# Banks enter Ethiopian sesame sector through risk sharing scheme

*Accessibility of agricultural finance in North-West Ethiopia is a critical problem, particularly for sesame growing areas. Unions and cooperatives lack the capital to support members with production and marketing activities. Therefore, most smallholder farmers (SHFs) are depended on informal money lenders (IML's), especially for the last stages of the agricultural season. Loans from IML's are paid back in kind with extremely high 'interest rates' of more than 250% on an annual basis. A famous saying among farmers is: 'shi by shi' or in other words 'borrow 1000 ETB, pay back 2000 ETB' (100% interest costs for a few months).*
*The financial sector has long been disinclined to finance farmer organisations due to the various risks and uncertainties in the agricultural sector. To overcome these challenges a risk sharing financing scheme was established with Ethiopian commercial banks to reach farmers through providing output marketing loans to unions and cooperatives.*

**Finance gap for agricultural marketing credit**:

The formal financial sector is less actively involved in the sesame sector either because of risk factors or lack of humanitarian and financial resources. Some of the most important challenges are:

- Lack of collateral
- High production risks: weather conditions and pests and diseases
- High marketing risks: price fluctuations
- Weak financial literacy of farmers and limited management capabilities of cooperatives and unions
- Lack of agricultural expertise, appropriate loan product development, client profiling and risk mitigating strategies in financial institutions

Agricultural financial risks are also associated with farmer's repayment attitude. Enforcement of repayment and controlling default risks are cumbersome and costly because of legal procedures.
Based on a risk sharing approach, Benefit-SBN and Agriterra established a guarantee fund as partial collateral for a marketing loan provided to unions and cooperatives by commercial banks. Initially, a limited guarantee and marketing loan was provided in 2016. The success of the scheme, with zero repayment defaults and multiple benefits for different stakeholders, resulted in an ETB 30.5 million (more than € 930.000) loan for the sesame sector in 2019.

**Primary objectives:**

**1. Boost output marketing of PCs and Unions:** unions and cooperatives face financial deficiencies to collect members' sesame production.

**2. Reduce credit costs and increase smallholder's income**: through timely disbursement of the marketing loan, cooperatives can provide finance to members to cover production costs during the weeding and harvesting period. This affordable alternative to informal money lenders reduces credit costs.

**3. Ensure fairer spot market prices:** if cooperatives are not present at spot markets, traders collude and are able to fix prices.

**4. Strengthening union, cooperatives and member financial capabilities and relations:** the financing scheme and support interventions improve the financial skills of all stakeholders and relationships based on stronger collaboration and mutual benefits.

**5. Build trustful relations between banks, unions and cooperatives:** strong repayment, savings and transaction performance as well as appropriate products and bank services for long term financing.

## Financing scheme modality

The marketing loans provided to unions are on-lended to cooperatives, who gain access to marketing credit and can serve smallholder members with input finance during the last stages of the production season. Thus, improving the access to finance at all levels based on four types of agreements:

- Risk sharing agreement between bank and guarantor
- Loan agreement between banks and unions or cooperatives
- Marketing credit loan between unions and cooperatives
- Input credit loan between cooperatives and smallholder farmers

The most important aspect of the financing scheme is the risk sharing percentage in case of defaults. Recognizing the importance of building trust between banks and farmers, initially 50% of the provided principal loan amount was guaranteed. Equalling the percentage of the total defaulted amount that would be covered. Based on a proof of concept and zero loan defaults the guarantee fund percentage was gradually reduced to 20%.

The union receives a one-year market credit loan from the bank. This is the minimum term due to the 27% payment fee for every loan provision of the national bank.

The union provides a loan to selected cooperatives for approximately eight months. The cooperative uses the capital for short term (3-4 months) input loans to farmers and as marketing credit afterwards. The input loans are targeted to finance the last stages of the production season to reduce risks by having the crops already in the field. Farmers repay their loan in-kind to strengthen the cooperatives marketing activity. In every step along the chain a small amount of 0.5 to 1% is added to the interest rate to cover the loan management costs.

## Financing scheme implementation

There are several important activities to develop a successful risk sharing financing scheme.

- Bank introductions, concept note and workshop

A cooperative bank or bank with farmers as shareholder is a logical starting point. To establish bank interest for the agricultural sector, a thorough introduction is needed. Often, there is more understanding and engagement at the branch level. The branch managers in the sesame area helped with arranging an appointment at the headquarter. First, the sesame sector, stakeholders, financing challenges and opportunities and the suggested financing modality and intentions were carefully introduced. After that, a concept note to further explain the credit needs, collaboration modalities and division of tasks and responsibilities was developed. Multiple discussions at different levels took place to get the different decision makers on board to support the proposed risk sharing financing scheme.

