for them to adopt or expand the use of improved farming technology;
- b. Information financial institutions have about the agricultural and fisheries sectors;
- c. Information, especially for policy makers, about the performance of financial service support for the agricultural and fisheries sectors.

These are discussed, in turn, below.

### 2. Information Available to Clients

#### 2.1 Financial Management Skills

Much is written about the skills required by the staff of financial institutions. A recently published book<sup>4</sup> explores the other side: the skills required by farmer clients of banks and other financial institutions, and how these skills can be improved through actions taken by governments, not least through adjustments to general education in schools. There is every reason to believe that clients' financial management skills are no less important in Uganda than else-

where, and are therefore worthy of attention. The needs of small-scale traders in this connection closely parallel those of farmer clients of financial institutions.

What are the practical implications of this objective? Heney (2000, page 75), when discussing ways by which farmers' financial skills can be improved, lists the following as important: "better literacy, better analytical skills, better understanding of enterprises, better awareness of goals, better budgeting, better management of savings, better knowledge of financial services".

The last of these targets financial institutions directly. Indirectly, through product design, financial institutions can impact on several other goals in Heney's list. Government policies and outreach programmes can impact many of these requirements. However, there are some that financial institutions can target. The last in the list, "better knowledge of financial services", is a matter for awareness building and marketing. Others, especially "better understanding of enterprises, better awareness of goals, better budgeting, better management of savings" are all objectives which careful product design can address, albeit indirectly.

The implications for support efforts to improve product design for institutions expanding into rural areas are clear, i.e. products should be designed in such a way as to contribute to the understanding clients have of financial services, and how they can be helped by using them. For example, school savings schemes have a strong, early childhood, educational value; loan application methods can be designed to incorporate simple financial analysis and budgeting (including whole household budgeting, where appropriate), the use of which involves a learning process<sup>5</sup>.

#### 2.2 Market Opportunities

It is clear that the Ugandan agricultural and fisheries sectors can only develop soundly if signals concerning demand for products are received by key actors. Such signals are generated in destination

<sup>4</sup> Heney, J.A., Enhancing Farmers' Financial Management Skills, FAO/GTZ, Rome & Eschborn, 2000

<sup>5</sup> Heney, op.cit. p.81

markets (for exported commodities and products) and in terminal markets – effectively Kampala (for other commodities and products). This process requires suitable information transmission mechanisms so that meaningful marketing messages can be effectively fed back along the marketing chain to the primary producers, and to the input suppliers on whom they depend.

In Uganda the formal demand transmission mechanism for farmers is provided by the regional Foodnet Service, supported by USAID and the IITA (International Institute of Tropical Agriculture). Some of the clients of this service pay for up-to-date market information, sent by email (currently 100 traders subscribe to this service<sup>6</sup>); others have access to price information conveyed by SMS messages on cell phone networks (for which there is a charge); free access is available over local FM radios throughout much of Uganda, where an effort is also made to broadcast in local languages. Clearly the last of these transmission mechanisms is the one of most relevance to small-scale farmers.

The information from Foodnet includes prices for 27 commodities, in 3 markets in Kampala (based on daily collection of price information), and from 16 markets in rural (district) centres, derived from weekly price collection in these markets. There is also an important regional component, as Foodnet operates also in Congo, Ethiopia, Eritrea, Kenya, Madagascar, Rwanda, Sudan and Tanzania, in other words, in all the important *regional* markets for Ugandan produce (chiefly maize and beans). A monthly bulletin is produced which is a regional trade overview, noting production levels and shortages, and current trade patterns – including estimates of current, informal, cross-border trade. By noting localised demand situations for particular products, information is also conveyed about new product possibilities and new markets.

Foodnet is an impressive achievement, and deserves ongoing support by the GoU so that the market information provided, and on which the agricultural sector increasingly depends, can continue to be available<sup>7</sup>. Some users (e.g. traders) can pay for the service. However, for the bulk of the farming community, whose price information needs are less time-sensitive, market information is readily accessed from broadcasts over local FM radio stations.

<sup>6</sup> Personal communication from Dr. Shaun Ferris, Coordinator of the Foodnet Project.

<sup>7</sup> There are many examples in the developing world of market information services that have been started by donor-funded projects. Few of these have become sustainable. The usual reason for their demise has been the unwillingness of governments to pay the costs involved, especially for collection of price data on a regular basis, so that the information disseminated is timely and therefore optimally useful to growers and traders.

