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*Crop and Trade Financing to Provide Small Farmers, Processors and Traders access
to Agricultural Inputs and Commodity Financing*

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UNDERLYING PROBLEM IN AGRICULTURAL SECTOR FINANCING

Agricultural production financing is considered a highly risky venture by lenders and are therefore very reluctant in involvement despite availability of funds and yet in developing countries, investment finance and working capital are the main bottlenecks for smallholder farmers because of the general absence of viable and sustainable rural financial system.

World-wide, small-scale farmers require short term production loans that are repayable immediately after harvesting/marketing of produce within a maximum of one year as most of the productive and high yielding technologies are available to farmers as purchased off-farm inputs and, therefore, which directly increase demand for additional financial resources. The complications and bottlenecks associated with rural financing have continually led to the reluctance of financial institutions to engage in these undertakings. These dilemmas include:

- Absence and/or inappropriateness of pledgable collateral
- Small scale nature and geographic scatter of rural farmers
- Difficulty in monitoring and control of farmers' activities
- Absence of legal framework for agricultural credit
- Poor rural infrastructure

These Agricultural Credit Management Proposals will therefore attempt to ameliorate these agricultural finance predicaments, which include:

- I Provision of Production Credit to Farmers through:
 - 1) National All-inclusive Production Credit Program
 - 2) Production Financing through Farmer Groups/Societies
- II Financing of Processors and Traders through Field Warehousing

I. PRODUCTION CREDIT TO SMALL SCALE FARMERS

1. National All-inclusive Production Credit Program

This Agricultural Credit Management Program is conceptualised to deliver agricultural inputs on credit to all farmers in a countries commodity sector in an efficient manner. The lender will provide the inputs to the borrower who could be the National Commodity Association or Authority with a credit manager/collateral manager entrusted with the responsibility of loan policing. The funds are recovered through a uniform in-built component in the farm-gate price paid for the produce by the processors who will in turn pay an input levy to the lender. A control and monitoring system of marketing and processing of the produce required for the efficient levy collection will be a function of a Credit Manager. The major players comprising:

- The Input Financiers/Lender (Banks/Inputs Suppliers)
- The Credit Manager/Collateral Manager
- The Borrower (National Commodity Association)

This program requires the input financiers/supplier to make available to all farmers across the country a range of Inputs on credit. The proposed Inputs distribution program by the input supplier shall allow each farmer to use the inputs on his crop at the National Research authority recommended rate.

The processors shall agree on the terms and procedures of the recovery process of the facility. The cost of the exercise is to be recovered by collecting a « inputs levy » in effect deducted from the farmers' produce price and paid to the input financier's collection account by each processor dependant upon the amount of produce they purchase.

Stakeholders Association

The success of this program would require the existence of a strong processors/stakeholders association to foster collective decision making and implementation while reducing the incidences of defiance of resolutions due to peer pressure. The association should be a limited liability company and every processor is a compulsory member. The association shall have the authority to borrow on behalf of the processors and to bind the processors to repayment agreements.

Farmer Registration

To ensure that farmers needs are met, a registration exercise shall have been carried out by an appropriate agency recommendably the extension service. This farmer registration should be the basis for distribution of the Inputs according to the registered farmers needs. The farmer will be required to provide certain key information such as seed planted, area established, planting dates, expected yield etc which will be collaborated with information collected by the extension agents.

Recovery

Determination of Inputs Levy

The input financiers/input supplier in consultation the processors and other stakeholders shall meet at least one month before the start of the anticipated buying season and agree on the expected crop. All costs of implementing this proposal will be calculated and this total divided by the expected crop. This will be translated into a unit levy per kilogram of processed commodity produced, and this in turn will be converted into a levy per kilogram of produce purchased and each processor will be required to pay this over and above whatever price is being paid to the farmer for their produce. It will be paid directly to a input financier's collection account. Actual payments shall be reconciled against processed

commodity production records on an ongoing basis throughout the produce purchasing and processing period.

Payment of Input Levy

The inputs levy will be paid prior to processed commodity despatch. The levy payable will be assessed on the basis of the produce equivalent of the actual processed commodity weights to be despatched. Payment shall be made directly to the designated input financier's collection account and an inputs levy deposit slip shall be issued to the processor specifying the amount paid and net weight of processed commodity.

Collateral Manager

The services of an appropriate independent collateral manager will have to be engaged for the purposes of loan policing. The collateral manager will be entrusted with the responsibility of monitoring the receipt storage and processing of produce at all plants in the country. The Collateral manager will also verify the payment of inputs levies prior to dispatch of all processed commodities from the processing plants. This will involve the physical presence of the collateral manager's representatives in all processing plants countrywide.

