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Summary report of the 9th Consultative Forum on Coffee Sector Finance

Background

1. The 9th Consultative Forum on Coffee Sector Finance took place on Tuesday 24 September 2019 during the week of the 125th Session of the International Coffee Council in London. It supports the implementation of Resolution 465 by gathering experts to validate solutions in the area of price risk management that were identified as part of the five international consultative events of the first phase of the ICO Structured Sector-wide Dialogue held between March and June 2019. The theme 'Effectively managing price risks in the coffee value chain: a response to the coffee price crisis' aimed at exploring how innovative and market-based approaches can improve farmers' resilience against price volatility and price shocks.

2. The forum was chaired by Mr Kirill Matrenichev of the Russian Federation and comprised two panels bringing together panelists and moderators, experts from the coffee sector, the financial industry, international organizations and academia.

SUMMARY REPORT OF THE
9TH CONSULTATIVE FORUM ON COFFEE SECTOR FINANCE

Introduction

1. Farmers, especially smallholders, are frequently exposed to risks, whether these concern agricultural risks, such as unpredictable weather patterns and plant diseases, or market risks, including volatile output prices. These external shocks can negatively affect farmer's incomes and livelihoods. With price risk management mechanisms (PRMMs) in place farmers are more likely to address market risks resulting in a more stable income that facilitates planning and seasonal production decisions as well as undertaking long-term investments in their coffee-farming business. Financial price risk management mechanisms, such as derivatives and insurance, are available, however, smallholder farmers and those not aggregated in cooperatives often lack access to these formal tools, making them the most vulnerable of the value chain. This is due to widespread low financial literacy and transaction costs associated with small-scale producers that can be prohibitively high. For their part, commercial banks and financial institutions are often reluctant to lend to smallholders due to the perceived riskiness resulting from lack of recognizable credit scoring mechanisms and collaterals.

2. However, farmers need access to loans and financial services to cover their seasonal costs, including working capital and investment capital to maintain future coffee production and, if coffee is their only source of income, to cover their cost of living. Sara Mason of SHIFT Social Impact Solutions, a consultancy firm, stressed the significant contribution of coffee production for some farmers to earn a living income.

3. In his keynote presentation, Aly-Khan Jamal, from Dalberg advisory firm, introduced various models to help farmers mitigate risks related to price volatility in the coffee market. The subsequent discussion during the Forum focused primarily on individual farmers' access to risk management and aggregating resources at the levels of individual farmer cooperatives and finally sharing risks across actors in the value chain.

1. Individual farmers' access to risk management

a. Constraints faced by smallholder farmers in accessing financial services

4. The **costs and risks** associated with investing in smallholder farms are often perceived as prohibitively high by financial institutions that provide credit and services to farms. Smallholder farmers' inability to access long-term affordable credit prevents

investments in farms, leading to the persistence of low productivity, low income diversification and consequently low incomes. In principle, local banks would be best positioned to provide financial services to smallholder farmers, particularly rural banks with good local branch networks and effective digital services. However, in many coffee producing countries rural credit markets fail as coverage of rural areas by banks and credit and financial services providers is low. Where banks are present, credit officers in local branches often do not have the necessary skills and expertise to assess agricultural and market risks faced by farmers. Therefore, traders, input suppliers and processors try to fill the gap to manage price risks by assuming some of the market risks. Development banks, such as the FMO in the Netherlands, support them in doing so, by providing resources and funds to traders and processors, as pointed out by Hans Boogard.

5. Similarly, IDH launched the €100 million FarmFit Fund to catalyze investment at scale, allowing banks and financial institutions to make sound impact investments and help support sustainable smallholder farming. The fund takes the highest risk position in an investment, taking responsibility for the first losses incurred. It unlocks farmer finance across financial institutions by providing liquidity, de-risking, leveraging risks and long-term financing to farmers, allowing investment into renovation and rehabilitation and income diversification. This permits smallholder farmers to access market benefits that larger producer organizations and commercial farmers have in the rest of the world. IDH also extend funding to buyers of coffee, for example traders, so they can in turn provide financial services to smallholder farmers, a practice that was initially perceived too risky by many value chain actors.

