Document of

**COMMON FUND FOR COMMODITIES**

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# PILOT SHORT- AND MEDIUM-TERM FINANCE TO SMALL SCALE COFFEE FARMERS IN KENYA (CFC/ICO/20)

(To be financed under the Second Account)

## FINAL APPRAISAL REPORT

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Pilot Short Term and Medium Term Finance to Small-Scale Farmers in Kenya

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| **Broad goal**<br>Poverty alleviation in rural areas through improvement of coffee farmers standard of living | An increase in per capita income of coffee farmers participating in the target areas. | (a) National statistics; Data on production<br>(b) Demographic data, Records of land use. | (a) Prudent and stable macro-economic environment.<br>(b) Continuation of policy of poverty alleviation and modernisation of agriculture. |
| **Specific objectives**<br>(a) To promote a sustainable agricultural input-credit for coffee farmers;<br>(c) To improve productivity, yield and quality of coffee;<br>(d)To disseminate a sustainable input-credit system in other coffee producing countries | (a) Number of farmers receiving input credit.<br>(b) Good husbandry of coffee farms; Production of quality product; Yield improvement. | (a) Commercial banks reports; Data from farmers associations.<br>(b) Increase in production of good quality coffee.<br>(c) Increase in farmers' assets utilised for coffee production & processing. | (a) Stable and conducive land policy.<br>(b) Prices sufficient to compensate additional efforts and to generate surplus for loan repayment.<br>(c) Input and equipment prices maintained at a reasonable level. |
| **Outputs**<br>(a) Technically equipped farmers.<br>(b) Sustainable input-credit system developed.<br>(c) Enhanced quality productivity.<br>(d) Increased farmer's income. | (a) Number of farms equipped and well managed.<br>(b) Number of farmers utilising credit facilities and their repayment record.<br>(c) Increase in production per hectare.<br>(d) Increase in farmer's revenue net of repayments. | (a) Detailed survey on the impact of the project.<br>(b) Bank statistics.<br>(c) Government statistics.<br>(d) Farmers survey & interviews. | (a) Timely availability of credit and inputs<br>(b) Appropriate extension advise<br>(c) Coffee diseases are contained at tolerable levels.<br>(d) Improved rural infrastructure. |
| **Inputs and activities**<br>(a) Set up credit points for farmers.<br>(b) Purchase inputs.<br>(c) Carry out training programmes in crop husbandry and credit management.<br>(d) Monitoring and evaluation. | (a) Off take of inputs<br>(b) Number of training programmes conducted. | (a) PEA progress reports.<br>(b) Project evaluation. | (a) Availability of funds for monitoring and for purchasing inputs disbursed in time.<br>(b) Adequate supply of planting materials.<br>(c) Governments remain committed to enhance farmer incomes. |

## Project Location

## MAP


The colours, boundaries, denominations, and classifications in this map do not imply, on the part of the Common Fund for Commodities or its Members, any judgement on the legal status of any territory, or any endorsement or acceptance of any boundary. The projections used for maps may distort shape, distance, and direction.

## ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| AFC | Agricultural Finance Corporation |
| CBK | Coffee Board of Kenya |
| CFC | Common Fund for Commodities |
| ICO | International Coffee Organisation |
| IFAD | International Fund for Agricultural Development |
| KPCU | Kenya Planters' Co-operative Union |
| KTDA | Kenya Tea Development Board |
| NCPB | National Cereals and Produce Board |
| NGO | Non-governmental Organisation |
| PEA | Project Executing Agency |
| SCIP | Second Coffee Improvement Project |
| UNCTAD | United Nations Conference on Trade and Development |
| UNOPS | United Nations Office for Project Services |
| USD | United States Dollar |

## PROJECT SUMMARY

**Objective and scope of the project:** The central objective of the project is to increase the benefits to smallholder coffee farmers through the creation of a suitable and sustainable agricultural inputs credit scheme, i.e. to promote their access to credit for their inputs. The project comprises of the following components:

1. Study of previous experience with input credit systems in Kenya
2. Design of the loan structure and input delivery system in light of the requirements and previous experience
3. Provision of Technical Support to Coffee Producers in terms of general agricultural extension advice, quality control, drying and processing.
4. Capacity Building in credit appraisal and loan monitoring in the participating banks.
5. Provision of services for tracing, tracking and securing coffee along the processing chain.
6. Project Co-ordination

| | | |
|---|---|---|
| **Recipient of Grant** | **:** | International Coffee Organization |
| **Supervisory Body** | **:** | International Coffee Organization |
| **Project Executing Agency** | **:** | United Nations Office for Project Services (UNOPS) |
| **Location of Project** | **:** | Kenya |
| **Duration of Project** | **:** | Five years |
| **Estimated Total Cost** | **:** | USD 3,044,900 |
| **Financing sought from CFC** | **:** | USD 1,444,900 (Grant)<br>USD 1,000,000 (Loan) |
| **Counterpart co-financing** | **:** | USD 600,000 KPCU |

# I. INTRODUCTION

## A. PROJECT BACKGROUND

**Project concept**

1. During the Regional Round Table meeting on commodity development in Africa held in Cairo, Egypt from 8th-12th November 1999, it was noted with great concern by all participants that following the suspension of agricultural input credit schemes in most producing countries for (especially) the small producers partly due to trade liberalization policies implemented across Africa and the world at large, incomes of farmers have been drastically reduced. Agricultural Input Finance has been declining since the early nineties when countries started to liberalise and dismantle the commodity marketing boards which used to provide input credit to small producers. This decline or lack of input finance has led to reduced agricultural production, reduced yields, reduced emphasis on quality, reduced investment in the sector and reduced income for small producers. This is increasing poverty in most coffee producing countries in Africa. Most of the banks which entered the sector to fill the gap left by the Marketing Boards lost money because there was no reliable system of collecting loans advanced to small producers. The purpose of this workshop was to come up with new structured credit schemes for small producers that are suitable for the liberalised commodity markets. The main reason is that farmers cannot produce high quality coffee with high yield as they use less inputs now than in the past, when they were provided with credit with repayments in-built, in producer prices. Besides by the time the smallholder farmers realise revenues from the crop sold they have already incurred substantial expenditures during the course of a cropping season that these mainly get priority at the time they receive their incomes, relegating the inputs requirement to secondary needs - not because inputs are less important but rather because they are not of immediate importance at that time.

2. On the other hand, they are constrained to sell their crop immediately as they do not have any credit that could provide them room to negotiate a better price and avoid selling their crop in a short period of time after harvest.

**Consideration of the project by ICO**

3. Participants of the Regional Round Table Meeting on Commodity Development in Africa held in Cairo, Egypt 8 to 12 November 1999 identified input credit as a major constraint in enhancing production and productivity of coffee in producing countries, and as a result they recommended that CFC should be asked to finance projects on inputs and marketing credits in various countries. A draft project brief was prepared by the Tanzania Coffee Board and forwarded to CFC and ICO. Kenya Planter's Co-operatives Union also sent a project proposal to CFC and ICO. It was therefore considered that a regional project proposal for three countries including Uganda, Kenya and Tanzania should be prepared. During the first presentation of the project outline to the International Coffee Council held in May 2000, the Democratic Republic of Congo and Nigeria expressed their interest in joining the project and sent their draft proposals to the ICO.

**Consideration of the project by the Consultative Committee of CFC**

4. The project profile was submitted to the Common Fund for Commodities for consideration by its Consultative Committee. The Consultative Committee in its meeting held in July 2000 reviewed the project profile and recognised the importance of input credit financing in the context of poverty alleviation and sustainable commodity supply in the liberalized market environment. However, as the credit in agricultural sector has always been an area of high financial risk, the Consultative Committee recommended that a workshop be organised to investigate the problems encountered and to identify the measures to be taken with the involvement of other institutions.

**Salient points and recommendations of the workshop**

5. CFC funded a three day workshop in Nairobi, Kenya from 4 to 6 April 2001 in collaboration with International Coffee Organisation, PTA Bank and Kenya Planters Co-operative Union. The main objective of the workshop was to develop new structured schemes for small producers that were suitable for the liberalized commodity markets. Participants in the workshop included representatives from Kenya, Uganda, Tanzania, Nigeria, Democratic Republic of Congo. Côte d'Ivoire and Malawi. Representatives of IFAD and UNCTAD also participated.

6. The participants of the workshop noted the critical need of making input finance more accessible to the small-scale farmers. However, it was felt that ways of mitigating the inherent risks of financing the small-scale farmers need to be addressed. It was appreciated that Kenya was more advanced in structured finance for commodities especially coffee and could serve as a good site for implementing a pilot project in this respect. Consequently, the CFC requested Kenya to update the already submitted project document to incorporate the relevant recommendations of the workshop and also to provide additional information of the project components by including objectives and activities. The following points were raised at the workshop:

- Agriculture is important to African economies;
- Agricultural productivity in Africa has declined thus affecting the entire economy and increasing poverty;
- Liberalization process leading to collapse of domestic production and trading systems has exacerbated the decline;
- Lack of access to agricultural credit has been identified among the factors influencing decline in productivity;
- Input credit financing is a way to improve farm incomes and alleviate poverty;
- Need to mobilise local resources such as pension and insurance schemes to augment other credit sources;
- High interest rates deter borrowing by the agricultural sector;
- High interest rates on commercial loans;
- Lack of producer associations or weak ones where they exist;
- Group lending identified as a way of reducing transaction costs;
- Collateral based credit introduced in some countries to facilitate traders to enhance competitiveness;
- Politically motivated systems are not sustainable;
- Commercial banks require incentives to lend to agriculture.

To manage the risks, the workshop recognised that:

- Loan facilities that are linked to repayments proved to be the most effective as farmers who default do not get continuous support in subsequent years;
- Through the use of proper extension services arrangements, close farmer supervision, farmers ability to produce is enhanced;
- Through means of collateral management it is possible for financiers to provide a discount financing. It also mitigates the risks by capturing the entire flow of both physical commodity as well as receipts.

7. The Executive Board approved the project “Pilot Short Term and Medium Term Finance to Small Scale Coffee Farmers in Kenya”, as described in document CFC/EB/32/20 with a grant of USD 1,444,900 (equivalent to SDR 1,121,129) and a loan of USD 1,000,000 (equivalent to SDR 775,922) (Decision EB/XXXII/15). In approving the project the Board recommended that during project implementation links should be established with the Warehouse Receipt Projects and the Price Risk Management Projects being implemented with CFC support.

## B. OVERVIEW OF THE COFFEE ECONOMY IN KENYA

8. Coffee has been an important commodity in Kenya because of its contribution to foreign exchange earnings, farm incomes and employment opportunities. Coffee accounts for about 25 per cent of the total export earnings. It is a major source of income to many rural households. The rural based small-scale farmers account for 70 per cent of the total production with their farms occupying approximately 123,000 hectares of land and supporting directly 300,000 households. Over the recent years, coffee’s contribution to the economy has diminished. Coffee production in Kenya has declined in the last 10 years. The current level of production is only 60 percent of what it was in 1987/88. In 1999/2000 coffee contributed only 9% of the foreign exchange earnings. This sharp decline in coffee contribution was a result of both the decline in world prices as well as the decline in production.

9. Of the 70% of the workforce employed in the agricultural sector, coffee accounts for approximately 30%. Kenya is a small participant in the world coffee production, producing less than 2 per cent of the world coffee output. Both small-scale (co-operatives) and large-scale (estates) produce coffee in Kenya. The smallholder sector is about 76 per cent of the national area under coffee. However, its yields are lower than in estates and consequently, the contribution to the national production is limited to about 55 per cent. The last five-year average is calculated at 49,500 tons of coffee for the small-scale coffee farmers.

10. This decline in production of coffee is more pronounced in the small-scale farms than the coffee estates mainly due to lack of agricultural credit for the small-scale farmers. The recent legislation has given small estates (these of about 5-7 acres) a greater measure of freedom, both in processing and bringing their coffee to market. The small-holder farmers are still obliged to work through their co-operatives. Some of the co-operatives have been working well as is seen by the good quality coffee in the auction. However, the difficulties relating to payments actually reaching farmers, and past indebtedness continue to vex the producers.