The latter ought to be regarded by government as a public good, and fully funded accordingly.

## **2.3 Improved Farming Technology**

Market information provides the base for farm production to be market led, supported by research and extension services, which in Uganda also aim to be sensitive to market conditions. Technical material is an important part of the information flow needed in rural areas. To meet this need the Government's NAADS (National Agricultural Advisory Service) initiative is now getting established. For crops such as coffee, other support networks, such as the Uganda Coffee Development Authority are also important. The NAADS services are provided free of charge to the farmer, as are services from commodity-specific bodies: however in the latter case the overall costs are met by the industry itself.

Specific donor-funded projects, such as SPEED and IDEA, have also had an important technology transfer role. As projects such as these come to an end, it is understood that NAADS will take over the associated responsibilities.

Financial institutions can utilize such services as sources of information leading to better lending (see following section).

## **3 Information Flow to Financial Institutions**

### **3.1 The Use of Information**

Financial institutions can use information about the agricultural and fisheries sectors in order to increase their efficiency in all phases of banking, i.e. product design (savings products and loans) and, for credit operations: loan assessment, loan supervision, loan collection and arrears control, realization of collateral. There are also senior level tasks that require a good knowledge of these sectors, including ensuring portfolio balance, asset-liability management, liquidity management, loan-asset portfolio management. The risk associated with sectors exposed to the vagaries of climate, disease, price fluctuations, isolation and transport difficulties all mean that the very best information mechanisms must be in place for effective lending to these sectors.

### **3.2 Personnel**

Any financial institution including the agricultural sector in its forward business plans would need to have some specialist knowledge in-house, perhaps in a specifically-designated unit.

Some of the information will be gained in-house through recruitment of suitable staff. Clearly this is the short-cut route to a financial institution gaining the required expertise. It is not known to the mission how effectively current university training in Uganda prepares students for possible employment in banks and MFIs serving the agricultural sector. However, given the Cinderella status of agriculture among many younger people, it would be surprising if there were to be the sort of lively demand that would prompt university departments to include relevant learning modules in their courses. This is an area that may warrant investigation, and possible remedial action.

Uganda is far from being alone in this situation. Many countries currently face shortages of suitably trained manpower for financial intermediation in rural areas, and require assistance in remedying this situation. This has been recognized by a number of donors and development organizations. As a result the multi-donor Rural Finance Learning Centre (RFLC)<sup>8</sup> has recently been established. The objective of the RFLC is to be a source of information of direct use to universities and other organizations that are involved in training for rural banking activity. The needs for in-house training are also relevant here. Assistance in the form of on-line lessons for self-study, course materials for trainers, as well as a searchable database of resources can also be provided by the RFLC

### 3.3 Ongoing Information Flow

Financial institutions that may have only basic knowledge about agriculture need to develop ongoing linkages with the major commodity organizations, such as the CDO (cotton) and the UCDA (coffee). This will assist in keeping up-to-date with opportunities for new product lines. Banks and MFIs may also prepare to respond to the growing demand for financial services, especially for loans, by using an *Agricultural Enterprise Watchlist*. A sample of such a watchlist is given in the draft in Section 3.4 below. The intention of this draft watchlist is not to stand in its own right as a finished product. Rather it is intended to prompt thinking on the part of financiers as to new areas of business in the agricultural and fisheries sectors, coupled with staff capacity-building requirements, which would need attention in preparation for increased business with these sectors.

<sup>8</sup> Information available from the Chief, AGSF, AGS Division, FAO Rome (email [doyle.baker@fao.org](mailto:doyle.baker@fao.org)) or email direct to [jennifer.henev@fao.org](mailto:jennifer.henev@fao.org)

### 3.4 Agricultural Enterprise Watchlist

An examination of the item-by-item demand for some selected items of Uganda's agricultural and fisheries products reveals opportunities for the future, together with a few areas of concern. The draft list below attempts to capture some of the points of relevance to banks and other financiers. It serves to illustrate in a summary, introductory form the sort of information to which banks need access in order to build a sound agricultural loan portfolio. Specialist agriculturalist loan officers need to maintain on-going databases about these product sub-sectors. These databases would essentially be expansions of the material that follows.