6. In addition, smallholder farmers stand at a disadvantage compared to other farmers due to often widespread **financial illiteracy** and low capacity for risk analysis and implementation of risk mitigation tools. Provision of risk management at the level of the cooperative can be an effective way of transferring knowledge while reducing transaction costs, as it is *'easier to organize workshops for the 5 people at the top of a cooperative instead of working with 5,000 small farmers'* according to Florent Baarsch of IFAD.

7. The PRM Initiative implemented by a consortium that includes Oikocredit, a social lender, and coordinated by Hugo Villela enables coffee cooperatives in the Latin American region to mitigate the volatility of coffee prices through financial strategies and tools. The program organizes workshops to transfer knowledge to producers (producer boards and producer management teams) about the financial strategy and

price risk management mechanisms, such as the complexities of harvest evaluation and prediction, coffee market fundamentals, inventory management, and financial hedging strategies. Training is complemented with implementation and monitoring of these tools. The program currently focuses on Central and South America but many of the lessons learned could be applied to other producing regions.

b. Derivatives

8. Derivatives (futures or options) are a contract between two parties, where the price is determined by coffee traded in the Intercontinental Exchange (ICE). They offer the buyer the right (but not the obligation) to buy or sell coffee in ICE at an agreed-upon price during a certain period of time. Access to derivatives taking up a position in the coffee futures market allows buyers, including cooperatives, intermediaries, exporters, and importers, to implement hedging strategies to protect themselves from price volatility. Sharing risks across actors in the value chain through derivatives gives farmers a sense of **predictability** that could incentivize farmers to invest in their farming businesses, which would ensure farmers with **better livelihoods**, potentially enabling a **living income.** The challenge, however, lies in ensuring that these are available to a broader set of farmers in the value chain. Smallholder farmers have limited access to the coffee futures market due to their lack of sophistication and the size of individual transactions, which increases their vulnerability to shocks and hinders economic opportunities.

9. On the other hand, medium- and large-scale farmers often have the opportunity to hedge their coffee with an option scheme, as seen in the case of Mercon Coffee Group. This increases farmer's flexibility of when to sell coffee. The coffee sits in the warehouse, and is still the property of the farmer, reducing their risk when faced with price volatility. When the spot price of coffee reaches a price that is acceptable for the farmer, he or she sells the coffee to the buyer, benefitting from market upswings.

10. Through their CACHET program, IFAD provides smallholder farmers with access to financial derivatives traded on international financial markets (e.g. Intercontinental Exchange or Chicago Mercantile Exchange). Specifically, IFAD works with existing value chain intermediaries, such as traders, exporters, cooperatives or rural finance institutions, who have already built a strong relationship of trust with the farmer. For instance, the CACHET program offers **price risk insurance** at the level of cooperatives, which in turn facilitates the trickle down of benefits to small-scale farmers. IFAD insures the **downside**

risk faced by these value chain intermediaries. If the price at which cooperatives can sell coffee falls below the price that was offered to farmers, the price insurance is triggered. It protects the position of cooperatives, which in turn can pass on benefits of the insurance to members through guaranteed minimum prices.

11. Providing insurance can be very costly, depending on the relationship between the guaranteed minimum price level (often based on production costs plus margin) and the market price. In IFAD's case, the cost of the insurance scheme is at present covered by donors; however, the aim is to include in other value chain actors, such as traders and roasters, for the economic benefit of all. Price insurance guarantees farmers a price above their cost of production, thus allowing them to generate profits and re-invest in their farms. Offering price risk insurance to farmers may come at a cost, but in the long run can, under specific circumstances, benefit all actors in the value chain.