Insurance

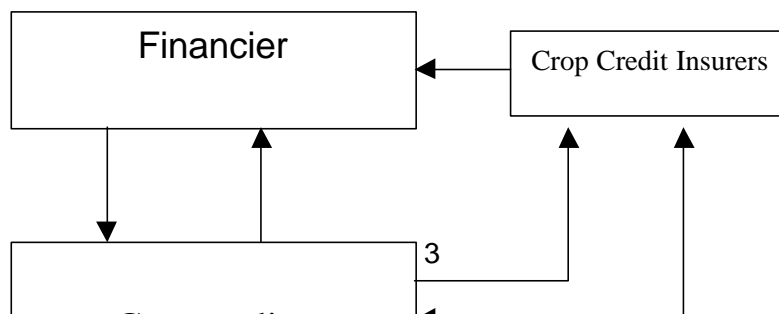
The input financier's ability to recover its crop-credit loans from growers is dependent on the actual production and yields achieved in the season. The lender should seek Aggregate Production Shortfall Insurance coverage for protection in the event that the national aggregate crop harvest falls below a pre-determined threshold.

The Aggregate Production Shortfall Policy is designed to indemnify the input financier at the point when the national harvested production of the commodity falls below an agreed Insured Yield level per sown acre and in aggregate, below which the input loan through the levy on each kilogram of processed commodity will not be recovered. This policy is to indemnify the input financier by the amount that the Actual Harvested and commodity Production falls short of the Insured Production, due to the action of Insured Perils. The insured perils to be covered will include all climatic and biological factors which may impact on crop production and yields such as drought, hail, wind, excess rain, pests and diseases.

In addition, the input supplier will ensure that all inputs procured under the facility are adequately insured against all risks at all stages from procurement, storage to distribution to the farmers. The processors will similarly be required to take all risk insurance coverage on the commodity stocks held at the buying centres and the processing plants. This is to mitigate the risk of loss of the produce stocks prior to settlement of the payable inputs levy.

Security

Raw produce and processed commodity stocks will comprise the collateral and their release will only be subject to the levy payment. The Collateral Manager shall only release the processed commodity for dispatch only on confirmation of payment of the levy.



Input Financing

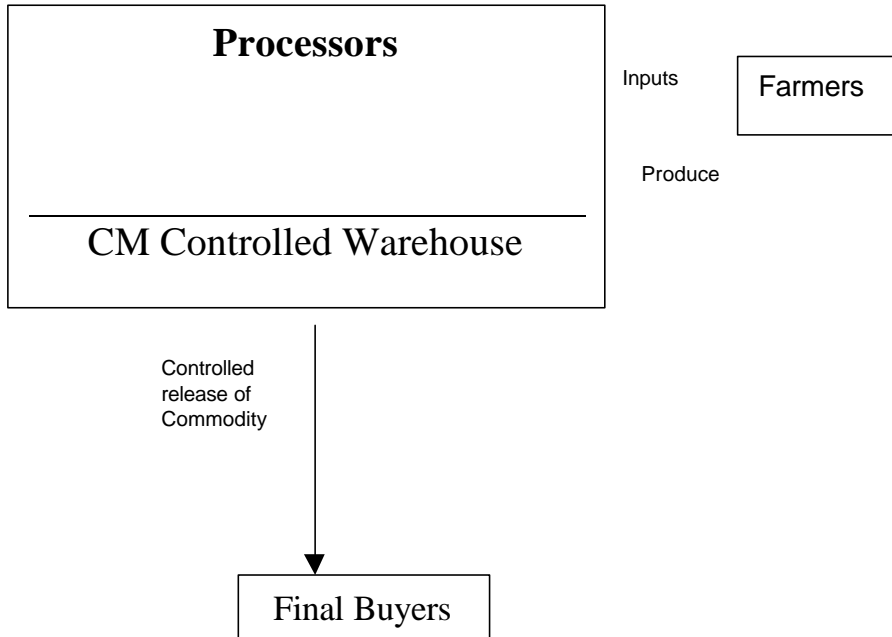
Loan Repayment

Reporting/Advising

Reporting

Supply Inputs
on Credit

- Plant inspection
- Weight verification
- Quality control
- Input levy payment verification



2. Production Financing through Farmer Groups/Societies

The Agricultural Credit Management Program is conceptualised to deliver agricultural credit inputs to farmers in an efficient manner to farmers through farmer groups or societies.