#### Coffee

The dismal outlook for standard grade Robusta has already been mentioned in this report. As a means of adding value, a start has been made in upgrading to wet-processing technology, in order to produce a higher quality product. This start, to date, has been small, involving some 2 percent of the crop. An eventual investment of \$40m in wet-processing technology is envisaged in the current plans of the Uganda Coffee Development Authority. Even though the market indications for superior Robusta are currently favourable it would be important to harmonize the rate of this development with the growth of the speciality-coffee market, especially if an *appellation controlée*<sup>9</sup> market labeling approach is taken for a part of the crop. It is understood that the *appellation controlée* approach to attempting to build value in the market is the current objective, with a start having been made by identifying four such zones<sup>10</sup>. One notes that this marketing strategy will doubtless need a great deal of promotion, with equal certainty that there will be stiff competition from other producing countries. However, it is in harmony with the trend for information on the origin of products that is increasingly demanded by the consuming markets in the EU and US.

Again on the production side, efforts are being made to replace aging and often virus-affected coffee trees with newly developed strains of robusta, resulting from plant breeding in Uganda.

The situation with Arabica, which accounts for just 10 percent of Uganda's coffee production, is less serious, as established markets continue to provide demand for the Ugandan crop.

<sup>9</sup> An *appellation controlée* system is analogous to that used in the French wine industry. It is a marketing strategy in which the geographical origin of the product is stated on the package, in a system which has controls exerted by an authority which itself is subject to impartial monitoring.

<sup>10</sup> "Uganda Competitive Private Enterprise and Trade Expansion Project (COMPETE), Final Report," Kampala, May 2002, Section B3

## Cotton

Cotton was first grown on a commercial scale in Uganda in 1903, so the industry is well established, with a great deal of local expertise developed in production, trading, processing and marketing. Although Ugandan cotton, being handpicked and roller-ginned, is higher quality than much of the cotton in the market, it is still very vulnerable to market downturns, often caused by over-production in those countries providing a heavy subsidy to producers.

Recent project activity in Uganda has demonstrated the benefits to be gained through the use of improved on-farm production technology, involving the use of purchased inputs. It is likely that as the benefits of this technology become apparent to farmers, then demand will increase for seasonal production loans. Semi-commercial and commercial farmers are those most likely to be involved in this trend<sup>11</sup>.

## Fish

It is estimated that one million persons are involved in the fish trade in the country. Some 80 percent of these work in the domestic market, in processing and (small-scale) marketing ends of the industry. Approximately 75 percent of the total production is consumed domestically or in the immediate region, mostly for human food, but some as a protein-rich ingredient in livestock feed.

Fish exports have been a relatively recent area of business, and returns are impressive for species such as Nile perch. Local processing facilities for exported products consist of some 11 plants, with a substantial over-capacity at present levels of permissible catch.

Since the capture fisheries resources are limited, attention is being given to the following measures:

- a) reducing the proportion of fish caught but rejected due to incorrect or below-standard post-catch and pre-processing handling;
- b) investigating the requirements and developing the technology for cage production of Nile perch or an introduced species such as Barramundi (Australian origin);
- c) further developing pond aquaculture of Nile tilapia and mirror carp.

All of the above measures require a mix of public funding (information in the main) and private investment, with a likely heavy demand for loan financing

Currently aquaculture in Uganda accounts for only 1 percent of total national production of fish, well

below the global proportion of 26 percent by weight (FAO, 2000). The global trend is one of continued expansion, especially in developing countries, with total farmed fish production, by weight, likely to surpass total global beef production in 2011. The extent to which Uganda participates in this trend is at present unclear, but financiers should be aware of the potential in this industry<sup>12</sup>. They should be equally aware of the uncertainties involved, particularly in terms of disease and algal bloom outbreaks that have been responsible for incidents of heavy mortality of farmed fish in many countries, from New Zealand to Norway, with banks experiencing losses as a result. The lesson in this is that financiers should obtain the very best technical advice available, while being wary of rapid expansion of intensive fish farming enterprises.

## Coarse grains

The principal coarse grain in Uganda is maize (corn) with the coarse grain crops more suited to drier conditions (sorghum and finger millet) grown chiefly in the north of the country. Although maize is currently the chief cereal crop and is likely to be so in the immediate future, there is likely to be increasing demand for sorghum, for brewing. Purchases of Ugandan maize by international relief agencies have been important outlets, and there is no sign that this trade will diminish in the next few years. However, it is the Kenyan market that is likely to generate the major future sustained demand. Important too will be the demand for maize as an ingredient of feeds produced for the growing Ugandan livestock industry.

