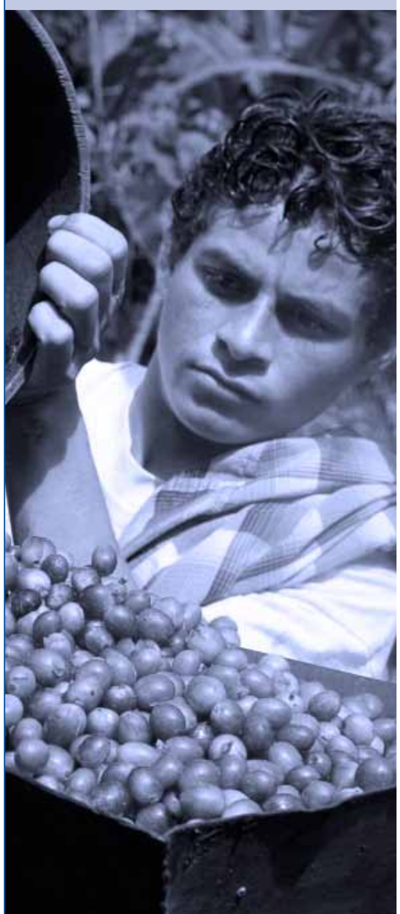
Microfinance

OCCASIONAL PAPER

Facilitating Financial Linkages for Smallholder Producers in Nicaragua



Finance is critical for smallholder producers to successfully engage in value chain initiatives. In many cases, financial institutions are reluctant to lend to smallholder producers since they lack the collateral needed to secure a loan and assure the lender of their ability to repay. The role of an external intermediary is often important to bridge the gap between smallholder producers and financial service providers. This paper highlights the role that CRS and its implementing partners have played in creating effective linkages between financial service providers and smallholder producers in Nicaragua.

In September 2007, CRS took the lead in implementing a Global Development Alliance (GDA) project funded by the United States Agency for International Development (USAID). The project "Alliance to Create Rural Business Opportunities through Agro-Enterprise Relationships (ACORDAR)" was designed to increase the income of poor families, ensure permanent employment, and strengthen the commercial capacity of 7,000 poor rural families in 50 municipalities. The project is being carried out in partnership with municipal governments, supermarket chains La Union and La Colonia, the Nicaraguan Exporter Association (APEN), LAFISE, and a number of microfinance institutions. It provides technical assistance to small- and medium-scale Nicaraguan farmers to produce agricultural goods, based on known market demand. ACORDAR is being implemented by CRS, Lutheran World Relief (LWR), the Aldea Global Association of Jinotega (AG), and TechnoServe (TNS).

ACORDAR is working to strengthen 107 smallholder cooperative enterprises and 8 second-tier cooperative associations. Ninety percent of the 7,000 targeted producers are organized in these cooperatives. Sales from the production (determined by the market prices) has provided $57 million in gross sales during the first 30 months of the project. While no consolidated information exits on the net increase it is estimated that these efforts have generated 12,000 permanent jobs from the specific interventions that are designed to improve the value chain engagement, post harvest management, and commercialization. ACORDAR is involved in supporting the production of fruits, vegetables (including roots and tubers), red and black beans, coffee, and cocoa.

Project activities are centered on investments in infrastructure, development of commercial capacity, and the transfer of appropriate technology. The intention was for small- and medium-scale farmers to be the owners of the production and post harvest infrastructure, thus increasing their ability to compete in the market. Investments in infrastructure include packing centers for vegetables and coffee, cold storage rooms, community storage centers, a biofertilizer processing plant, a dry coffee mill, ecological wet coffee mills, machinery for the drying and fermentation of cocoa, and irrigation technology. The improved commercial production capacity of the ACORDAR supported producers has helped to strengthen the access of their cooperative enterprises to better market intelligence, has enhanced their ability to manage their businesses, and has increased their exposure to opportunities for sales to regional and international markets.

In addition to these investments, access to finance has been a focal point of the project in supporting sustainable production activities. One of the important contributions of ACORDAR has been its ability to link small- and medium-scale have experienced great difficulty in accessing finance for their production activities in the past, CRS and partners have worked hard to establish strategic alliances with microfinance institutions (MFIs) and international investors. These alliances have allowed the cooperative associations, working in the coffee sector, to borrow at more favorable rates. This in turn has allowed them to pass on this lower interest rate to their member cooperatives.

Establishing links with financial providers and the role of intermediaries

CRS and its partners have been able to establish relationships with institutions such as Root Capital, Oikocredit, Rabobank, and other providers of large scale, low interest, second tier/wholesale loans. Many of these loans have been sourced for cooperative associations in the coffee sector who in turn make loans to their base cooperatives and end users. Some of these strategic alliances were established prior to the project, but some took effect during the project implementation.

In the case of socially minded investors, such as Oikocredit and Root Capital, having a technical support organization such as CRS, LWR, or TNS is helpful in lowering their investment risk as this linkage reduces the perception of risk based on the known integrity and technical service quality and supervision provided by these support organizations. In many instances, the reputation of an organization such as CRS, accompanied with an investment in smallholder producer capacity building is a sufficient guarantee for the investments made to these cooperatives.