- The Bank (Lender)
- The Credit Manager/Collateral Manager
- The Borrower (Primary societies/Farmer Groups)

The lender will provide the funds/inputs to the borrower with the credit manager entrusted with the responsibility of loan policing.

Primary societies as a finance intermediary have a comparative advantage in terms of farmers' membership, group lending, peer pressure, local knowledge, and lower transaction costs. In addition, primary societies may have the capacity to process loan applications and credit management including enforcement in the case of default.

This mode of agricultural financing will depend upon the loan management capabilities of the groups/societies. Where efficient loan policing can be ensured by the societies, the monitoring of crops in the field will not be necessary on the assumption that peer pressure and joint liability in the society is sufficient to prevent default at this stage, however, monitoring, inspection and /or collateral management will be required at the post harvest stage.

Incompetence of exist Co-operative Society Systems

The existing co-operative society framework is characterised by various deficiencies that have lead to their failure to effectively operate in the current competitive environment. These deficiencies include:

- Lack of support from parent co-operative unions
- Lack of pertinent ownership
- Lack of effective management
- Degeneration of infrastructure

Due to mismanagement over the years, the Co-operative unions have degenerated into financially non-viable entities and the various attempts to revitalise these unions have not been sustainable. As a result, the unions have not been able to solicit sufficient crop finance, and even when available, financial mismanagement and debt burdens have limited their performance. The affiliate primary societies are therefore the end losers with the following experiences:

- Crop purchased at non-competitive prices
- Purchase commonly on credit and untimely payment
- Non-payment of society fees by unions
- Total failure to purchase crop where union's ginneries are not being utilised

The primary societies in turn became institutionally and financially derailed with the lack funds for repair and development of infrastructure. This is coupled with the lack of interest in member participation in effective management of societies due to lack of ownership following the loss of patronage from parent unions.

Recommended Restructuring of Societies for Successful Participation

For these societies to sustainably operate efficiently and competitively, institutional change in form of change of ownership of the societies should be effected. The ownership should be relinquished to the member farmers becoming farmer associations making them liberalised marketing units. They shall then reap all the associated benefits of the trade such as earning commissions from buyers of their produce and the associated financial empowerment required for infrastructure and human resource development and the management professionalised. Such genuine farmers associations are known to be effective and successful by virtual of peer pressure, local knowledge, and lower operating costs. Under this arrangement, every commodity farmer should mandatory be a member of the associations so that all farmers are included in the development programs.

In turn, the unions should be restructured to operate as competitive processors. This should involve the disposal of their excess processing capacities to alleviate their current financial predicaments maintaining one processing plant of their choice. The sale of the excess capacity should be carried out through transparent sale under competitive bidding and the funds used to relieve their debt burden as well as recapitalise the retained processing plant.

Operation of the Program

Role of the Input Financier(s)

- To advance Credit to eligible societies in a criterion agreed upon with the credit manager.
- To authorise the disposal of stock (produce in society warehouses) in a manner agreed upon by all parties.
- To receive and make use of information and documentation, provided by the Credit Manager,
- To pay to the Credit Manager on their relative due dates all management fees payable as agreed by both parties.
- To receive produce proceeds for loan repayments and make payments of societies' net proceeds accordingly.

Role of the Borrower (societies)

- To submit accurate and correct information to the lender and credit manager at the time of loan application.
- Receive and disburse inputs to members, enforce all required loan policing activities, and receive and store produce in the CM controlled warehouse.
- To provide all information as may be required by the credit manager.
- To arrange, in conjunction with the lender and the credit manager, the disposal of stocks.
- To disburse members' net proceeds in a satisfactory manner.

Role of Credit Manager

- To participated in the borrower selection process.

- To undertake efficient inspection, monitoring and/or collateral management activities as agreed by the lender.
- To forward to the lender all relevant information and documentation from the inspection, monitoring and control activities.
- To monitor and ensure payment of produce into a collection account.
- To monitor the disbursement of societies' net proceeds by the bank and subsequent disbursements to the farmer member.

Benefits to Various Participants

Benefit to the lender (Bank)

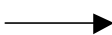
- Reduced lending costs
- Reduced lending risks
- High loan recovery performance
- Development of secure rural investment

Benefits to the Borrowers (Societies/Farmers)

- Availability of credit
- Simplification of loan procedure
- Timeliness of loans
- Improvisation of security
- Reduced cost of loans
- Convenient repayment criteria

Benefits to the Credit Manager

- Increased clientele by virtue the development and expansion of secure rural investment opportunities.
- The resultant growth in the agricultural sector would ultimately lead to increased volume business in the subsequent pre-export marketing activities.