## C. THE RELATION OF THE PROJECT TO THE OBJECTIVES AND POLICIES OF THE COMMON FUND'S SECOND ACCOUNT

11. The project has been designed to address farmers' husbandry and marketing problems that prevent them from taking an active and profitable role in coffee industry. The results of the proposed pilot project will not only assist Kenya but also the other coffee-producing developing countries in Africa, particularly least developed countries, to function effectively in a liberalized global economy. The measures to be introduced will enhance the participation of small scale farmers in the coffee industry and increase their earnings from coffee production and marketing. This will be achieved through better quality of coffee as a result of availability of critical farm inputs and higher yields and enhanced production enabling the efficient use of land resources.

12. The policy, in particular its micro-policy aspects, will focus on operational measures to: strengthen farmers' institutions, including human resource development and to expand agricultural credit system, so that the foundations will be laid for more effective production and marketing of coffee in the future.

## D. CONSISTENCY OF THE PROJECT WITH ICO STRATEGY FOR COFFEE DEVELOPMENT

13. In its development strategy (ICO document no. EB-3531/95 Rev.2), the ICO recognises that with the transition in many exporting countries to liberalized coffee sectors care is needed to ensure that the benefits of increased market flexibility are not jeopardised by the elimination of necessary functions undertaken by the marketing boards and similar regulatory bodies. It agrees with the generally held notion that the longer-term development objective of these countries should be a reduction of their excessive dependence on primary commodities, by diversification into industrial development. It accepts that the attainment of their long-term development objectives has been more difficult due to prolonged depressed commodity prices, particularly for coffee. In order to create a more favourable atmosphere for economic restructuring and development, the ICO has included the following objectives in the core of its development strategy: reduction of short-term excessive fluctuations in coffee prices and export earnings; improvement of market access and reliability of supply; the improvement of market structures and enhancement of the participation of producing countries in the marketing, transporting and distribution of their commodity exports. The proposed project includes concrete actions that need to be taken to achieve these core objectives of the long-term coffee development strategy.

## E. INSTITUTIONS INVOLVED AND RESPONSIBILITY

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# II. PROJECT DESCRIPTION – INTEGRATED INPUT CREDIT SCHEME

## A. PROJECT RATIONALE AND OBJECTIVES

### Project Concept

14. The pilot project is seeking to build an Integrated Input Credit Scheme that establishes direct links between the farmers and the financial institutions. To enhance the capacity of the farmers cooperatives it incorporates agricultural extension and strengthening of the management of cooperatives as it integral part. Further to enhance the confidence of the financial institutions it would enhance the capacity of the financial institutions in credit appraisal and loan monitoring. The key to the success of this pilot scheme is the ability of the financial institutions to monitor and control the movement of cash and coffee during the production, processing and marketing cycle. The project will build the capacity of the institutions involved to assess the needs of the farmers and extend loans and provide appropriate extension services. It would also build the capacity of the institutions to control and monitor movement of cash and coffee by establishing a computer based tracking system.

**The Existing Lending Structure in Kenya**

15. Currently commercial banks extend loans to the coffee sector through the coffee factories which on-lend to coffee farmers. The reason why banks prefer to finance at factory level is because the factory owners guarantee the repayment of loans and also provide additional security desired by the banks. It is at this stage that coffee has entered a commercial cycle and acquired a monetary value. The coffee factories provide security to the financial institutions in the form of parchment coffee or land and buildings. Except for large corporate owned estates, commercial banks do not provide input credit to coffee farmers directly.

## Project objectives

16. The project objectives are:

(i) To extend credit to farmers and co-operatives to purchase inputs to enable them to produce coffee in the most cost effective and efficient manner.

(ii) To develop and implement strategies of minimising performance risks – failure to produce sufficient quantity of coffee, credit risk, weather risk (developing assured irrigation), and price risk to reduce the overall risk of the lending institution and cost of borrowing to farmer/cooperative.

(iii) To build credit assessment and loan monitoring capacity of the participating banks in the area of agricultural lending to enable them to carry out credit risk assessment of eligible farmers or co-operatives and to identify suitable borrowers for the pilot.

(iv) To introduce the use of services for tracing, tracking and securing coffee along the supply chain as part of the loan conditions in order to reduce the risk of lending for the financial institution and to reduce transaction costs for the lending institutions.

(v) To encourage the use of hedging tools for price risk management by coffee factories and lending banks and to link the project to other Common Fund Project on Coffee Price Risk Management.

17. The core of this project is to have targeted disbursement of loans to the farmers and co-operatives and to monitor the application and repayments of such funds. The monitoring would cover coffee from the plantation through the processing stages until the Auction. The success of the scheme will depend on the ability of the farmers to produce sufficient quantity of coffee to meet their financial obligations and the ability of the banks to control and monitor the physical movement of coffee by tracing, tracking and securing coffee along the chain. The scheme will establish Critical Control Points at each stage of the process chain. These will include check on quantity of coffee cherry delivered to the Washing Stations (owned by the co-operatives or individual farmers) and quantity of parchment coffee obtained after drying the coffee. Control will also be exercised on quantity of green coffee obtained after milling. The standard ratio in Kenya is 5kgs of cherry = 1kg of parchment = 800 grams of finished green coffee. The system will also monitor deviations from this standard. Besides keeping check on the physical quantities, scheme would also determine procedures for tracking of identity of coffee from each co-operative/farmer so as to obviate mixing of lots and premiums for good quality coffee.

**What is new in this Pilot Scheme?**

18. The Integrated Input Credit Scheme will establish direct relationship between the farmers and their co-operatives and commercial banks. The scheme will empower farmers to choose their own supplier of agricultural input instead of the current system where the loan provider (Coffee Factory) determines the supplier from whom inputs are to be purchased. The scheme will introduce services for tracing, tracking and securing coffee along the coffee chain for the lending banks to enable them to monitor and control the coffee movement. For enhancing sustainability, the project will build the capacity of lending banks and providers of technical assistance to the farmers by enhancing their capacity with training and equipment. It is envisaged that the scheme will introduce a smart card (like a credit card) which would contain all the relevant information about the farmer who is taking a loan, i.e. identity, amount of loan, repayments, plantation size, input requirements. The card will be updated each time a transaction takes place e.g. delivery of coffee, purchase of inputs. The introduction of smart cards is likely to greatly reduce the administrative costs of the participating banks.

**Service Providers**

19. The project will identify and contract the services of various service providers to support the farmers in a sustainable way. The project would also assist in building capacity of some of the service providers and to train them to understand and implement the proposed input credit scheme. The services required can be classified under the following main components:

(i) Provision of technical support to coffee producers in terms of agricultural extension advice, quality control, drying and processing. This support will be provided by Extension Officers from KPCU and Coffee Research Foundation to the farmers and co-operatives.
(ii) Capacity building in credit appraisal and loan monitoring in the participating banks. Training bank officers on the fundamentals of agricultural lending and coffee crop and plantation valuations.
(iii) Provision of Services for tracing, tracking and securing coffee along the coffee processing chain. Assisting banks in monitoring the movement of coffee from plantations of the financed farmers/co-operatives to the Coffee Auction.
(iv) Project Co-ordination – A proper management and tracking system has to be developed to manage the Integrated Input Credit Scheme. The management will be housed in the existing institutions to enhance their long term management capacity.

## B. PROJECT COMPONENTS

20. Two pre-project implementation studies were scheduled to be carried before commencement of the full implementation of the project. Study No. 1 and Study No. 2 were carried out before the project components were designed.

**Study No. 1: Study of previous experience with input credit systems in Kenya**

**Objective:** Review the previous assistance and operational performance of credit schemes for the coffee sector in Kenya:

- previous assistance and operational experience of that assistance;

- problems encountered and suggested solutions.

**Output:** A report summarising past experiences has been completed. A summary of the report is at Annex I.

**Inputs:** The cost of this component is **USD 25,000**

**Timing:** Three months at the beginning of the project.

**Study No. 2: Design of the loan structure and input delivery in light of requirements and experience**

**Objective:** To design a loan scheme to be operated through a financial intermediary.

**Output:** A loan proposal specifying the loan scheme, draft loan agreement and draft loan implementation agreement with a local financial institution. The proposal containing sample business plans, income statements for borrowing farmers demonstrating viability of the investments proposed, the number of farmers targeted and the estimated size of the loans, total loan volume over the project period and manner of repayment of the loan. A report elaborating the above has been prepared but the proposed loan scheme is to be modified to the situation on the ground in Kenya. Annex II contains the summary of recommendations made by the consultant.

**In-puts:** The cost of this component is **USD 40,000.**

**Component 1** Selection of Bank(s)

**Objective –** To identify and select a suitable bank(s) to participate in the project.

**Output –** Suitable Bank(s) identified

1.1 Identify Bank(s) engaged in agricultural lending with outreach in coffee growing areas
1.2 Evaluate their ability to engage in the project
1.3 Select suitable Bank(s)

**In-put:** The cost of this component is USD 18,000

**Component 2** – Provision of Technical Support to Coffee Farmers and Co-operatives participating in the pilot project – To be implemented by Agricultural Support Services Provider i.e. KPCU, Coffee Research Foundation and others

**Objective** – To increase the productivity, efficiency and improve quality of coffee produced by coffee farmers.

**Output** – An increased output in terms of volume and quality of coffee produced per hectare.

2.1 Provision of crop husbandry and other agricultural extension support to 15 Co-operatives, 100 Small Coffee Estates and 25 Medium size coffee estates by 18

Coffee Extension Officers.

2.2 To help farmers run co-operatives as viable businesses by making them aware of their role in the management of co-operatives.
2.3 Provision of management support to co-operatives and farmers in the area of corporate governance, management of credit and enhancing basic business management capabilities. Capacities of the cooperatives to provide extension support to farmers will also be strengthened.
2.4 To provide Curing Factory Management training in quality control management, warehousing and inspection.
2.5 Educate farmers on application and use of inputs
2.6 To collect, verify and collate farm statistics in the project location in order to compare the information with the baseline situation at the commencement of the project.

**Total Component Cost – USD 1,065,000**

**Component 3** – Building the Credit Appraisal and Loan Monitoring Capacity of Commercial Banks – To be implemented by the Credit Analyst/Loan Monitoring Specialist.

**Objective** – To assist banks in establishing professional agricultural lending practices.

**Output** – Growth of portfolio of loans for the coffee sector and the development and incorporation of appropriate agricultural lending practices in the functioning of banks.

3.1 Determine and agree on the lending and the credit monitoring terms between the farmers, co-operatives and the commercial bank(s).
3.2 Evaluate the capacity of the commercial bank to conduct credit appraisal and monitoring of agricultural loans.
3.3 Assist banks in setting up the agricultural credit appraisal and monitoring system.
3.4 Training officers of the participating banks in credit appraisal, monitoring and evaluation of agricultural loans.

**Total Component Cost – USD 237,000**

**Component 4** – Provision of Services for tracing, tracking and securing coffee along the coffee chain – To be implemented through a suitable entity to be identified.

**Objectives** – To document, monitor and control the movement of coffee from farm to auction and to monitor the payment to farmers after auction within the Integrated Input Credit Scheme.

**Output** – A functioning tracing, tracking and securing system from production, processing to auction.

4.1 Design a suitable tracing, tracking and securing system, which is compatible with the Integrated Input Credit Scheme.
4.2 Identify a tracing, tracking and securing company and negotiate a service agreement that specifies costs and responsibilities.
4.3 Design and install a coffee tracing, tracking and securing system.
4.4 Develop training manuals for tracing, tracking and securing services.

4.5 Promote the system to other banks and for other commodities.

**Total Component Cost – USD 120,000**

**Component 5** – Provision of Input Credit to Farmers and Co-operatives – To be implemented by one or two commercial banks.

**Objective** – To assist farmers to access input finance at reasonable credit terms and to establish a direct relationship between farmers, co-operatives and the commercial bank.

**Output** – Improved productivity from farmers with access to credit, savings accounts and technical support services.

5.1 Negotiate and enter into a Loan Agreement between the identified commercial bank or banks with a branch network in the coffee growing areas and the Common Fund.
5.2 Design the loan disbursement and repayment schedules between the banks and farmers/co-operatives that are in consonance with the crop cycle.
5.3 Elaborate and agree on the loan monitoring and the reporting requirements between the farmers/co-operatives and the lending bank.
5.4 Analyse the farmers/co-operatives input financing requirements and agree on the selection criteria for the farmers/co-operatives that will participate in the scheme.
5.5 Develop suitable contractual arrangements between banks, farmers/co-operatives, curing factories and marketing agents which takes into account tracking, tracing and securing needs for management control
5.6 Design suitable instruments like the promotion and use of a smart card that reduce the administrative cost of the loan.
5.7 Document the performance of the loan in terms of costs, interest rate, defaults and other relevant statistics.