2. Risk sharing across actors in the value chain

12. Since smallholder farmers are not as well positioned to hedge risks at the futures market, sharing risks across actors in the value chain can reduce the exposure to the risks of individual farmers. Reallocating risks across actors in the value chain can be achieved through mechanisms such as **over the counter contracts** (OTCCs) (i.e. forward contracts), private bilateral agreements that allow farmers to protect themselves from volatility by pre-agreed pricing or contracts, and **futures or financial derivatives.**

a. Types of long-term contracts

13. A long-term contract, for example between farmers and input suppliers, can allow smallholders to invest in their farms by transferring some of the risk stemming from market volatility to the buyer of coffee, which usually has greater access to formal risk management tools. Farmers are less inclined to sell coffee at the moment of harvest when prices tend to be at their lowest in order to access inputs for the next season, thereby reducing their cash flow risk. Alternatively, up- or down-stream value chain actors, such as in input providers or traders, can supply farmers with fertilizers, processing equipment, irrigation systems and machinery that enable farmers to achieve higher yields and quality, often resulting in improved profitability. An example of pre-harvest financing through provision of inputs was presented by Yara International. Under a barter scheme in Brazil, Yara provides inputs in exchange for a previously agreed-upon quantity of coffee.

14. A fixed price over the counter contract allows the farmer and the buyer to agree in advance on the price of a future sale, so that the farmer is guaranteed the agreed-upon price if the market price drops. The farmers set a price upon a relevant reference (i.e. cost of production) plus a margin. This would ensure that farmers cover their full production costs, while allowing for re-investment in their farms and, potentially, a profit. Along with other private sector companies, Mercon Coffee Group has started engaging in these long-term commercial relationships, and also offers business support to farmers with regard to market fundamentals and understanding their costs of production in order to set a profitable price, as pointed out by Giacomo Celi. Long-term contracts with fixed prices can be an effective tool to mitigate the impact of short-term variations in the world market price for coffee. However, contracts are not decoupled from long-term price trends.

b. Contract enforcement

15. Over the counter contracts and financial derivatives are associated with the default risk — the risk that a contract is not fulfilled. This entails that the farmer does not side-sell their coffee when the market price is higher than the previously contractually agreed price. In order to be effective, these contracts therefore **require longstanding relationships and trust between actors**.

16. The issue of trust and long-term relationships as a key driver for efficient firm-to-firm relationships was a central theme in the discussion. Rocco Macchiavello, of LSE, offered an in-depth explanation, based on his own research. He noted that contracts along the value chain, whether at the farm gate (such as the case of Yara International) or at the point of shipment (such as the Mercon Coffee Group), are hard to enforce, especially in an environment with weak institutions. Conceptually, contracts which involve providing fertilizer, a forward contract, a loan, an insurance or any other transaction are a promise for the future in exchange for something at present. To enforce these contracts or promises, it is necessary to leverage long-term relationships based on trust.

17. For example, according to Giacomo Celi, Mercon Coffee Group is better positioned to offer hedging to longstanding clients. To engage farmers in strong, long-term relationships the company offers technical assistance and agronomic advice through their LIFT program, where a group of agronomists makes regular on site visits.

Conclusion

18. There is widespread concern about the access of farmers, especially smallholders, to financial services and price risk management tools (derivatives, OTCCs, insurance), which were discussed extensively throughout the Forum. Smallholders often do not have access to key risk management strategies to protect themselves from price shocks and market volatility. For smallholders, there are important barriers and costs to accessing these price risk mechanisms, such as **lack of awareness** and **financial literacy**. Financial institutions are faced with **high transaction** costs in providing services to scattered smallholder farmers. There is a profound information asymmetry between farmers and finance providers, resulting in an unfavorable risk profile of agricultural producers.

19. The **rise of new technologies and digital innovation** could achieve a positive impact on producers via various channels, including access to financial services. Introducing digital technologies to agricultural price risk tools also has the potential to reduce the barriers and transaction costs faced by farmers. For example, **drones** can be used to detect diseased crops, **mobile payments** can accelerate insurance claims and **satellite imagery** allows for the remote collection of weather data and facilitates the development of index-insurance products.