PROPOSED STRUCTURE OF AGRICULTURAL CREDIT MANAGEMENT FOR PRIVATE SECTOR LENDING THROUGH SOCIETIES/FARMER GROUPS



II. FINANCING OF PROCESSORS AND TRADERS THROUGH FIELD WAREHOUSING

There are a larger number of smaller and less experienced traders in agricultural commodities, the result largely of the drive to privatisation and the subsequent change of ownership and structure of many of the former State Trading Enterprises and co-operative unions.

These small scale traders and processors do play an important role in the economies of developing countries by promoting competition for farmers produce with positive farmer price implications. In the absence of such traders, the commodity sector could be dominated by the larger scale producers who may promote negative tendencies such as zoning of farmers and formation of price cartels that could be counter productive to the development of the sector in the long run. There is thus the need to support these small scale producers by way of provision of accessible crop finance loans.

In addition, primary societies if restructured as recommended into viable marketing units, could be used appropriately for a vehicle for credit transmission to farmers especially using the produce stock as collateral where the infrastructure allows. Commodity financing through field warehousing provides the most appropriate financing mechanism in the context of these traders taking into consideration the stringent security requirements of traditional banking that are deterrent. Field warehousing facilities the use of the commodity received as collateral for securing the loans managed by a collateral manager.

Operation of this Program

In this mode of financing, a warehouse established on the premises of a borrower is controlled by a collateral manager to ensure custodianship of goods owned by borrower and creates an effective bailment based on local laws and regulations. The Collateral Manager will have continuous, notorious and exclusive possession of the goods on behalf of the lender.

A warehouse receipt is then issued to the lender by the collateral manager to transfer title of goods to the lender. The lender can then make appropriate financing disbursements against the stock held. Repayment of the loan is based on the control of all sale transactions to ensure the payment of sale proceeds to the lender's collection account.

The value of warehouse receipt depends on the performance of the Warehousing Company or Collateral Manager, of its financial capability and its own insurance coverage.

Advantages of Field Warehousing

- No geographical limitation.
- Flexibility from up-country.
- No additional cost.

Vital Issues of Consideration in Field Warehousing

- The bank accepting receipts of a particular field warehousing organisation should give consideration to the following:

- The validity and trustworthiness of the Warehouse receipt
- The nature of the underlying collateral

Under the first consideration there should be determined:

- a) The financial condition of the warehousing company
- b) The extent of its experience and the capacity of its organisation
- c) Whether the premises for the contemplated warehouse set-up are suitable for storing the particular goods
- d) Whether the leasing arrangement is in legal form
- e) Whether the goods are properly segregated from unpledged assets of the borrower
- f) Whether signs and markers are clearly displayed inside and outside the warehouse
- g) Whether the goods are adequately described as to quantity and nature in the receipt and are readily identifiable in the storage premises
- h) Whether the receipt itself meets the requirements of the laws of the state in which it is issued

Qualification of a Collateral Manager

- The CM must be licensed to issue Documents of Title in the Relevant Country
- The CM procedures employed legally sufficient to perfect a possessory pledge?
- The CM must have Insurance Coverage against Professional Indemnity and Fraud
- The CM must ensure that the Commodities are Covered Against all risks i.e. Fire, Flood, Theft and other Risks and must ensure that the Bank is the loss payee in the insurance policies
- The CM must have adequate Local Supervisory Staff to regularly Audit the commodity stocks

Conclusions

These three credit management proposals are designed to deliver credit to farmers, small scale processors and traders in a manner that would suit financiers by mitigate their traditional problems that include amongst others:

- deficiencies in loan appraisals
- bureaucratic delays in loan processing and disbursements
- ineffective loan portfolio management
- poor loan demand assessment
- high interest rates
- lack of trained personnel in loan management
- high operational costs
- unacceptable low recovery performance
- political inference

Notable advantages of these proposals include:

- Identification and mitigation risks involved with agricultural lending through an efficient monitoring, inspection and collateral management system required for loan policing.
- Loan policing activities undertaken by the collateral manager greatly relieve the lenders of length administrative and transactional procedures which otherwise renders the operation unprofitable. This would also subsequently facilitate the promptness.
- The credit management systems ensures freedom from political interference by engaging an independent loan management intermediary free from any inclinations or prejudices as have always characterised rural financing endeavours.