**Total Component Cost – USD 1,215,000**

**Component 6** - Project Management, Monitoring and Implementation – To be implemented by the National Project Co-ordinator and the Project Executing Agency

**Objective** – To ensure that project resources are properly directed to meet the project objectives in the most cost effective and efficient manner.

**Output** – A well documented pilot Integrated Credit Scheme which can be transferred and disseminated to other banks, commodities and countries.

6.1 Provide overall leadership of the project by embracing the project vision and objectives.
6.2 Appoint the National Project Co-ordinator with the capacity, vision and skill to implement the project.
6.3 Strengthen the local capacity of collaborating institutions to co-ordinate project activities. The project will enter into a Memorandum of Understanding (MOU) with each of the collaborating institutions that specifies the relationship, duties and responsibilities of each party including the support be provided to the

collaborating institution by the project.

6.4 Enter into Contract with Service Providers of (i) agricultural technical services, and (ii) tracking, tracing and securing entities and the Commercial Bank.

6.5 Mobilise additional loan funds from local banks and use the CFC loan as leverage to raise additional money for the scheme.

6.6 Analyse the results of the project and prepare reports for dissemination of the results.

6.7 Prepare Annual Work Plans and Budgets and closely monitor project implementation.

6.8 Prepare regular progress reports, a mid-term evaluation report, annual accounts, and audits and project completion report.

**Total Component Cost – USD 407,900**

## C. BENEFITS AND BENEFICIARIES

21. The project would result in benefits to farmers and the government. Farmers will receive support to buy inputs and better manage their crop that will enable them in producing quality coffee that can attract better prices. Traders, exporters and processors will benefit from an improved organisation of coffee farmers. The country will benefit from incremental earnings resulting from enhanced quality production. This project may be a prelude to other sub-sectors in agriculture and its spill-over effects may start a whole chain of activities geared towards ensuring credit to smallholder farmers in Africa.

# III. ORGANIZATION, MANAGEMENT AND IMPLEMENTATION OF THE PROJECT

### Proposed Management Structure

22. It is envisaged that UNOPS as the Project Executing Agency will implement the project activities through a National Project Co-ordinator (NPC) preferably to be based in the Participating Bank. The NPC will be appointed by UNOPS and will report to UNOPS. The National Project Co-ordinator will be assisted by specialists appointed by UNOPS and seconded to the collaborating institutions like KPCU, Commercial Banks and companies responsible for tracking and securing commodities. The following experts are foreseen in the project, an Agronomist, a Credit Analyst, IT Specialist and a Loan Monitoring Officer. The NPC will receive and collate the work plans and budgets from the collaborating institutions in terms of the Project Implementation Agreements entered between the PEA and the Collaborating Institutions. The Annual Work Plans and Budgets will be approved by the SB and CFC.

23. To ensure timely review of the project outcome, the PEA will prepare half yearly reports that will also be presented to ICO/CFC highlighting the project milestones vis-à-vis the expected deliverables.

24. The human resources committed under the above mentioned structure will be complemented by Co-operative Extension Officers and Agricultural Extension Officers dedicated to the project from the governments and quasi government agencies.

## A. PROJECT MONITORING, SUPERVISION AND EVALUATION

25. The Common Fund will monitor and supervise the project. The Fund will receive and review progress reports prepared every six months and make annual supervision missions to the project. The Common Fund will approve annual work plans and budgets for the Integrated Input Credit Scheme. The International Coffee Organisation as the Supervisory Body is expected to review annual work plans and budgets, progress reports and to carry out annual supervision of the project activities. A final project evaluation will be carried out at the end of the project. It is expected that the project results will be shared with other African countries during and after the project.

## B. PROJECT RISKS

### General

26. The major risks involved in this project are the possibility that some of the fundamental assumptions made are not fulfilled mainly that:

a) The country continues to adopt prudent and stable macro-economic environment;
b) The country continues to pursue the policy of poverty eradication and modernisation of agriculture;
c) The country continues to be politically stable;
d) The government continues to provide a supportive policy, legal and regulatory framework.

27. In addition to the above, there are other associated risks in lending to the farmers which include:

- Uncertain weather trends
- Price fluctuation of the commodities on the international market;
- Crop disease's
- Performance Risk
- Risk of Loss of Coffee Stocks

### Uncertain weather trends

28. One of the key risks in the coffee industry, as in any agricultural commodity, is the weather risk. It should be borne in mind that the coffee growing areas are designated along both topological as well as climatological lines. The degree to which weather trends may vary from year to year is fairly consistent on an average. The importance of recognising this risk is based on the structure of the financing being sought. The short-term working capital finance should be flexible to allow for the use of in-flows (sales proceeds) expected from the two or even three seasons as opposed to one season.

29. Whilst certain countries have a form of crop insurance covering the entire crop, there is need to develop insurance covers that are independent from those provided by quasi government institutions.

**Price Fluctuation**

30. The volatility of coffee prices make planning a very difficult task indeed. Hedging instruments that are presently available are high cost. It is noted that CFC has its institutional mechanisms of hedging exposure of volatility and that under the funding lines available farmers and other financiers will begin to obtain comfort from the same.

**Crop Disease**

31. Coffee Disease has a major effect on coffee productivity because of the amount of money used to prevent diseases. However, recent developments of antidotes for common coffee decease have reduced the risk of disease significantly. This has been evidenced by the industry's ability to 'ring-in' common ailments such the coffee berry disease before any catastrophe occurs.

**Performance Risk**

32. The commercial risk of repayment for the funds being lent to the farmers exists. Traditional forms of lending have consistently relied on land as collateral for credit. In order to overcome this risk the structure for lending that has been proposed ensures that the appraisal, approval, disbursement and collection of loans is undertaken by skilled personnel in all areas of agricultural lending. Through the employment of the UNOPS capacity and the support of the respective coffee regulatory institutions recovery of loans will be closely monitored in order to ensure performance and to initiate timely remedial actions.

**Risk of Loss of Coffee Stocks**

33. There is a risk that loss of cherry or clean coffee through theft or natural calamity may result on the inability by the farmers to repay their loans. This risk can be mitigated through insurance covers, which can be obtained from the market.

## C. PROJECT COST AND FINANCING

**Budget Assumptions**

(a) The project will cover 1,625 farmers based on the following categories:

(i) Small and Medium Scale Estate Farmers

- Between 5 and 10 acres of coffee bushes — 100 farmers
- Between 10 and 20 acres of coffee bushes — 25 farmers

(ii) Co-operatives

- 100 farmers, each drawn from 15 Co-operative Societies to be selected in the coffee growing regions in Kenya — 1,500 farmers

Total — 1,625 farmers

(b) The project will establish a satellite stations in 18 locations thus one close to each of the

15 Co-operative and 3 to cater to the Small and Medium Scale Estate Farmers.

(c) The project will establish a Wide Area Network with 18 Workstations located close to the project sites.

(d) The equipments will be used to strengthen the capacity of Service Providers.

(e) The Common Fund will provide a loan of up to USD 1 million to one or two banks working with the project.

(f) Average coffee yield per hectare in cherries Smallholders - 4,400kgs; Estates – 6,250kgs.

(g) Average coffee yield per hectare in parchment coffee – 690kgs – smallholders and 1,250kgs – Estates giving an average of 940kgs per hectare.

(h) Average coffee yield per hectare in Green coffee – smallholder – 550kgs, Estates - 1,000kgs giving an average of 750kgs per hectare.

(i) The cost of production is estimated to be USD 500 per hectare for small producers and USD 1,000 for estates if they use the recommended production inputs. It is recognised that most coffee producers are no longer using the recommended inputs because of the low coffee prices.

PILOT SHORT AND MEDIUM TERM FINANCE TO SMALL SCALE COFFEE FARMERS IN KENYA

TABLE 1

**Summary Project Cost by Category of Expenditure**

| **Category** | **Total Cost**<br><br>**USD** | **CFC Contribution USD** |
|---|---|---|
| I – Vehicles, Machinery and Equipment | 251,000 | 251,000 |
| II – Civil Works | 0 | 0 |
| III – (a) Materials and Supplies - Grant | 55,000 | 55,000 |
| (b) Materials and Supplies – Loan | 1,000,000 | 1,000,000 |
| VI – Personnel * | 981,000 | 381,000 |
| V – Technical Assistance | 68,000 | 68,000 |
| VI – Duty Travel | 100,000 | 100,000 |
| VII – Dissemination and Training | 192,000 | 192,000 |
| VIII – Operational Costs | 160,000 | 160,000 |
| IX – Monitoring and Evaluation | 90,000 | 90,000 |
| X – Contingencies | 40,870 | 40,870 |
| XI – PEA Management Fees | 107,030 | 107,030 |
| Total Project Cost | 3,044,900 | 2,444,900 |

* Kenya Planters Co-operative will provide in kind contribution of USD 600,000 in the form of staff costs of Extension Officers.

TABLE 2

**Summary Cost Table by Components in USD**

| **Project Component** | **Total Cost** | **CFC Contribution** |
|---|---|---|
| 1. Selection of Banks | 18,000 | 18,000 |
| 2. Provision of Technical Support to farmers | 1,065,000 | 465,000 |
| 3. Building the credit appraisal and loan monitoring capacity of Commercial banks | 237,000 | 237,000 |
| 4. Provision of Collateral Management and Inspection Services | 120,000 | 120,000 |
| 5. Provision of Input Credit to Farmers and Co-operatives by Commercial banks – USD 1 million as a loan | 1,215,000 | 1,215,000 |
| 6. Project Management, Monitoring and Implementation and contingencies | 389,000 | 389,000 |
| **Total** | **3,044,900** | **2,444,900** |

TABLE 3

**Summary Financing Plan by Component and Source in USD**

| Component | CFC | Counterpart | Total Cost |
|---|---|---|---|
| 1. Identification of Bank(s) | 18,000 | - | 18,000 |
| 2. Provision of Technical Support to farmers | 465,000 | 600,000 | 1,065,000 |
| 3. Building the credit appraisal and loan monitoring capacity of Commercial banks | 237,000 | 0 | 237,000 |
| 4. Provision of Collateral Management and Inspection Services | 120,000 | 0 | 120,000 |
| 5. Provision of Input Credit to Farmers and Co-operatives by Commercial banks – USD 1 million as a loan | 1,215,000 | 0 | 1,215,000 |
| 6. Project Management, Monitoring and Implementation and contingencies | 389,900 | 0 | 389,900 |
| **Total** | **2,444,900** | **600,000** | **3,044,900** |

## TABLE 4 DETAILED BUDGET TABLE

| CFC | UNOPS BL | COFFEE PILOT KENYA | 2005 | 2006 | 2007 | 2008 | 2009 | TOTAL |
|---|---|---|---|---|---|---|---|---|
| **I** | | **Vehicles, Machinery and Equipment** | | | | | | |
| | 4201 | Computers and Servers - Wide Area Network | 94,000 | | | | | 94,000 |
| | 4203 | Office Furniture -Filing Cabinets etc | 4,000 | | | | | 4,000 |
| | 4204 | Photocopiers | 3,000 | | | | | 3,000 |
| | 4207 | 3 Vehicles[1] (double cabin pickup trucks) | 75,000 | | | | | 75,000 |
| | 4208 | 18 Motor Cycles [2] | 63,000 | | | | | 63,000 |
| | 4209 | Other Misc. equipment [3] | 10,000 | 2,000 | | | | 12,000 |
| | | Sub-Total | 249,000 | 2,000 | - | - | - | 251,000 |
| **II** | | **Materials and Supplies** | | | | | | |
| | 4102 | Software - Credit System | 30,000 | | | | | 30,000 |
| | 4105 | Technical Materials | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 10,000 |
| | 4206 | Other Materials | 3,000 | 3,000 | 3,000 | 3,000 | 3,000 | 15,000 |
| | | Sub-Total | 35,000 | 5,000 | 5,000 | 5,000 | 5,000 | 55,000 |
| **III** | | **Personnel** | | | | | | |
| | | | | | | | | - |
| | 1101 | National Project Co-ordinator | 24,000 | 24,000 | 24,000 | 24,000 | 24,000 | 120,000 |