After a few years of experience, a multi-stakeholder reflection workshop was organized. New banks were invited to attend and learn from the experiences of the first partners: Cooperative Bank of Oromia (CBO), Setit and Metema union and four multi-purpose cooperatives. The convincing results and achievements of previous years helped to raise the interest of new banks to enter the negotiation phase.

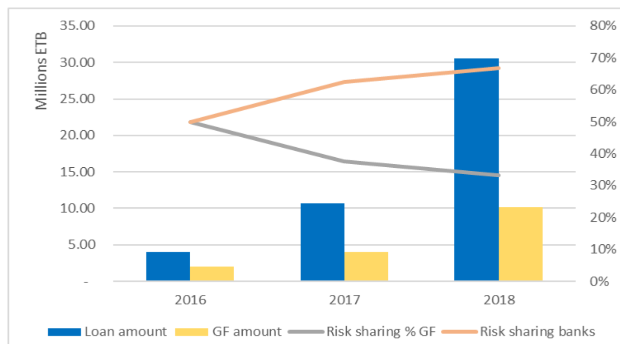
## Key facts:

- Agriterra & Benefit-SBN collaboration since 2016
- Year on year scaling of the financing scheme
- Expansion to 3 Banks: CBO, Abay, Lion

- 3 Unions: Setit, Metema and Dansha Aurora
- 21 cooperatives receive on-lending from three unions
- 2 Cooperatives directly financed: Sanja and Godebe
- 11,791 smallholder farmers reached; 2,396 women

| Financing scheme data | | | | |
|---|---|---|---|---|
| | 2016/2017 | 2017/2018 | 2018/2019 | 2019/2020 |
| Banks | CBO | CBO | CBO, Abay, Lion | Abay |
| Borrowers | Setit union, Metema union | Setit union, Metema union | Setit union, Metema union, Dansha union, Sanja Cooperative | Metema union, Sanja cooperative, Godebe cooperative |
| Guarantee % | 50% | 37% | 33% | 20% |
| Loan amount ETB | 4 million | 10.7 million | 30.5 million | 15.5 million |
| # of Cooperatives | 4 | 7 | 22 | 10 |
| # of Farmers | 1067 | 2995 | 5541 | 2188 |

- Reducing guarantee fund percentage from 50% to 20%
- Reducing interest costs from informal sources of ~200% to ~18% p.a. of formal financial institutions
- 100% repayment results across all years
- 19/20 exit year: strict conditions of max. 20% risk share and union ability to replace guarantee fund early to release project funds




- Promotion of saving: 1018 saving accounts opened
- Additional shares sold to members: 5366 worth more than 312,000 ETB
- Increased cooperative marketing transactions: cooperatives under Metema union aggregated more than 2,500MT; this was less than 40MT three years ago.

♦ Bank negotiations

During the negotiation phase the exact terms of the financing scheme are agreed. This includes the total loan amount, financial product development, interest rates and risk sharing percentage and related guarantee fund amount. Also, the practical arrangements to deposit the guarantee in local currency (ETB) at a blocked account of the bank were discussed. A deposit in local currency is preferred to eliminate foreign currency incentives.
The critical point of attention in this phase is to ensure full commitment of the bank to achieve the objective of the agricultural financing scheme and reach a legally binding contractual agreement. The biggest challenge is to adapt the banks' organizational structures, procedures and products to integrate agricultural particularities. For instance, the bank needs to invest in human resources to attract agricultural expertise and to handle "non-standard" loan assessments and agreements.

♦ Union and cooperative assessment and selection

An important step to assure the success of the financing scheme is the careful selection of union, cooperatives and farmers. The banks lacked the capacity, experience and knowledge to perform a thorough client assessment. For this risk mitigation activity special tools have been developed by the collaborating support projects to apply objective and comprehensive criteria. The selection of unions and primary cooperatives is based on a multi-step assessment including:

- **Basic profile and information gathering at union level:** select unions based on management, marketing and loan provision potential.
- **Pre-assessment:** pre-assessment of cooperatives under selected unions based on eight essential minimum requirements: agricultural potential, professional staff, experience, accessibility, audit history, good governance, membership relationship and warehouse availability.
- **Thorough assessment:** visit cooperatives for a few hours to collect information on ten different dimensions: vision, financial performance, marketing, sourcing, governance, management, administration, assets, enabling environment and risks.
- **Performance assessment:** monitoring and evaluation during preparation, implementation and follow up of the financing scheme.