An early lesson learned has been that while it is initially important for support organizations to play a role in intermediation — in cases where it is deemed essential — it should be viewed by all stakeholders as a temporary one. Support organizations should seek to prioritize capacity building activities for smallholder producers, especially in helping them understand the different financial mechanisms and their appropriateness for various phases of the different production cycles. It is imperative that farmers are aware of the limitations of each financial solution so that they can make informed decisions.

Furthermore, an additional lesson learned has been that in addition to awareness of various financial instruments, helping farmers build strong negotiating skills is critical in ensuring that they are able to bargain well not only for affordable financing, but also as they work with value chain actors to establish mutually agreeable terms to support their production and marketing activities.

Alternative Sources of Finance under ACORDAR

Finance for the ACORDAR farmers was sourced from a range of financial mechanisms, including but not limited to MFIs. It is often advantageous for a smallholder producer to diversify his or her financial streams depending on which financial mechanism is most appropriate for a specific production activity.

Sources of Finance

Finance from Social Investment Funds

Traditional investors look for a financial return on their investments that is comparable to other market rates. When combined with a collateral requirement, this type of finance is usually outside the scope of what a smallholder producer can feasibly access and afford. A social investment fund, unlike a traditional investment, provides their investors with a dual (financial and social) return on their investments. Loans are not interest-free; however, they are provided at lower than the market rate as the primary goal is to safeguard the borrower's financial well-being as well as the investment. This is the social return, which is defined as the ability to support underserved groups in need of finance, while still earning a small financial return on their investment. Root Capital and Oikocredit are examples of such investors.

In the case of Root Capital, the provision of finance to a cooperative is dependent on that cooperative's ability to successfully market its coffee to international buyers and roasters. As part of its social mission, Root Capital is concerned that the cooperatives they support are engaged in ecologically sound cultivation and post harvest practices, and must focus on quality products for expanded market access. Cooperatives which meet these criteria are in a better position to negotiate for funding from Root Capital. Loans provided by Root Capital are focused on production and post harvest activities that enable coffee cooperative members to produce at optimal yields and quality, and at scale. In partnership with ACORDAR, Root Capital has budgeted to extend up to $4,000,000 in loans to small- and medium-scale coffee farmers through their cooperatives associations.

Loans provided by Root Capital are given directly to the cooperative associations. The cooperative associations have well-established credit programs and the required accounting software to manage the loan portfolio. The cooperative associations have well-trained credit promoters and loan portfolio managers. Once Root Capital disburses the loans, the cooperative associations on-lend the funds to the base cooperative or, in some cases, directly to the farmers.

Cooperative associations earn a nominal interest margin on these loans. Loan terms range from 6-18 months, depending upon the crop cycle.

In-kind/non-cash investments from other value chain actors

In addition to finance from socially-minded investors, a number of smallholder producers have been able to find alternative and creative sources of finance. For example, a number of bean and vegetable producers are able to access in-kind (not cash) investments from commodity buyers and input suppliers. These investments provide the fertilizer and seeds for production and the use of post harvest processing equipment and storage facilities to complete the cycle. The producers must then sell their production to the commodity buyers or input suppliers to repay these "in-kind loans." The value of the production minus the value of the inputs is then given to the producer. These in-kind investments can help to jumpstart the production activities of the smallholder producers that lack the necessary upfront finance needed to support their production activities. Without this, these producers would not be able to respond to market demand.

Even producers, who have succeeded in producing and harvesting their crops, often lack the proper cleaning, packing, and storage facilities to ensure that their crops successfully make it to market. These producers require additional support. In-kind support for post harvest activities (use of specialized equipment for a fee to be paid after the crop is sold) can assist smallholder producers when they are unable to invest in these facilities themselves. However, one must be careful not to become too dependent on external assistance as there are times when the dependency on these in-kind investments can compromise the farmers' negotiating power and thus their ability to secure a better price for their production.

ACORDAR has shown that when support services are provided, as under this grant, farmers can and should be encouraged to link with other value chain actors to ensure their sustainable participation in the value chain. As with any financial service, it is imperative that the farmers understand the terms of the loans so they can evaluate the appropriateness, affordability, and limitations of the resources being offered.

Working with Microfinance Institutions

Many of the MFIs that partner with the ACORDAR project had prior experience in designing agriculture loan products and an active agriculture portfolio. Despite their experience in this area, the creation of agriculture loan products using alternative forms of collateral, such as warehouse receipts or a forward contract with a commodity buyer has yet to occur. This is specifically the case when smallholder producers lack traditional collateral. The lack of acceptable collateral substitutes has resulted in bottlenecks and delays in loan processing, which impacts small- or medium-scale farmers' ability to meet production targets.