[1] 1 National Project Co-ordinator, 1 Agronomist, 1 Training Manager/ Credit Analyst

[2] 18 Extension Officers

[3] Misc. Equipment for the 18 workstations (supplementary)

| CFC | UNOPS BL | COFFEE PILOT KENYA | 2005 | 2006 | 2007 | 2008 | 2009 | TOTAL |
|---|---|---|---|---|---|---|---|---|
| | 1101 | Agronomist | 18,000 | 18,000 | 18,000 | | | 54,000 |
| | 1101 | Training Manager / Credit Analyst | 18,000 | 18,000 | 18,000 | | | 54,000 |
| | 1101 | IT Specialist | 24,000 | 24,000 | | | | 48,000 |
| | 1101 | Loan Monitoring Officer | 18,000 | 18,000 | 18,000 | 18,000 | 18,000 | 90,000 |
| | 1302 | Driver | 3,000 | 3,000 | 3,000 | 3,000 | 3,000 | 15,000 |
| | | Sub-Total | 105,000 | 105,000 | 81,000 | 45,000 | 45,000 | 381,000 |
| V | | **Technical Assistance** | | | | | | |
| | 1151 | International Consultant | 58,000 | | | | | 58,000 |
| | 1152 | Consultant TA and DSA | 10,000 | | | | | 10,000 |
| | 2101 | Sub contracts | | | | | | - |
| | | Sub-Total | 60,000 | - | - | - | - | 68,000 |
| VI | | **Duty Travel** | | | | | | |
| | 1601 | Travel Costs | 23,000 | 23,000 | 18,000 | 18,000 | 18,000 | 100,000 |
| | | Sub-Total | 23,000 | 23,000 | 18,000 | 18,000 | 18,000 | 100,000 |
| VII | | **Dissemination and Training** | | | | | | |
| | 3101 | Local Training [4] | 36,000 | 36,000 | 18,000 | 18,000 | 9,000 | 117,000 |
| | 3102 | Training External | | | | | | - |
| | 3106 | Regional Workshop | | | 25,000 | | | 25,000 |
| | 3103 | Documentation | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 10,000 |
| | 3104 | Meeting Support Services | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 10,000 |

[4] Local training on various aspects of the project

| CFC | UNOPS BL | COFFEE PILOT KENYA | 2005 | 2006 | 2007 | 2008 | 2009 | TOTAL |
|---|---|---|---|---|---|---|---|---|
| | 3105 | Training Trainers | 15,000 | 15,000 | | | | 30,000 |
| | | Sub-Total | 55,000 | 55,000 | 47,000 | 22,000 | 13,000 | 192,000 |
| | | | | | | | | |
| **VIII** | | **Operational Costs** | | | | | | |
| | 4301 | Farmer Extension - Credit & Technical Support | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 100,000 |
| | 5101 | Car and Motorcycle maintenance, fuel and insurance and maintenance of other equipment* | 8,000 | 8,000 | 8,000 | 8,000 | 8,000 | 40,000 |
| | 5201 | Reporting Costs | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 10,000 |
| | 5301 | Sundries | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 10,000 |
| | | Sub-Total | 32,000 | 32,000 | 32,000 | 32,000 | 32,000 | 160,000 |
| | | | | | | | | |
| **IX** | | **Monitoring and Evaluation** | | | | | | |
| | 5202 | Project Launching | 10,000 | | | | | 10,000 |
| | 5202 | Monitoring and Evaluation CFC & ICO | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 | 25,000 |
| | | Mid-Term Evaluation | | | 25,000 | | | 25,000 |
| | | Final Evaluation | | | | | 30,000 | 30,000 |
| | | Sub-Total | 15,000 | 5,000 | 30,000 | 5,000 | 35,000 | 90,000 |
| **X** | | | | | | | | |
| | | **Contingencies** | | | | | | |
| | 5390 | Contingency | 13,000 | 5,000 | 6,000 | 6,000 | 18,870 | 40,870 |
| | | Sub-Total | 13,000 | 5,000 | 6,000 | 6,000 | 18,870 | 40,870 |
| | | | | | | | | |
| | | Total Budget | 592,000 | 237,000 | 219,000 | 131,000 | 166,870 | 1,337,870 |
| | | | | | | | | |
| **XI** | | **PEA Supervision and Monitoring** | | | | | | |
| | | Management Fees 8% | 46,320 | 18,560 | 17,840 | 10,960 | 13,350 | 107,030 |
| | | | | | | | | |
| | | **Total and Management Fees** | 625,320 | 250,560 | 240,840 | 147,960 | 180,220 | 1,444,900 |

* UN Rates for use of Cars – currently 12.4 cents per km for motor vehicle 1,444,900

**Annex 1**

## SUMMARY OF PREVIOUS EXPERIENCES IN KENYA BY 1ST CONSULTANT

Small-scale farmers produce 60% of the coffee produced in Kenya while the plantation estates account for 40% of the production. Over a period of 30 years, coffee production increased from a paltry 2000 tons to over 129,000 tons in 1987/88. This increase in production was mainly due to the success of small holder coffee farms introduced at the independence of the country. This was supported by an efficient and well-manned extension service in addition to subsidised coffee seedlings and farming inputs. After the peak of production of some 129,000 Mt in 1987/88 coffee production fell attributed either singularly or by combination of the following factors:

- Droughts and erratic rainfall patterns;
- High cost of inputs and agro-chemicals;
- Lack of financing for inputs and when available only at prohibitive interest rates;
- High processing costs;
- High labour costs;
- High transaction costs by organisations processing and marketing coffee

Though lack of access to credit has always been a factor hampering production, the adoption of the liberalisation policies have exacerbated the problem because it led to the suspension of agricultural input credit schemes in most producing countries thus impacting negatively on the small holder producers. In addition, liberalisation has led to an increase in the cost of inputs and also an increase in the cost of credit from commercial banks. Small-scale farmers thus are unable to access credit at critical times resulting in reduced yields and lower quality of production. Lack of lending institutions that understand the socio-economic circumstances have left a major financing gap to producers.

Commercial banks lack schemes that could accommodate the long periods of time between the investment (husbandry), harvesting or picking, processing and marketing of coffee, which extend between 6 to 10 months before receipt of sales. Small-scale farmers have also been unable to self-finance farm operations due to fluctuating and often low prices, which have led to serious economic difficulties. Due to the high dependency of households on agriculture in meeting their household requirements such as food, medical, health and water, the households are unable to save earning from agriculture that would be re-invested back the following season.

**Existing sources of input finance**

The banking sector has traditionally shied away from lending to agriculture in general particularly due to the perceived and real inherent risks in agriculture. These are mainly uncertain weather trends, price fluctuation on the international market, crop diseases and uncertain policy environment. In order to ensure that the agricultural sector enjoyed the support of banks, the Central Bank of Kenya has over the past two and half decades ensured that an average of between 20 and 30% of the bank lending assets were in support of agriculture. Due to the risks identified above, a number of banks have found it difficult to rely on the farm produce as a source of comfort in lending criteria. This has increasingly led to an “asset” based lending approach by banks who lend mainly on the additional comfort derived from security rather than the underlying transaction cycle of the “crop to sales” approach.

Commercial banks that would support the agricultural sector rarely observe the set statutory requirements. An example of this is sighted in the lending made to coffee exporters, which has erroneously qualified as "agricultural lending" as opposed to being reported as "traders" in commercial bank returns to the Central Bank. By lending to coffee traders and exporters many banks have reported these assets as falling within the definition of "lending to the agricultural sector" for compliance purposes. This flawed approach by the banks has made it more difficult for small-scale farmers to obtain credit directly from banks. It is notable that, even though it is an acknowledged fact that agriculture plays a dominant role in the economy, the banking sector continues to release minimal support to the sector. Notwithstanding that the agricultural sector contributes over 30% of the GDP, lending by commercial banks to the agricultural sector stands at a mere 5.35% of the total lending assets to the private sector in 1998. The total incremental lending to agriculture stood at 10.8% compared to manufacturing (17.8%), trade (16.5%), other activities (13.9%) and building and construction at 13.3% over the past 12 months to August 1998. Thus the actual lending to small-scale farmers directly is actually minimal given the reporting methods employed by some banks.

**Commercial banks** The commercial bank that provides significant input finance to small-scale farmers is the Co-operative Bank of Kenya. Kenya Commercial Bank Ltd. is also providing credit in a limited way. Statistics reveal that commercial banks have forsaken this aspect of agricultural lending preferring to lend toward the commercial and marketing aspects of the value-added chain. Commercial banks in Kenya have a very limited exposure to agricultural input.

**The Co-operative Bank of Kenya** lends for inputs, factory development, electrification and crop advances to the small-scale farmers. The bank lends the money to the farmers through their co-operative society after receiving an undertaking from the Coffee Board of Kenya that covers the entire borrowing supported by the assignment of payments from the small-scale farmers. The marketing agent, Coffee Board of Kenya remits to the Co-operative Bank of Kenya receipts of the auction sales proceeds less statutory deductions and milling charges. Notably, co-operatives societies are required to cover the repayment and take the necessary pro-rata recoveries from members. Following the liberalisation of the coffee sector the Coffee Board of Kenya is now just a regulatory body, which does not take part in the coffee marketing. There are now three marketing agents, which bring coffee to the auction.

**Kenya Commercial Bank limited** has special loan schemes targeted at various sectors of the economy. One such scheme is the small-scale tea and coffee farmers loan scheme. The scheme was started in July 1995 and allocated Kshs.1.35 billion. The loan facility is available to small scale farmers who wish to develop a minimum of two acres of tea or coffee and for those who already have one or more acres under tea/coffee and wish to increase their acreage up to a maximum of five acres. The funds may be utilised for initial farm preparations, purchase of seedlings and labour costs. The loan bears interest of 0.5% above bank's base rate (currently 25%) and is repayable over a period of 5 years with a grace period of 2.5 years. Loan repayments can be structured to accommodate farmer's seasonal production and income. Acceptable securities of adequate value are needed to secure the loan. According to the bank, the scheme is popular with small-scale farmers in the Rift Valley, Kakamega and recently a lot of applications from Embu district.

**Input finance projects**

**The Agricultural Finance Corporation (AFC),** which is a parastatal, was the main source of farm input credit for maize, wheat and dairy farmers. Credit from AFC was provided to mainly large-scale producers who sold their produce through the National Cereals and Produce Board (NCPB) another parastatal whose function was to buy maize and wheat from farmers and sell it later to them and to the millers at pan seasonal and pan territorial prices. Money loaned to farmers, as working capital, was recovered by the NCPB on behalf of AFC when the crop were sold. In this manner, the AFC was assured of the loan recovery. The dairy farmers also sold milk through the Kenya Co-operative Creameries who also recovered loans advanced to dairy farmers for milk production. But maize, wheat and dairy marketing was liberalised from the early 1990s when the private traders were allowed to compete with NCPB in the purchasing of maize and wheat. Milk marketing was also liberalized and as a result, private milk processors emerged to compete with Kenya Co-operative Creameries Ltd in marketing of milk.

Following the liberalization of the cereals and milk marketing, it was no longer possible to guarantee that the credits provided to the farmers would be recovered because the marketing was no longer streamlined. For several years, the AFC suffered high default rates thus making it impossible to continue offering the credit to the farmers. The private sector was also unwilling to provide farmers with working capital because of lack of guarantee that the output would be sold through them. Cereal producers thus are unable to raise enough working capital to re-invest in food production.

**Kenya Tea Development Agency** The small-scale tea farmers receive inputs and extension service from the Kenya Tea Development Agency (KTDA), which is a small-scale farmer owned and managed organisation. KTDA provides fertiliser to tea small-scale farmers on credit. Small-scale farmers are allowed to borrow a 50 kg bag of fertiliser per every 500-tea bushes. Because KTDA is the agency through which the small-scale farmers' tea is sold, credit on fertiliser is recovered before payments are made to them. Due to bulk purchases of the fertilisers and the ability to source directly from dealers abroad, KTDA small-scale farmers are able to get the fertiliser at competitive prices compared to those in the local markets.