20. **Digital technologies** can also play an important role in **linking farmers to markets** and providing greater **market transparency.** By creating independent market places such as **digital platforms**, one can connect buyers and producers directly so as to fix their price based on relevant reference points (i.e. cost of production). Additionally, **mobile applications** can be used to cut out middlemen and link smallholders directly to buyers. Digital technologies and the access to the Internet could allow rural farmers to access **marketing and agricultural information** (information on farming best practices, market prices, weather forecasts and news events) and help them make more informed decisions to potentially increase their income by better aligning farm output to market demand.

21. The discussion also suggests that **farmer aggregation** into cooperatives is an effective way for smallholders to improve their access to financial services and also to factor and output markets. Pooling smallholder farmers' produce into cooperatives gives them a more reliable quantity of coffee and helps them reach new markets, thereby reducing transaction costs for buyers. Cooperatives improve farmers' access to market information, providing them with stronger bargaining power and economies of scale, which can increase the price received for their coffee and decrease the cost of inputs.

Additionally, they offer opportunities for adding value to their product (for example, giving farmers a share in milling or washing stations) with a positive impact on farmers' livelihoods.

22. Digital technology and farmer aggregation are **enablers of PRM access,** which are promising ways of permitting remote and small producers to connect to markets, plan their future production, which in turn would increase farmers' livelihoods and contribute to achieving a living income.

ANNEX

9TH CONSULTATIVE FORUM ON COFFEE SECTOR FINANCE

'EFFECTIVELY MANAGING PRICE RISKS IN THE COFFEE VALUE CHAIN: A RESPONSE TO THE COFFEE PRICE CRISIS'

09:30 – 9:45 **Welcome and keynote**

- Kirill Matrenichev, Chair of the Consultative Forum, Russian Federation
- José Sette, Executive Director, ICO
- Aly-Khan Jamal, Global Head of Agriculture & Food Security, Dalberg

09:45 – 11:00 **Panel 1: Innovation in price risk management at farm and cooperative level**

The objective is to review price risk management options available to smallholder farmers either individually or through cooperatives. The discussion will evolve around successful risk management tools employed in coffee and in other agricultural sectors, as well as new technology based solutions.

Moderator: Denis Seudieu, Chief Economist, ICO

- Florent Baarsch, Environmental & Climate Economist, West and Central Africa Division, International Fund for Agricultural Development (IFAD)
- Aly-Khan Jamal, Global Head of Agriculture & Food Security, Dalberg
- Sara Mason, Founder and Principal Consultant, SHIFT Social Impact Solutions
- Dominic Strano, Senior Investment Manager, IDH the Sustainable Trade Initiative
- Hugo Villela, Coordinator, Price Risk Management (PRM) Initiative

11:00 – 11:30 **Coffee break**

11:30 – 12:45 **Panel 2: Sharing price risks with economic agents along the value chain**

The discussion will identify ways of sharing price risks assumed by growers with supply chain actors, including coffee buyers and providers of agricultural inputs. The panel will explore ways of crowding-in value chain finance by reducing the perceived risks (including default risk) of providing credit to farmers through novel contractual arrangements, strengthened institutions and public guarantee schemes. Supply chain innovations such as direct trade will be assessed.

Moderator: Christoph Sänger, Senior Economist, ICO

- Hans Bogaard, Manager of Farmers Finance and Africa, The Netherlands Development Finance Company (FMO)
- Giacomo Celi, Sustainability Director, Mercon Group
- João Moraes, Global Crop Manager Coffee, Yara International ASA
- Rocco Macchiavello, Associate Professor of Management, Department of Management, London School of Economics (LSE)

12:45 – 13:00 **Concluding remarks: outcomes and next steps**

- Kirill Matrenichev, Chair of the Consultative Forum, Russian Federation