As with cotton, maize responds well to investment in seasonal inputs (hybrid seed, fertilizer and, in some areas, pesticides), once the benefits to labour and land productivities have been realized through attention to planting in rows (which greatly reduces the labor requirement for adequate weed control), and correct plant spacing/ plant population.

Maize occupies an unusual place in Ugandan agriculture, because unlike the case of many neighbouring countries, it is not the chief staple cereal. This position is held by plantain banana (*matooke*). Maize is therefore more in the nature of a cash crop. One feature of this status is that there is no cultural or traditional imperative for it to be cultivated, allowing the perception of market demand to provide the incentive for it to be grown. This highlights the potential role for new maize marketing strat-

<sup>12</sup> One substantial scheme, the Bunamwaya Fish Farming Scheme, plans some 70 ponds, each of 1800 m<sup>3</sup>, with total production by the end of 2004 of some 2000 tonne of tilapia ([New Vision](#), 19 Nov. 2003).

<sup>11</sup> Information from the Cotton Development Organization

egies to play a role in improving livelihoods of farmers in maize-growing areas.

The potential for maize exports has already been noted. A recent study<sup>13</sup> has noted (PSFU 2003 page xvii) "Pre-processing maize exports in the form of storage, cleaning and re-drying are important for the preservation and stabilization of maize grain in preparation for export. Re-drying and storage will encourage long-term stocking of excess maize. This will provide an all year round market to maize farmers and stabilize prices. As a result, farmers will gain confidence in the crop, increase production and generate adequate and predictable excesses for export. Cleaning and sorting will help to improve the quality and consistence of the grain, making it more readily acceptable on the export markets. However, technology and investment in these important operations is still lacking." The same publication addresses possible future demand for investment funds, inter alia, for post-harvest equipment, which would include "dryers, shellers, storage. At an estimated cost of US\$25,000 per unit, an investment of US\$1,000,000 would cater for at least 40 rural-based farmer groups. Simple and effective storage, re-drying and cleaning systems for grain should be initiated and encouraged to ensure preservation of harvested grain."

#### **Vanilla<sup>14</sup>**

No one expects the current high prices to continue, yet Uganda is well-suited to vanilla production from an agro-climatic point of view, and its high value-to-weight ratio puts it in a better position to sustain high transport cost than is the case with crops such as cotton and maize. Assuming that the current (very high) price levels do not drop too dramatically, then there is likely to be a continuation of the significant private investment in this industry.

#### **Roses<sup>15</sup>**

From a small beginning a significant export trade has grown (worth some \$30m in 2002), though its impact on the vast bulk of the population has been insignificant. Production is intensive, and the market is closely tied to the Dutch international flower trade. Future developments are likely to be an expansion along the model already developed, i.e. capital intensive, tightly controlled, and in the hands of a small number of operators. It is likely that the roses industry could expand to be worth some \$80m per annum over the next few years.

#### **Livestock and Poultry<sup>16</sup>**

Given the usual trend for demand for livestock products to increase faster than demand for crop products as urban incomes increase, demand will grow in Uganda for dairy products, beef, pig meat and products, and poultry products.

The financing requirements, especially for intensive livestock production can be substantial for a small farmer/entrepreneur. Typically for a modest 500-bird broiler unit the capital investment needed is Ushs1.5m (\$750), with a further Ushs1.7m in operating capital required per batch of birds. Whereas to date there has been little borrowing in the broiler industry, as units have grown from small beginnings, this may change if demand picks up. Borrowing demand will also grow from existing, proven operators wishing to expand their enterprises.

Investment in dairy enterprises, especially those utilizing Friesan/Ankole cross cows (which are valued at Ushs1.2-1.5m each), is very much larger again. Currently there is apparent over-production in the dairy industry, but given very low per capita consumption levels, this situation may well change quickly.

Beef cattle are well suited to large tracts of the country, but most cattle ranches are not currently producing optimally, and many require considerable investment in breed improvement and facilities such as water supply.

Pig production, based on the Cambrough (Landrace/Large White cross) has a bright future, as demand is good and growing, returns are attractive and a number of support initiatives by the GoU and donors are underway. Pigs units potentially have a significant benefit/cost advantage over broiler chickens in that their feed cost per unit of live weight gain is lower, due to their lower requirement for protein (which is costly) in the feed.