**Second Coffee Improvement Project (SCIP)** This credit scheme was negotiated between the government of Kenya and the International Development Association of the World Bank for the implementation over the period 1980-1986 (SCIP 1). The second project (SCIP 2) became effective for implementation from late 1990 and came to a close in June 1998. The project was aimed at increasing small scale coffee incomes through increased coffee production and quality through provision of credit finance to improve payment systems by offering some cherry advance payment systems (CAPS), farm input credit, factory improvement and construction of new factories, training and institutional support to the coffee industry. The credit was administered through the Co-operative Bank of Kenya.

| Item financed by the project | Allocation |
|---|---|
| - CAPS | Kshs 800 million |
| - Inputs | Kshs 2.44 billion |
| - Factory Development | Kshs 527 million |

The Co-operative Bank is charged an interest of 8% and then on lends the monies at a margin of 7%, which comprises a management fee and administration charges. The farm-input credit was provided to co-operative societies at 15% interest rate. Participating co-operative societies appointed the Co-operative Bank as their commission agent so that repayments could be recovered from the sale revenues received from the Coffee Board of Kenya by the Co-operative Bank on behalf of the farmer beneficiaries.

In addition to the SCIP loans, the Co-operative Bank also offers co-operative societies loans at commercial bank interest rates. Part of these loans are used to finance the operational expenses by the co-operative societies while the rest are used to procure farm inputs which are provided to small scale farmers on credit. The credit just like the SCIP loan is recovered from coffee sales that are handled by the co-operative Bank from the Coffee Board of Kenya on behalf of small-scale farmers.

**Problems/constraints of the previously implemented projects:**

**SCIP 1:**

- Mistakes that took place during the implementation of this project were among others poor construction of factories due to poor supervision and establishment of economically unviable factories due to lack of proper appraisals. And the decisions to establish factories were politically motivated.
- Delayed payments
- Heavy deductions up to 60% of total sales
- Unfavourable input credit repayment terms (90 days)
- Unfavourable interest rates for credit
- Poor management of coffee factories as a result of untrained or untrainable factory managers.

As a result the performance of this project was very poor and the cost of production went up leading to reduced returns to farmers.

**SCIP 2 (1990-1998):**

- It was put in place to alleviate problems identified during implementation of SCIP 1. Its main objectives were increasing small-scale farmers income, generate foreign earnings, create employment and develop capacities for the institutions involved in the implementation of the project.
- Lack of adequate revolving fund, as the repayment period was only 2 years was one the limiting factors
- Credit period for the facility was too short to encourage favourable farm input borrowing;
- Low coffee prices
- Erratic weather (El Niño, La Niña phenomena)
- High interest rates
- Coffee market liberalization
- Devaluation of the Kenya Shilling
- Delay in implementation of the project
- Delay in establishing the policy on disbursement leading to a delay in draw down. This led to expensive local borrowing.

However, provision for farm input component was completely utilised by end of the project disbursing Kshs 2.44 billion (USD36 million).

**Stabex Funds (European Union)**

This ongoing project has initially allocated USD 6.7 million and has accumulated USD 13.4 million dollars as a revolving fund.

*Problems/constraints*

- The project lack of clear policy of disbursement

- Delayed disbursement
- Misallocation of funds
- Untimely availability of funds for utilisation by farmers
- Misapplication of funds.

To summarise, it appears that no significant impact has been felt by small-scale farmers from these funds.

**Present Lending Arrangements**

The management and commission agents licensed to operate in Kenya are as follows :

- Kenya Planters Co-operative Union Limited ;
- Thika Coffee Mills Limited
- Socfinaf ;

As most agents rely on commercial borrowing for onward lending to clients, their credit terms have in most cases been in line with commercial rates thereby not being attractive to many small-scale farmers. Several changes in the way coffee is marketed have been introduced in Kenya in recent past. Before these changes only Coffee Board of Kenya could present or offer coffee for sale at the auction but now the CBK's role was changed to being a regulator only. Only the three Marketing Agencies are authorised to sell coffee on the auction floor.

**Co-operative societies:** Co-operative societies are regulated under the Co-operative Societies Act. Small-scale farmers are able to join together and form large groups through which they are able to more efficiently utilise their resources and enjoy economies of scale. It is through the co-operative societies that small-scale farmers are able to establish primary factories for wet processing. Co-operative societies also provide a large proportion of all input financing that small-scale farmers require. They in turn obtain the financing from the commercial banks (mainly from the Co-operative Bank of Kenya). <u>Most co-operative societies require the farmer to have been an active member for at least 4 picking and delivery seasons to qualify for credit</u>. The following lending procedures are set by co-operatives societies:

- Small scale farmers request for input finance in form of kind rather than cash;
- The Co-operative society assesses the farmer's requirements based on the output history of the farm;
- The Co-operative requires the farmer to assign payment proceeds to them as Agent in order to enable the co-operative to be repaid;
- Small scale farmers collect deliveries of inputs at the designated warehouse or factory;
- Repayments are obtained upon receipt of sales proceeds from the Coffee Board of Kenya.

**Kenya Planters Co-operative Union Limited:** Historically small-scale farmers and co-operatives have been able to obtain credit from the Kenya Planters Co-operative Union Ltd. mainly as an advance against parchment. KPCU was the de-facto miller for over 45 years. KPCU Ltd. Originally catered for all producers of agricultural commodities in Kenya. However, coffee soon became its core business and KPCU Ltd has supported the industry both as a miller as well as providing financing and crop husbandry (extension) support. KPCU provides input finance through the following modus operandi:

a) KPCU advertises the facility to small scale farmers and co-operatives and invites written requests;

b) KPCU will use its Farmer Services Unit to ascertain the crop estimates for the season. This exercise determines the amount of credit to be extended to each farmer and co-operative;
c) KPCU will usually provide the input credit by issuing Local Purchase Orders (LPO's) in favour of the merchandisers or dealers in fertilisers and agro-chemicals. These merchandisers normally allow a 45 to 60 day credit for their goods against such LPO's. The small-scale farmers are required to collect the inputs directly from such merchandisers upon production of the LPO.
d) Recently, KPCU has opted to seek direct funding from offshore banks, which provide finance at a discount compared to the local costs. Such facilities enable KPCU to source the input directly from producer factories.

KPCU support to small-scale farmers' input finance has been on the decline due to the inaccessibility of credit for on lending.

**Proposed Lending Arrangements**

**Requirements of Commercial Banks**

Requirements imposed by the commercial banks normally for financing agricultural input are (i) Collateral adequate to secure the finances or borrowing, (ii) Valuation of collateral, and (iii) Secure guarantee. A sizeable number of farmers are able to meet the requirement of collateral, but they may not afford valuation costs, legal fees and the processing charges for such loan.

**Cash-Flow Lending Model**

Previous coffee financing schemes in Kenya, notably SCIP I and II, were characterised by poor lending decisions, lack of suitable control mechanisms and low repayments. Clearly the credit operations of these schemes were not sustainable. However models of successful lending programmes to small-scale agricultural producers do exist in the East African context, notably at Centenary Rural Development Bank in Uganda and Equity Building Society and K-Rep Bank in Kenya. These cash-flow lending models (as opposed to asset-finance loans secured against physical commodities, such as advances for coffee 'parchment') share the following characteristics:

- Lending to individual farmers, with legally-enforceable contracts drawn and executed between the lending institution and the farmers
- Technical assistance to farmers on modern crop husbandry provided by third-party actors
- An analysis of the farmers' debt repayment capacity based upon the entire household income, rather than solely on the proceeds from cash crop production
- Monthly interest payments on the outstanding loan balance during the production cycle with principal repayment upon sale of the crop at the end of the growing and harvesting season
- Securing loans through the assignment of a chattel mortgage in favour of the lending institution of personal and household items such as bicycles, wheelbarrows, and home furnishings.

**Working Arrangements for Execution of a Cash Flow Based Lending**

A tri-partite working arrangement among the principal parties needs to be established to effectively manage the input credit scheme:

- The **farmers' co-operative societies** should identify the high-quality small-scale coffee producers (defined as those farmers producing upwards of 10 kg of AA quality coffee per tree) who could benefit from credit for inputs. The societies should provide factual evidence of not only the farmer's production but also the number of trees being cultivated. The societies will be responsible for sensitisation and education role to assist farmers in practising good crop husbandry, as well as convincing farmers to repay loan obligations correctly. They will select of millers and marketing agents in a free and transparent manner. The millers / marketing agents so selected will be registered with the Kenya Coffee Board to safeguard the flow of funds from the sales of coffee to effect loan principal repayments.

- **KPCU** will provide continuous capacity building and other technical support for the societies' management committees; field committees; the societies' Secretary / Treasurer; and factory managers to verify the information on individual farmers' production; provide direct technical assistance to farmers to enable them to produce high-quality coffee at lower cost; and increase the production efficiencies of the entire coffee processing chain.

- The **participating financial institutions** will be responsible for analysing the farmer's input financing requirements and ability to repay; develop suitable contractual arrangements and interest and principal repayment schedules; and prepare chattel mortgages to partially secure the loans and encourage the farmers to repay according to agreed-upon terms. The lending institutions will also responsible for ensuring the timely collection of interest and principal repayments.

**Criteria for selection of financial institution**

Against this background of a weak formal financial sector, the task of selecting a suitable financial institutional partner(s) is further constrained by:

- the necessity of finding those institutions with retail branch operations in the high-quality coffee growing areas;
- identifying those financial institutions that have adopted a microfinance approach to providing micro-credit and savings services to the economically-active poor without high barriers to entry; and
- selecting those financial institutions with current or prior experience in providing credit to small-scale agricultural producers.

After an analysis of the local Kenyan formal financial system the possibility that KPCU itself could serve as the project financial intermediary was assessed. KPCU does have a history of extending credit to farmers' societies in the form of advances against the physical delivery of 'parchment' coffee, as well as other large, often unsecured loans to large coffee producers; however there have been significant problems with these credit operations, resulting in a high level of charges for bad debts against earnings and resulting in an operating loss for KPCU in 2001. These events indicate that whilst KPCU is conversant with asset-based lending against physical coffee, it is clear that they have been less successful in cash flow lending unsecured by physical inventory. This cash flow lending is the model that will be used for the input credit in this project.

The proposal from KPCU to operate the input credit component of the project themselves has been carefully reviewed; while some aspects of their proposal have merit, other, more suitable formal financial sector institutions exist in Kenya who offer an appropriate range of micro-finance, retail banking services for the target client group in the proposed project region.

In addition, the high-level project rationale is to encourage commercial banks to provide financing for the coffee sector in Kenya. By developing a deep and lasting relationship between formal financial sector actors and small-scale coffee farmers (which will include not only the provision of credit but access to other appropriate financial services such as savings and funds transfer services) the livelihood of the farmer's entire household will improve, food security will be enhanced, and the project's rural poverty reduction goals will be realised.

## Annex II

## RECOMMENDAITONS MADE BY THE CONSULTANT ON INPUT CREDIT SCHEME

**Financial Institutions who will borrow from the Common Fund for Commodities**

The Common Fund in collaboration with the Government of Kenya and KPCU will appoint a bank with a branch network in the Coffee growing areas. The bank so identified will be the borrower of the CFC loan subject to the loan being guaranteed in conformity with the Loans Policy of the Fund.

**Suitable Loan Terms between Participating Financial Institutions and Small-Holder Coffee Farmer Borrowers**

Loan Terms and Conditions - Participating Financial Institutions to Individual Farmers

a. Maximum Loan Amount

According to calculations of input costs constructed with coffee extension experts, it is estimated that USD 500 is the maximum amount required to finance inputs sufficient for one hectare, equivalent to 1300 trees. It is expected that a majority of the loans will be to farmers with one-half hectre or less, the equivalent of USD250.

b. Selection criteria for clients

In the first instance, the farmer's co-operative societies will compile the list of their "A" group farmers, those individuals already practising good plant husbandry and producing high-quality coffees in above-average quantities per tree. The specific client selection criteria include:

- Producing during the last four (4) years, not less than 7 kg per coffee tree for a loan for up to one-half hectare USD 250
- A low level of verifiable existing debt to other financial institutions, which has been regularly paid and not currently in arrears.
- Good moral character

From the list of these "A" group farmers the society and technical assistance provider will conduct on-farm inspections to verify the acreage being cultivated and number of trees requiring financing for inputs. This information will be recorded and presented to the participating financial institution that is 'twinned' with the farmer's co-operative. From this master list, the banks will be required to engage in their own independent due diligence assessments, develop schedules of goods (bicycles, wheelbarrows, home furnishings, etc.) to be pledged by the farmers as chattel mortgages, and calculate the loan amount. The loan amount, including monthly interest payments to be met, should be a part of the loan agreement between the participating financial institution and the individual farmer to be duly executed.

c. Chattel Mortgages

Each participating financial institution may, at its discretion require farmers to sign a chattel mortgage pledging various personal and household assets belonging to the farmer as collateral for access to input credit. The assets pledged can encompass a range of common household items and include such things as bicycles, wheelbarrows, radios, table and chairs, and cooking utensils. Experience with successful small-holder agricultural lending schemes where farmer/borrower were required to pledge these items clearly shows that a borrower will go to great lengths to avoid arrears and risk the loss of stature within the household and in the community which occurs when these possessions are lawfully seized to make good on loan defaults. The monetary value of these items are unlikely to cover the principal and interest at risk in a default situation; nevertheless the very public seizure of these goods is a strong incentive for farmer/borrowers to meet their obligations under small-holder lending schemes.