In cases where MFIs have been more willing to expedite the loan process, based on an awareness of the technical assistance that comes from CRS, LWR and TechnoServe, MFIs are able to support production and post harvest management activities. MFI funding that comes from social investment funds allows the MFIs to expand lending as long as the cooperative business is able to demonstrate market demand and commitment from a buyer along with proof that they are able to meet this demand. This has not been a problem for the coffee cooperative associations operating under ACORDAR because they had a previous track record of buyer contracts for export before the project began

Primary uses of loans

The loans sourced by the farmers under this project have been used to finance inputs (seeds, fertilizer, and labor) for production. In the case of coffee, loans are used to finance the labor costs associated with the harvest, storage, and rental of processing facilities. To a lesser degree, loans are used to purchase inputs needed to maintain the perennial crops. For cocoa producers, loans are provided for labor for pruning, weeding, and cocoa processing. Farmers that produce fresh fruits and vegetables use their loans to purchase row covers, plastic sheeting, fertilizer, and labor.

Other crops such as red and black beans have not utilized much commercial credit under the ACORDAR project to date. This is primarily due to the fact that the producers grow beans on very small plots with minimum inputs needed. While much of this production is meant for sale in local markets the finance for such small-scale activities is seen as too costly and a risk for many financial institutions. Without access to finance farmers cannot invest in production on larger areas or in new more productive varieties. As such, bean farmers remain among the poorest farmers within the ACORDAR project. In response to the unmet demand for finance from bean farmers, CRS has provided project funds for cash advances to bean farmers to pay for processing and storage. These funds are available only to the cooperative associations. This mechanism is similar for coffee and cocoa as more storage equals greater volumes that can eventually be sold at a higher price thus increasing the return to the farmers and eventually leading to economies of scale.

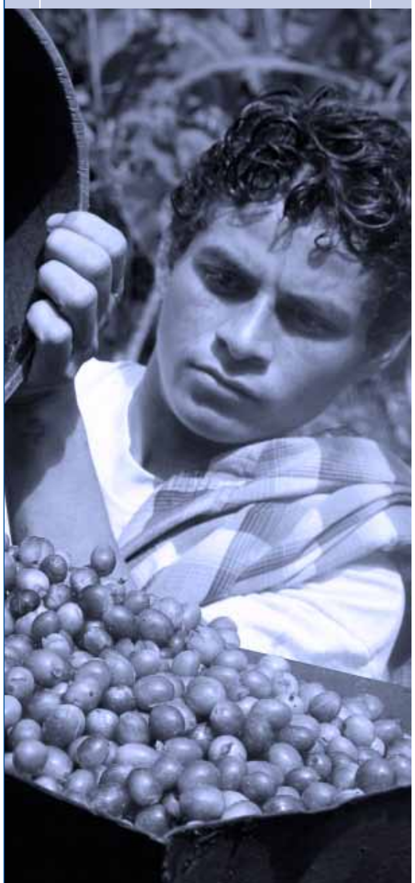
Outcomes and achievements

Before ACORDAR, only about 15% of producers supported in the project received loans from a microfinance institution. After two years this percentage increased to approximately 30%. In addition, this has helped some farmers diversify their sources of finance by accessing loans from their cooperative associations or base cooperatives, in addition to their traditional sources. Loan sizes vary depending upon the crop. In the case of fresh fruits and vegetables, loan sizes range from US$7-8,000 per ha. In the case of coffee, loans are provided in the form of a cash advance ranging from $150- $2,400 per ha.

Key steps in ensuring a well-functioning relationship with financial institutions

The lessons learned in working with financial service providers revealed that four key elements are necessary to ensure a well-functioning relationship between farmers and lenders:

1) A Memorandum of Understanding or formal agreement between the financial service provider and the cooperative association is needed to clearly



identify the demand for credit and agreed-upon terms and conditions loan use and repayment.

2) The lender must have a working knowledge of relationships that exist between the farmer cooperatives and other value chain actors, as well as field level knowledge of the service providers responsible for assisting in production, post harvest management, and commercialization in order to be able to assess the potential for profitability and the producers' ability to repay.

3) While it is important for support organizations to play a role in intermediation — in cases where it is deemed essential — it should be viewed by all stakeholders as a temporary one. Support organizations should therefore prioritize capacity building activities for smallholder producers to meet the longer term needs.

4) In addition to awareness of various financial instruments, helping farmers build strong negotiating skills is critical in ensuring that they are able to bargain well not only for affordable financing, but also as they work with value chain actors to establish mutually agreeable terms to support their production and marketing activities.

5) MFIs need to accept a broader range of collateral substitutes, such as harvest contracts and smaller physical assets rather than requiring only traditional collateral (e.g., properties). This is an area that needs to be further developed if MFIs are to have a greater impact on smallholder production activities.

ACORDAR has shown that it is possible to establish a win-win relationship with MFIs and other financial service providers to support the financial needs of small-scale farmers. Lending to small- and medium-scale producers that would otherwise not have been able to access finance helps the financial institutions increase their outreach and develop new and profitable products.

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