#### **4. Information about the Performance of Financial Service Support for the Agricultural Sector**

##### **4.1 Policy Generation and Delivery - Requirements**

The objective of sustainable, effective and efficient provision of financial services in rural Uganda requires substantial attention to achieving a supportive policy environment. Since the policy mix which

<sup>13</sup> PSFU (2003) "Identifying Improvement Opportunities and Diagnosing Prospects in Uganda's Maize Supply Chains" Private Sector Foundation of Uganda (PSFU), Kampala, 2003.

<sup>14</sup> Personal communication from IDEA Project staff.

<sup>15</sup> Information provided by IDEA Project.

<sup>16</sup> Much of the information in this section was provided in interviews with senior officials of the Livestock Division of MAAIF, Entebbe.

is relevant depends on several government ministries, there is need for two basic information sets.

First, information on the current delivery of financial services, rural deposits, farming loans, fisheries advances, repayment rates, delinquency, and use of collateral.

Second, common information on the respective, current policy foci of all relevant ministries – MAAIF, Finance Planning and Economic Development, Commerce, Lands, as they impact on financial services to agriculture.

#### **4.2 Information**

The first information set requires commitment to an ongoing mechanism whereby information more detailed than that collected by the BoU is collected, analyzed and presented to policy makers in an optimally useful format. The objective is to facilitate the identification of remedial and improvement measures through informed, timely policy adjustments.

#### **4.3 Coordination**

The second information set involves establishing a suitable forum for the exchange of information, with the focus on ministries rather than donors, but with donor participation. Indeed, there is growing recognition of the need for an appropriate mechanism for continuous exchange, apart from the immediate needs of donors. Several initiatives are relevant here, and the Mission has recommended an overall Plan, which would encompass the interests of all stakeholders and provide a basis for consistent policy making and project design. An important part of the operations of the Plan would be information exchange.

# Annex 5

## Insurance as a Financial Service

### 1. Management of Risk

The management of risk using the financial mechanism of insurance is a fundamental part of a modern economy. Risk impacts all stages of the production/ marketing/ processing/ storage/ export/ retail chain. Within this chain investments are made in short-term items such as on-farm inputs, produce buying, and other working capital needs. Investments of a longer-term nature are also involved, including on-farm storage and machinery, transport vehicles, warehouses, processing and packaging equipment. Risks to some of these items are commonly insured, with property, machinery breakdown and vehicle insurance policies being prominent in Uganda. Insurance shares with other financial services the need to control costs and risk. Managing risk is both the business of insurance and a challenge, in that insurers confront the special problems involved in the business, especially those of moral hazard and adverse selection. Designing and marketing insurance products for large numbers of widely scattered farmers throw these issues into very sharp focus<sup>17</sup>.

Potentially, other types of insurance products related to agriculture and to farmers are:

- ✍ Livestock insurance
- ✍ Growing crop insurance
- ✍ Life insurance, including for lower income persons
- ✍ Health insurance

### 2. Livestock Insurance

Livestock insurance has been available in the past in Uganda. The policy was a mortality cover, and only cross-bred cattle (not indigenous breeds) could be insured. The product was offered by the largest insurer, the National Insurance Corporation Ltd. (NICL), which is 100 percent owned by the government. Although this insurance product was profitable for NICL, it has been discontinued due to low demand. In turn this low demand was probably a result of very stringent conditions incorporated in the

<sup>17</sup> For a detailed discussion of these and related points, see Roberts and Dick (eds.), *Strategies for Crop Insurance Planning*, 1991, FAO, Rome

policy. These related in particular to the required proximity of veterinary care and separation of the insured cattle from local animals. The future for live-stock mortality cover is uncertain, but given the low historic loss ratio (reported to be just 12 percent) experienced on the discontinued product, it is likely that cover could be obtained again, if there were indications that the market would be sufficiently large<sup>18</sup>.

### 3. Crop Insurance

Growing crop insurance is currently not available in Uganda, although there is some demand (noted but not quantified by the mission) for protection on the part of investors who have a significant investment in growing crops<sup>19</sup>. There is a considerable research cost involved in establishing a crop insurance capability. Moreover, standard crop insurance products require individual loss assessment in the event of a claim. This essentially means that only very large enterprises (especially intensive, highly capitalised flower production units) could be included, because the costs of loss assessment are not in a linear relationship with either the magnitude of the claimed loss, or of the insured amount.