It will be the responsibility of the participating financial institution to draw up the list of assets to be included in the chattel mortgage, properly execute and store these documents, and take the necessary legal steps to seize the collateral in the case of unresolved default.

d. Loan Disbursements

Prior to loan disbursements there will be a need for the technical assistance provider and the leadership of the farmer's societies chosen for initial phase of the project to begin sensitisation and awareness-building among the farmers themselves on what the loan program is about, the necessity to repay the loans correctly, and the immediate need to practice good plant husbandry – even without a full financing to purchase inputs required for the flowering of the coffee early in the season – in order to produce good coffee for the ensuing season.

The farmers meeting the eligibility criteria for the loan programme will be allowed to draw down partially on the maximum loan amount of USD 500 per hectare. The technical assistance provider and the management of the societies will have to verify the size and quality of the coffee berries on the tree during the later stages of the season, and the farmer's may qualify for up to 30 % of the full season loan amount for which they would normally qualify. The farmer requires about 30% of the inputs value at the production stage. These funds will be used for purchase of inputs for soil amelioration, as well as for expenses associated with activities such as pruning and harvesting. The calculation of the loan amount for this first lending season will necessitate close co-ordination between the society, the technical assistance provider and the participating financial institution as it is important not to over-lend but rather extend an appropriate loan amount that the farmer can pay easily from the sale of coffee at the end of the season.

e. Interest Payments to Banks

Farmers shall be responsible for paying interest payments to the participating financial institutions on the outstanding loan balance according to the interest rate set at loan origination. Since it is envisaged that there will be no fewer than three (3) loan disbursement trances for each full growing season, the interest burden on the farmer will not be unsupportable. It is however necessary to ensure that the farmer has other sources of income to support the monthly payment of interest: zero-grazing dairy farming, tea production, and other horticultural crops.

f. Interest Arrears

If a farmer fails to pay three (3) interest payments calculated during the loan appraisal process and agreed to by both parties, the farmer will be suspended from the lending programme and subsequent disbursements during the same season will be halted. He will also be considered to be in arrears and the participating financial institutions can act to seize the chattel goods pledged in the loan agreement. Whilst it is the participating financial institution that has primary responsibility for the management of these arrears situations, it is expected that the farmer society will be informed of the non-payment and exert influence with the farmer to pay the obligations promptly and thus be re-instated into the programme. Under no circumstances should farmers with arrears be accorded additional disbursements for subsequent seasons unless exceptional extenuating circumstances exist.

g. Payments by Marketing Agents directly to Farmers

Written agreements should be made between participating farmer co-operatives and the marketing agents to direct the cash proceeds from the sales of coffee stocks of participating farmers to accounts maintained by the co-operative in favour of the farmer domiciled at the participating financial institution. This is similar to the arrangement under which KPCU makes advances for ‘parchment’ coffee, mills and markets the coffee, and then directs the funds to the co-operative less the amount financed. This payment arrangement will be facilitated by the issuance of ‘irrevocable payment instructions’ by farmers designating the participating financial institution (who extended the input credit) as the unique recipient of coffee sales proceeds. This payment scheme can be legally enforced by the Coffee Board.

h. Principal Repayments

Loan principal outstanding for each season will be repaid to the participating financial institutions upon direct payment by the marketing agent of the proceeds of the sale of coffee produced by farmers. The participating financial institutions will debit the farmers’ accounts for the loan principal and interest payable before allowing the farmers access to the balances remaining. If the coffee sales payment is not sufficient to liquidate the principal balance and any interest owed on that seasonal loan, the farmer will still be responsible for any sums still owing. In addition, further loan disbursements for subsequent seasons may be delayed or cancelled at the discretion of the participating financial institution; however in these cases consultation with the society management should be done to resolve the situation before other measures, including suspension from the programme, are made.

i. Loan Disbursements – Subsequent Coffee Seasons

Due to the length of the coffee growing season and subsequent processing and sales, cash proceeds will not be available to clear outstanding principal balances and associated interest payable before financing is required for inputs of the next season. Therefore two loans to each farmer is likely to be outstanding for a period of approximately 3-4 months during the following season.

While this is acceptable given the realities of the coffee growing and sales period, care must be exercised by the lending institutions not to over-burden the farmers with unacceptably high levels of debt during this period. Again, especially during the initial seasons of the programme, the input of the technical assistance provider and the societies as to the farmer's first season production (amount of coffee produced, quality) will assist in the calculation of loan amounts for disbursement in the second season.

Farmers must exhibit acceptable loan repayment to be considered for lending for the second and subsequent growing seasons. Borrowers who have had several periods of arrears (even if they have been cleaned up by the onset of the following season), or who have to be 'chased' by loans staff on a regular basis to make their scheduled interest payments will be dropped from the programme and other farmers recruited. These conditions, acknowledged to be on the conservative, strict side, imply the need for a significant and sustained level of farmer education and sensitisation on the part of the societies and the technical assistance provider, as well as the staff of participating financial institutions.

j. Continued Eligibility – Farmers' Societies

Farmer's co-operative societies will continue to be eligible for the technical assistance to be provided by the technical assistance provider, as well as input credit for individual farmers, if the performance under the credit scheme continues to be acceptable. Acceptable performance in this case is defined as less than five (5) percent of farmers in arrears during the 15-month coffee season. For those societies with a high level of arrears the project management team, technical assistance provider and participating financial institution should first investigate the underlying reasons for the arrears situation, while making it clear to the society's leadership that actions must be taken to correct this situation.

**Geographic coverage**

The project will select one co-operative from each of the 15 coffee districts and will also select medium and large farmers to participate in the pilot. The programme may also be expanded to farmer's societies in the vicinity of the co-operatives selected for the initial phase of the programme, in order to benefit from the proximity to the training for co-op management committees, factory managers and other capacity-building efforts to be undertaken by the technical assistance providers.

Further, it is suggested to 'twin' the selected farmer's co-operative societies with an identified financial intermediary located within a nearby radius. This will allow for ease of loan appraisal, monitoring and facilitate interest and loan repayments as mentioned; it will also provide for a high-degree of accountability on the part of the commercial banks (each bank branch will be responsible for one particular farmer co-op) to ease supervision by project management. It will also allow the banks to gain a better knowledge of the membership and production capabilities of the individual farmers, as well as allowing for the establishment of close working relationship with the direction of the co-op management and leadership.

The proposed pairings of coffee farmer's co-operatives and an identified financial institutions for the initial phase of the project should be developed after site-visits and the recommendations of the appropriate technical assistance partner.

The proposed selection criteria of farmer's co-operatives for inclusion in the pilot phase of the project should include:

- Consistently sound co-operative management structures, including long-serving management committees
- A low level of outstanding debt and acceptable performance in servicing debt in previous years, including to SACCOs and the Co-operative Bank
- A representative geographic distribution encompassing the coffee producing areas of Nyeri; Muranga; Embu; Meru; and Tharaka Nithi
- The demonstrated ability to produce over 200 bags of Parchment grade one and at least 200 bags of parchment grade two; millable lots of lower grades such as p3, and mbuni
- Reasonable efficiency and levels of production charges
- Commitment to producing differentiated, high-quality coffee using proper husbandry techniques
- Good evaluation by Ministry of Co-operatives
- A good experience working with technical service providers in previous years
- A functioning farmer's co-operative societies in the respective districts
- Easily accessible location to facilitate serving as a demonstration to farmers from other societies

**Form of the Input Credit for Final Borrowers**

The form of credits for inputs for the final borrower / smallholder coffee farmer shall be cash as loan proceeds from the participating financial institution. With the assistance of the selected technical assistance provider, arrangements with local input suppliers may be arranged so that prices are lowered due to volume discounts (all local farmers purchase their fertiliser / pesticide from a particular dealer; an arrangement can also be made so that inputs are supplied in kind, and equivalent payments on behalf of farmers are made directly by the local bank in lieu of a portion of the cash loan proceeds). This however would be left to the decision of the participating farmers.

It must, however, is kept in view that labour constitutes a significant portion of the expenses in cultivating coffee among smallholder farmers. These in-kind credit arrangements, if done centrally, also have the potential for funds diversion, substitute of inferior inputs, and other forms of funds mismanagement.

**Role of the Kenya Planters Co-operative Union and other Technical Assistance Providers**

The role of the Kenya Planters Co-operative Union (KPCU) and other service providers should be concentrated on the provision of appropriate, well-targeted technical assistance and capacity-building support to farmers and farmer co-operative societies. KPCU and other technical assistance providers should focus on meeting the capacity-building needs of farmer co-operative societies, and extension services to individual farmers. The capacity–building needs within the co-operatives exist on several levels, and must be addressed if these farmer societies are to play an effective role in extension and providing technical assistance to farmers who will participate in the pilot programme. KPCU or other service providers as appropriate will carry out a majority of the training and capacity building. The capacity-building needs of the co-operatives include:

- For the society Manager / Treasurer positions, training must be provided in record-keeping, consistent financial reporting and basic computer use (especially spreadsheet skills);
- For the members of the management committees, sensitisation on their role as co-operative managers and responsibilities to farmer/members;
- For the members of the field committees, more technical training on the correct application of inputs (fertilisers, herbicides, fungicides, pesticides) as well as information on the correct handling of these sometimes dangerous materials and potential environmental effects of incorrect practices;
- For factory mangers, training in accurate record keeping, machinery use and proper maintenance; and
- For the farmer/members of the co-operative, sensitisation on proper plant husbandry, the advantages of quality production, and the benefits of the co-operative movement producing activities such as bee-keeping, and discussion of environmental issues.

After the initial training sessions for the various groups, consideration should be given to inviting selected officials from neighbouring co-operatives to participate in these capacity-building activities. In this way, the management of nearby co-operatives can be strengthened with a view to expanding the number of co-operatives covered by the pilot scheme over time. The proposed training can be summarised in matrix form as follows:

| **Intended Beneficiary** | **Capacity-Building Activity** | **Frequency per Year** |
|---|---|---|
| Co-op Secretary / Treasurer | Record keeping; consolidation of factory processing results; loan repayment monitoring; basic computer skills | 3 x |
| Management committee members | Co-operative management and governance skills | 4 x |
| Field committee members | Proper plant husbandry; proper application of inputs; proper handing and storage of inputs | 2 x |
| Factory managers | Proper product handling and storage; pulping machine service and maintenance | 2 x |
| General co-operative membership | Re-enforcement of co-operative principles; organisation of voluntary labour inputs; proper plant husbandry; environmental issues, including proper storage and handling of inputs; other environmentally-sound income generation ideas; proper loan repayment and use of other banking services | 3 x |

**Terms and Conditions of the Agreement between the Project and the Participating Financial Institution**

a. Interest Rate

The Interest Rate (I.R.) payable from participating partner bank's to CFC shall be determined during negotiations in line with the CFC Loans Policy.

b. Domicile of Project Bank Accounts

For ease of accounting and project management, the project should maintain separate bank accounts for the credit component. Two accounts should be established: one for the loan fund (principal until drawn down by participating, and interest payments to be received from the participating financial institutions on the amounts drawn down); and a second for the loan loss reserve. These accounts should be lodged in a reputable commercial bank in Nairobi. The project should be responsible for all ledger fees and other bank charge incurred, although project management should make every attempt to negotiate with the commercial banks to have these charges reduced or waived completely.

c. Foreign Exchange Risk

The exchange rate shall be borne by the borrowing institution.

d. Loan Guarantee

The loan should be guaranteed in conformity with the CFC's Loans Policy. These will be negotiated with the borrowing institution.

e. Commitment fee

Due to the over-arching objective of encouraging formal sector financial institutions to establish credit facilities for small-scale coffee farmers on a sustainable basis, commitment fee requirements on un-drawn loan amounts from CFC shall be waived. A 'slow but steady' approach to client loan disbursements shall be adopted, to ensure that not only are suitable client farmers selected for the initial phase of credit extension, but that the monthly interest repayments are indeed made according to agreed upon schedules and the principal recovery mechanism also functions as planned.

**Proposed Lending Methodology**

It should at all times be stressed that the proposed lending model for smallholder coffee farmers is to be implemented as a ***commercial, sustainable*** credit mechanism.

**Primacy of bank's underwriting criteria and credit decision-making**

The partner financial institutions must evaluate and extend credit to individual farmers according to their best judgement. The bank's must engage in their own appraisal and independent due diligence review of each farmer's loan application to determine the appropriateness of the amounts being requested. This should include a review of the farmer's estimated ability to repay, including verification of number of coffee trees under cultivation; the value of chattel collateral offered; and a review of the farmer's indebtedness to other institutions, including SACCOs, KCB, farmer's co-operatives and Co-op Bank. If other debt is discovered, the capacity of the farmer to service all debt comfortably must be proven; otherwise the loan application may be modified or rejected at the bank's discretion. Similarly all chattel items to be pledged by the borrower to the bank must be verified.

**The need for capacity building for loans officers and provision of computers**

The project will carry out training sessions of approximately three- (3) day's duration for all loan officers' involved, with one-day participation of their respective Heads of Credit or other members of senior bank management. Topics to be covered include use of the loan application and interviewing techniques; loan amount calculations; data input into MIS; development in the coffee market; and so on. These meetings should also be seen as an important means of lesson sharing among commercial bankers, KPCU and other technical service providers, farmer's societies and the CFC/UNOPS team to explore common problems, emerging lessons, and other factors of common interest. These meeting will not only serve as an outlet for information-diffusion and skill-building among the banking staff, but will also re-enforce the positive, poverty alleviation aspects of the programme at all levels of the partner institutions.

The project will install a Wide Area Network which links all the 18 WorkStations located at branches close to the co-operatives and farmers who are being supported in this pilot.

## MONITORING OF THE PHYSICAL COFFEE FROM THE FIELD TO THE AUCTIONS

The movement of physical coffee from the farmers selected for inclusion in the input credit programme during the initial phases of the project to the final auction can be described schematically as follows:

| | | |
|---|---|---|
| Selected Farmer | => | Segregated collection at Society factory |
| Pulped Parchment coffee | => | Mill for sorting and hulling |
| Finished, graded coffee | => | Bonded Warehouse |

Note: at this stage, the coffee can be held as collateral and warrants issued in favour of the participating financial institution that has provided the farmers' credit. By holding the warrants the Proposed Financial Institution (PFI) effectively owns and controls the finished coffee.

| | | |
|---|---|---|
| Warehouse | => | Auction |

After the auction, the buyer will be instructed to pay the PFI warrant holder the amounts advanced to the farmers for the collateralised coffee. From this amount will also be deducted the cash amounts advanced to the farmers for inputs.

The remainder of cash will be returned to the operating bank accounts of the co-operative society located in the PFI which has extended the credit. Subsequent allocations of cash proceeds will be made to the coffee farmers based on the individual farmer's production.

**Audit Trail and Internal Check and Control Procedures**

In keeping with the forgoing consideration of ceding primacy for credit-making decisions to the partner commercial banks, reporting requirements of the banks lending activities and performance must be kept to a minimum, and standardised to allow for ease of monitoring by CFC and UNOPS. These reporting requirements should be incorporated in the Loan Agreements between CFC and the partner banks, and comprise the following:

Quarterly reporting:

- Number of loans disbursed during the quarter;
- Average size of loan disbursed during the quarter;
- Loan amounts disbursed during the quarter;
- Number of loans outstanding at quarter end;
- Amount of loans outstanding at quarter end;
- Number of loans with interest in arrears (more than one payment behind) at quarter end;
- Amount of loans with interest in arrears (more than one payment behind) at quarter end;
- Recovery plan for each loan in arrears.

Annual reporting:

- Number of loans disbursed during the year;
- Average size of loan disbursed during the year;
- Loan amounts disbursed during the year;
- Number of loans outstanding at year end;
- Amount of loans outstanding at year end;
- Number of loans with interest in arrears (more than one payment behind) at year end;
- Amount of loans with interest in arrears (more than one payment behind) at year end;
- Recovery plan for each loan in arrears;
- Interest payments received during the year.

Audit and Internal Controls:

The Participating Financial Institutions shall furnish to the Project Executing Agency (PEA) certified copies of their annual audited financial statements and an auditors' report for their respective lending operations on behalf of the Project, not later than three months after the end of each fiscal year. Independent auditors acceptable to the PEA shall carry out such audits.

The internal controls systems of the PFIs shall be used to monitor lending and repayments made under credits extended during the Project. The external auditors shall comment on the suitability of these internal controls systems as part of their annual assessment; remedial actions, if any, must be undertaken and completed within six months of any unfavourable report by the auditors.

**Sample Business Plans and Income Statements for Farmers to demonstrate project viability**

When calculated on an individual basis it is clear that with modest gains in coffee production per tree, stable prices for high-grade AA coffee, and market interest rates to repay commercial bank loans for inputs, that small-holder coffee farmers can not only comfortably service commercial bank loans for inputs but also show reasonable profits after the end of the coffee season. This is shown in the following individual farmer pro-forma income statement:

**Individual Farmer Income Statement / per Acre**

| | |
|---|---|
| **Annual Gross Coffee Income** 1300kg green @1.20 per kg | $1,560 |
| **Annual Net Coffee Income -** 65% | $1,014 |
| **Less: Total Loan Payments** plus Interest | $600 |
| **Coffee Profits after Loan Repayments** | $546 |
| **% Net Profit to Farmer** | ***30%*** |
| | |
| **Assumptions:** | |
| **Number of Coffee Trees per Hectare** | 1300 trees |
| **Amount Financed per hectare** | $500 |
| **Interest Rate** | 20% pa |
| **Coffee Produced – Kg. per tree** | 7kgs |
| **Coffee Price USD / 50 Kg** | $60 |

The Banks undertakes that loans for agricultural inputs for coffee production by small-holder farmers shall be made on terms whereby the Banks shall obtain rights adequate to protect the interests of the Banks and the Government including to the extent that it shall be appropriate: -

a) the right to take security or a security interest;

b) the right of the Banks to suspend or terminate the right of the borrower to use the proceeds of the loan upon failure by such borrower to perform its obligation under its agreement with the lender;

c) the right of the Banks to deduct the sum required to service the loan from the proceeds of the sale of coffee; and

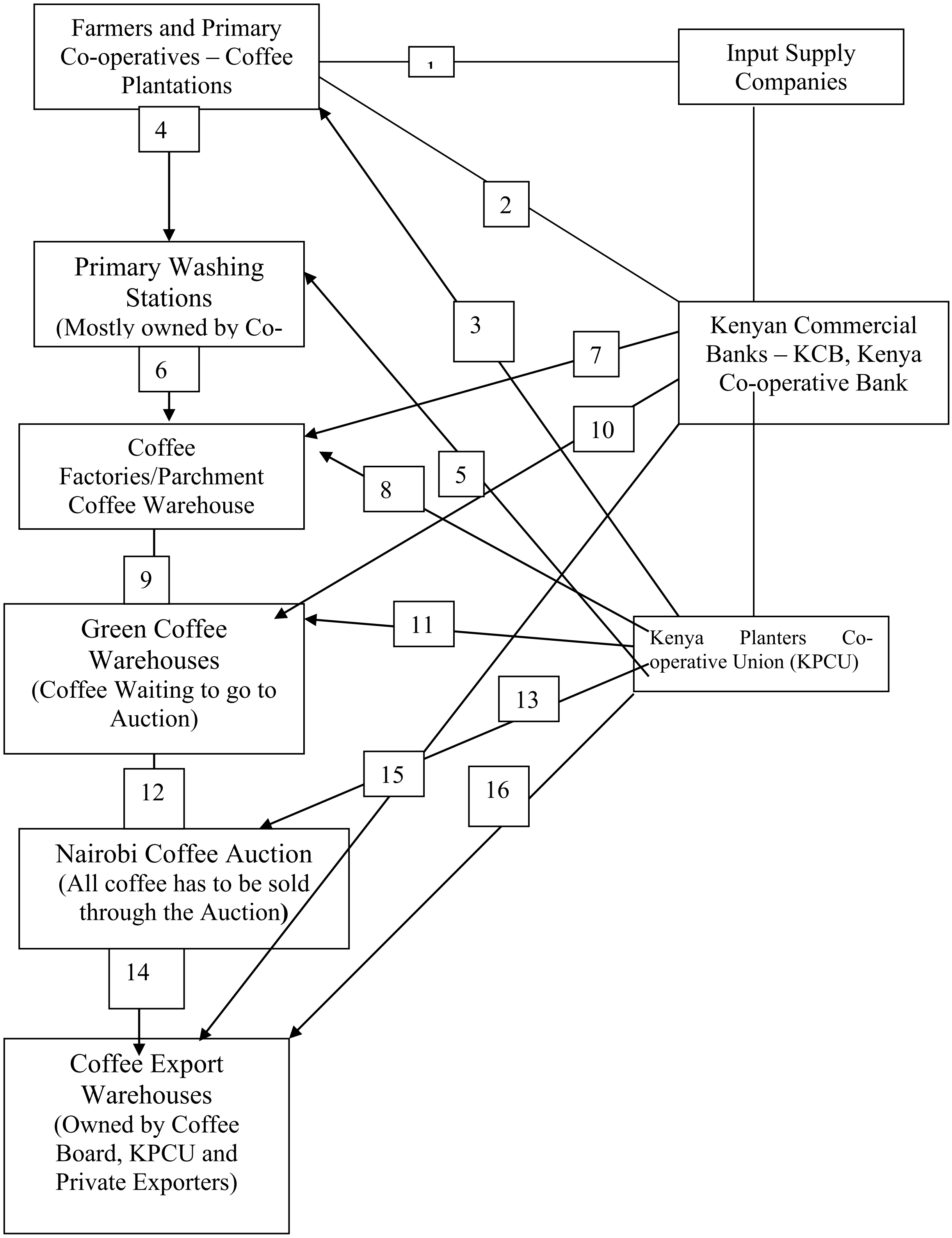
d) such other provisions as are necessary to ensure the due payment of the said loan;

Provided that the Banks shall,

(i) vet all applicants for loan and take all risks in respect of the funds loaned to farmers; and
(ii) the funds shall be on-lent to the farmers at prevailing commercial interest rates charged by the Banks.

**Annex III**

**THE STRUCTURE OF THE COFFEE SECTOR IN KENYA**



Description of Activities at each stage of the 16 Steps in the Coffee Chain in Kenya (Each Step is denoted by a number in the Diagram above) as currently applied (and to be modified in the pilot project).

**Step 1** – Relationship between farmers/co-operatives and Input Supply Companies

The supplier of credit usually determines the relationship between farmers and agricultural input suppliers unless the farmer is buying for cash. The commercial banks, that provide credit to the coffee sector, provide loans through to Coffee Factories that on-lend to farmers and co-operatives. Farmers are given up to 30% of the estimated value as input finance (crop finance). A credit line is given to the Factory at market rate and the factory will lend to farmers and co-operatives after adding a small mark up to cover administrative costs. The actual costs are negotiated each season depending on the market conditions. To ensure that the loan amount is used for inputs the farmers are given vouchers or purchase orders which they present to pre-determined Input Supply Companies. When the Input Supply Company releases the goods (inputs) it presents the invoice to the Coffee factory for payment. The coffee factory will recover the loan in accordance with a pre-determined and agreed deduction schedule that is negotiated when the loan is granted. Farmers with more than 2 hectares of coffee are granted loans as individuals while those will less than 2 hectares are grouped into co-operatives.

**Step 2** – Relationship between Farmers and Commercial Banks in Kenya

In the current credit arrangements in Kenya there is no direct relationship between the farmers and the commercial banks. [This pilot project is seeking to establish this link. It is the opinion of most banks that it is too expensive administratively to deal with each farmer or smaller co-operative because of the size of the loans and the logistics of monitoring the loan repayment. The project is seeking to demonstrate that given the technological advances in banking products a direct relationship can be established between the farmers and the banks via their bank accounts at substantially reduced costs. The development of smart cards and physical monitoring of coffee stocks should substantially reduce the risk and the costs of input finance.]