If large numbers of small farms were to be insured, then one approach to the problem of loss assessment cost is to carry out the procedure on an area rather than individual farm or field basis. This is done, for example, in India.

However, because the size of the potential market in Uganda is very limited, and because most insurers have little or no experience with agricultural insurance, it is unlikely that this type of risk management mechanism will become common in Uganda in the next 20 years. The only exception to this could be large nucleus estates, as and when these become more common. Here there is scope for economies of scale in marketing policies, in assessing losses and in settling claims. For example, insurance

<sup>18</sup> Personal communication, Chief Manager, Marketing, National Insurance Corporation Ltd.

<sup>19</sup> Personal communication from a major insurer, relating enquiries from clients.

cover can be designed so that it is automatic for all growers linked to a given nucleus estate. This eliminates nearly all marketing costs, while the nucleus estate recording system for areas planted and harvested provides a useful reference point for an insurer, and a low cost means to obtaining the information required. Economies of this type can permit insurance operations to be undertaken as a sustainable business activity, as for example in the sugar industry in Mauritius.

Again it is possible that a new type of crop insurance in the form of index or coupon cover may have some relevance in Uganda in the future. This uses a climate index as the trigger for qualifying a coupon holder, the insured, for an indemnity payment. This type of product is suited to addressing risk from a single peril of infrequent occurrence. To this end it may have a place in Uganda for the very infrequent peril of drought. However, much investigative work would need to be carried out before this possibility could be developed to the extent that it could be discussed at a political and/or farmer's level. To date the only working examples of this type of crop insurance product have been in Canada and the United States. However, insurance of this type is currently under consideration in Morocco, following some preparatory design work by the World Bank and KfW.

#### **4. Life Insurance**

Life insurance for lower income persons is a product that probably has a future in Uganda. This is largely because of the existence of the MFIs. MicroFinance Institutions already have close contact with their clientele, which affords an insurer a ready-made contact point. This reduces the transaction costs of marketing policies and handling claims. Moreover a lender has an interest in seeing that a loan is covered in the event of the death of the borrower.

What is uncertain is the size of the demand. At the time of writing, life policies written in Uganda exclude death from HIV/Aids as an insurable risk. However, as such deaths become less common then it is expected that this exclusion will no longer apply; indeed one major insurer has already commissioned actuarial work in preparation for the introduction of policies that will cover death from HIV/Aids.<sup>20</sup>

Since linking a loan to life insurance on the life of the borrower would reduce risk, some MFIs might offer this type of arrangement as a product, with a price that reflects the costs/benefits to both parties. Indeed, both commercial banks and MFIs that design and market term loan products for the purchase

of equipment, vehicles, water supply etc., could well make insurance of the borrower a condition of the loan. At first sight the lack in Uganda of a national identity card might suggest that identification difficulties might occur in the event of a claim. However, a major insurance company maintains that this is not a major area of difficulty. MFIs could readily negotiate with insurers to market their policies, in return for a modest commission. In effect, in doing so, the MFIs would act as specialised brokers.

#### **5. Health Insurance**

Health insurance is being tried in some African countries, including Uganda, where at least two schemes, Microcare (Kampala and S.W. Uganda) and Kitovu Patients' Prepayment Scheme (Masaka) operate. In the latter case the medical treatment is limited to that currently offered at Kitovu Hospital, a mission establishment. Here too the obvious problem for health insurers relating to the lack of a National Identity Card has been overcome by the Scheme issuing a photo ID card for participants. At Kitovu Hospital there has been a close link to the local MFI, FINCA, since the Scheme requires group participation, with at least 60% of any given group enrolling, and a minimum of four persons in each enrolled family. The current status of the Kitovu Scheme is that the cost of treatment plus the cost of administration of the scheme is roughly double the premium income, so sustainability is dependent on donor funding at the present stage.

Given the paucity of experience to date with this insurance product for lower income persons, coupled with the fact that it was not examined in any great detail during the present exercise, no firm conclusions can be drawn as to the future potential for health insurance.

<sup>20</sup> Personal communication from a major insurer.





**Contacts:**

Financial System Development Programme (FSD)  
c/o Bank of Uganda  
37/43 Kampala Road  
P.O. Box 27650  
Kampala, Uganda

Tel: (256-41) 253840, 258441-6 Ext. 2499  
Fax: (256-41) 349552  
Email: [fsd@bou.or.ug](mailto:fsd@bou.or.ug)