**Step 3** – Relationship between Farmers/Co-operatives and Kenya Planters Co-operative Union

In the current system, KPCU provides input credit, extension services, and farm inputs through its stores and coffee processing facilities to farmers. While the system looks neat and tidy on paper it does not give the farmer the power to choose his suppliers of service. The novelty in this proposal is empowering the farmers to choose their suppliers. If the bank gives a loan directly to the farmer he or she can choose the Input Supplier, the coffee processing factory of his or her choice and will source agricultural extension services from the best supplier of such services. This will have the effect of making KPCU more efficient when it competes for business to provide services. This can be made possible by the development of smart cards with microchips that contain information about the farmer and the loan facility. All the farmers who normally borrow crop finance have bank accounts with the main Kenyan banks that have introduced a network of ATM and debit cards.

**Step 4** – Relationship between Farmers/Co-operatives and Primary Washing Stations

In Kenya, all the coffee is wet-processed hence once coffee is picked it has to be delivered to the nearest washing station. The co-operatives and some individual farmers own most of the washing stations. There is no cash movement at this stage. The washing stations are operated by the farmers/co-operatives for fees to be paid when the crop is finally sold. The ration from Cherries to Parchment to Green Coffee is 5:1:0,8.

**Step 5** – Relationship between Primary Washing Stations and KPCU

The KPCU provides technical advice on quality control and management, primary processing and machine maintenance. KPCU also monitors deliveries of cherry by farmers because they would have advanced the farmer's loans for inputs. The services provided by KPCU are deducted when the farmer is finally paid for his coffee at delivery to the factory after drying the coffee. The pricing of these services could be made more competitive if farmers have a choice.

**Step 6** – Relationship between Primary Washing Stations and Coffee Factories

After drying, Primary Washing Stations send their coffee to the factory for milling. The factories provide credit to the farmers via the Primary Co-operatives and receive coffee via the same channel. The Factory pays a "Parchment Advance" on receipt of parchment coffee. The parchment advance is determined by estimated value of the coffee delivered but should not be more than 60% of the estimated value. The ownership of the coffee does not change hands but the Coffee Factory takes possession of the coffee. The Factory will mill the coffee and sell the coffee at the Auction and deducts all service costs plus any loans advanced in accordance with a pre-determined and agreed schedule. The Coffee Board of Kenya in terms of the Coffee Act publishes the processing costs.

**Step 7** – Relationship between the Banks and Coffee Factories

The commercial banks provide credit to the coffee sector through the Coffee Factories who then on lend that amount to the farmers. The coffee factories apply for the line of credit after assessing the credit requirements and two years delivery history of the farmer or co-operative. The banks prefer to give the loans through the coffee factories because the factory owners can provide security in terms of Plant, Land and Buildings or coffee stocks in the warehouse. This reduces the administration cost of the bank because they do not have to deal with many customers.

**Step 8** – Relationship between the Coffee Factories and KPCU

KPCU owns +80% of the Coffee Factories in Kenya. They have capacity to process over 2,4 million bags although now Kenyan production has gone down to 800,000 bags. The other two Marketing Agents own the other 20% capacity. The financing of farmers has been done through KPCU borrowing from commercial banks and advancing the same money to farmers through their factories. The pricing of the services and loan recoveries are totally controlled by KPCU which control the coffee stocks and the cash from the Auction.

**Step 9** – Coffee Factories to Green Coffee Warehouses

After milling and awaiting auction the coffee is stored in Green Coffee Warehouses where it is put into different grades in preparation for auction. The coffee is graded and co-mingled according to supplying co-operatives or farmers. Some commercial banks finance coffee against warehouse receipt at this stage. This is also a possible point of hedging using price risk management instruments by KPCU or the commercial bank. (This pilot project will introduce the use of Warehouse Receipts from parchment level.)

**Step 10** – Relationship between Green Coffee Warehouses and Commercial Bank

The Green Coffee Warehouses are owned and operated by the three licensed Marketing Agents. Again almost 80% of the capacity is owned and operated by KPCU. The Commercial banks provide trade loans to finance parchment advances against green coffee stocks.

**Step 11** – Relationship between Green Coffee Warehouses and KPCU

Most Green Coffee Warehouses are owned and operated by KPCU (80%) and the other two Marketing Agents control about 20% of the Warehouse space.

**Step 12** – Relationship between Green Coffee Warehouses and Nairobi Coffee Auction

All the coffee from the Warehouses has to be taken to the Nairobi Coffee Exchange for Auctioning. Only samples are presented at the Auction. When a buyer bids for a certain quantity of coffee at the Auction he will have the right to move that quantity from the Green Coffee Warehouse to a Coffee Export Warehouse. He is then issued with an Export Certificate upon delivering to the Coffee Export Warehouse.

**Step 13** – Relationship between Nairobi Coffee Auction and KPCU

KPCU besides housing the Nairobi Coffee Auction in its building is now an Authorised Marketing Agent, meaning it can present coffee at the Auction for sale and can also buy coffee at the Auction for export. It also operates the Coffee Export Warehouses that used to be controlled by the Coffee Board of Kenya.

**Step 14** – Relationship between Nairobi Coffee Auction and Coffee Export Warehouses

Once coffee has been bought at the Auction it is then moved to Coffee Export Warehouses were it is packaged ready for export. The Coffee Board of Kenya owns the warehouse space but it is leased to various exporters. Some banks finance traders based on the Warehouse Receipts of coffee already in the export warehouse as pre-shipment finance.

**Step 15** – Relationship between Commercial Banks and Coffee Export Warehouses

Most international banks provide lines of credit channelled through the local banks for pre-shipment finance to cover the period between shipment and payment. The loans are guaranteed through warehouse receipts based on inspection and security contracts. SGS Inspections Services control +70% of the collateral services market at the shipment level.

**Step 16** – Relationship between KPCU and Coffee Export Warehouses

From 2002, KPCU was authorised to buy coffee from the auction for export to various destinations. KPCU is buying coffee stocks and then marketing the coffee after purchasing from the auction. Most buyers at the auction buy on behalf of their Roasting or Trading Companies in Europe but KPCU is buying for marketing to an unknown importer. Thus KPCU uses a lot of the Export Warehouse space for longer periods than other traders who use the warehouses as transit. There are now plans to start roasting the coffee in Kenya by KPCU.

# ANNEX IV

## KENYA PLANTER COOPERATIVE UNION (KPCU) BACKGROUND INFORMATION

*(source: Kenya Planters Cooperative Union)*

The KPCU was formed in the early 1930's by the coffee farmers themselves with the primary objective of providing them with services at cost where a need had been recognised, in facilitating quality coffee production. The KPCU therefore started as a stockist of farm inputs and small farm tools & implements, where the Company would purchase such items in bulk, and then re-sell them to the farmers at cost, to enable them enjoy economies of scale. It was and has remained a non-profit making institution, and where the Company realises any surplus funds, such funds are applied towards reducing the cost of services to the farmer. KPCU circulates and publishes at the beginning of every coffee year the tariffs applicable for all the services it offers to the farmers.

The Company has also been able to pool funds from its members over the years to facilitate development initiatives, hence its ability to set up its milling/hulling, storage and warehousing infrastructure that have sprung up in its 15 branches located in all coffee growing regions countrywide. The KPCU therefore receives coffee from the farmers through its transit storage facilities and warehouses, for milling and sale through the Nairobi Coffee Exchange.

The KPCU also arranges for credit facilities with banks to meet the coffee farmers' credit needs, and has been carrying out this role with a consortium of local banks. Currently, the KPCU has made arrangements with Kenya Commercial Bank, which has extended a line of credit for crop advances to farmers. The role of KPCU in this arrangement is that it makes an application to the bank on behalf of the farmers. The bank is able to verify from past and current records the history of the farmers and the number of farmers utilising the services of the Organisation. Based on that information, estimates are made for crop advance on 30% of the projected value of the farmers' coffee held in the KPCU stores and warehouses.

And since the credit needs have to be synchronised with the seasonal requirements of the farmers, then the KPCU forwards to the banks the farmers' requirements for the funds based on their applications and the accompanying appraisal, for approval and disbursement. The importance of this is that the risk to the bank is greatly reduced as the KPCU guarantees the repayment of the funds, as it is the body that processes and markets the coffee. The Company also receives funds for sale of the coffee from the overseas buyers and the bank is further assured of repayment as the KPCU will have undertaken as a pre-requisite to have its receiving accounts for all coffee proceeds from overseas buyers paid to an account domiciled in the bank. This way, farmers are also assured of timely release of funds, for example, for picking and purchase of farm inputs when the rains set in, avoiding any delays that may be occasioned were the bank appraising the farmers directly.

The KPCU further guarantees the risk with the bank with its vast assets, which include land, machinery and other properties, through a floating debenture that also encompasses its milling income. It is worthwhile to note that no coffee leaves the KPCU warehouses until the Kenya Commercial Bank confirms receipt of the sale funds upfront from the overseas buyers. All Kenya coffee has to be paid for upfront before shipping is done.

The KPCU therefore plays a facilitative role, equivalent to that played by a collateral manager, and reduces the risk on the banks by tracking down the commodity upwards to the end buyer. The KPCU also tracks the flow of the funds downwards from the overseas buyers to the farmers, through the banks, thereby offering a crucial linkage between the buyers, the banks and the farmers. This way, the bank deducts its monies at source, before the proceeds are paid to the farmers. In addition, the KPCU takes out crop insurance for all the coffees in its stores and warehouses, and has taken a guarantee in favour of Coffee Board of Kenya to ensure that no farmers' moneys can remain unpaid whatsoever. The bank also carries out a random inspection and stock-count to vouch for accuracy of the information provided by KPCU.

All coffee delivered into KPCU storage facilities is allocated a distinctive number that easily identifies the coffee lot during all the stages that the coffee is set to undergo, which comprise of the parchment storage, milling/hulling, warehousing, sale at the auction, and the same number is used when processing the coffee sale proceeds for payment to the farmer once the same are received from the international buyers, through our bank. Coffee deliveries also comprise of different parchment grades that range from the premium to low-grade categories. Each of the grades is received in KPCU stores separately and allocated an out turn number, as a quality management measure.

The farmers therefore use this information when making their application for crop advances, to assist them in defraying some of the costs incurred during the coffee production process. The KPCU then receives the applications and verifies the correctness of the details, as a part of the evaluation process. The Farmers' Credit Manager, in liaison with the Quality Control and Marketing Manager, makes an estimate on the price that the coffee is expected to realise, and then calculates an advance while considering the needs of the farmer, and based on a 30% margin of the anticipated value of the coffee, to cushion the Company against any unprecedented slump in prices. The Credit Manager then submits this information to the Financial Controller, who furnishes the bank with the details, to facilitate release of the funds by the bank from the line of credit. It is at this point that the farmers receive their payments cheques for the crop advance. The KPCU will then track the coffee along the milling and sale process, and then advise the bank once the coffee is sold, to facilitate recovery of the advance before the net proceeds are availed to the KPCU for onward payment to the farmer.

So, the above explains the scenario in a post-harvesting financing arrangement. For pre-harvest finance, farmers have to sign an agency agreement to mill and market their coffee with KPCU, and its only those that have done so who would qualify for pre-harvest finance. In addition, they have to hypothecate their crop in the farms to the Company. They also have to have a good track record with the KPCU with no instances of bad debts.

KPCU Field Services Department must visit the farm to ascertain its status, do crop estimates and once funds are disbursed, follow-up its application and usage, and also monitor picking, primary processing of the coffee and the final delivery of the parchment coffee to our mills. In certain instances, we demand a farmer to have guarantees from four other farmers with a good past record. We also demand other forms of security, such as immovable assets or chattel mortgages, etc. We have standard contracts/agreements that farmers must sign to legally bind them to repay the debts.

To effectively carry out its central role in implementation of the project, the KPCU requires assistance in various areas to strengthen its capacity. The sensitive and crucial nature of the project requires that the Company revitalises a number of its facilities to enable the Organisation observe timeliness in information dissemination, appraisal of applications, collation of project data and results, and report back to other principal partners in the project.