Unions, banks and the Cooperative Promotion Office (CPO) were involved in the assessments and in the discussions to make a decision based on the outcomes.

♦ Loan product customization or development

The credit needs of unions and cooperatives for marketing and of farmers for input finance are assessed to support the development and customization of loan products. Loan products need to be tailored according to the purpose, time frame, administrative costs and risk mitigation measures at each level. Recommendations are provided to the bank on the timing of the loan provision in line with the agricultural season and costly activities of weeding and harvesting. Therefore, a phased disbursement is initiated through a 'credit freeze' account to hold the non-disbursed amount of the loan without accruing interest rates. Moreover, the guarantee found replaces traditional collateral requirements and should diminish over time based on the established trust and increased financial capacity and asset development of the borrowers. Also, discussions on the special categorization of the loan product to unions and cooperatives is held to negotiate better interest rates.

**Stakeholder benefits:**

The most important benefit of the financing scheme is the access to marketing credit for unions and cooperatives. Secondly, farmers receive input credit for weeding and harvesting.

However, the benefits go far beyond addressing the financing gap. Primary cooperatives benefit from attracting new members, increasing their internal capital through selling additional shares and establishing improved relationships with their members and unions. Moreover, primary cooperatives developed loan management capacities through trainings provided and experiences gained.

Banks benefit from attracting clients (both cooperatives and smallholders), increased volumes of transactions, interest rate earnings and above all gathering experience in the agricultural sector. One of the most important objectives of the banks to participate in the financing scheme is to respond to the demand of governments or agricultural shareholders and improve reputation among farmers.

**Banks**

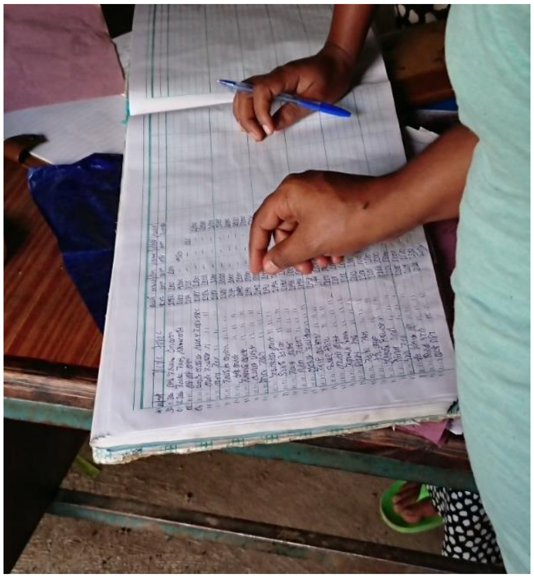
- interest rate earnings
- transaction volume / liquidity
- saving mobilization
- shareholder/customer relationship building

**Union/cooperatives**

- marketing credit
- loan management and marketing skills
- improved membership relation
- aggregate produce volumes for marketing
- price transparency and reduced traders' collusion spot markets
- internal capital mobilization

**Farmers**

- access to input finance
- reduced interest rate costs
- loan distribution and repayment coincide with agricultural season
- fair price at spot markets, e.g. acceptable difference between spot market and ECX
- saving opportunity
- strong relation cooperative and union



- Capacity building

Next to the support to the banks, capacity building is critical for each level of borrowers. Clarification to the participants of the objective of the financing scheme and challenge to establish a sustainable long-term relationship with the financing institution is important to ensure the loan is used for the intended purpose and appropriate risk mitigation measures are taken.
The largest responsibility and skill gap is at the cooperatives. Selected cooperatives received a loan management training to learn how to properly handle the on-lending to members. A three-day intensive training program covered all steps and administration requirements: from loan application, screening, disbursement up to repayment practices. Most important topics are the division of roles and responsibilities between the cooperative accountant, loan committee and board members as well as setting objective loan eligibility criteria and amounts. In addition, topics such as internal capital mobilization and the promotion of a saving culture are discussed.
Farmers' management of money, saving habits and repayment culture are also addressed through farmer financial literacy trainings. Cooperatives are advised to include the completion of this training as eligibility criteria.

- Monitoring and Support

Continuous follow up and support is needed during the season, especially at critical disbursement and repayment periods. Therefore, several visits are scheduled after the loan management training to ensure a qualitative implementation.
Risks that can evolve during the production and marketing season, like weather and market price conditions, require timely discussions with banks, unions, cooperatives, farmers and other stakeholders to identify which strategies are best to effectively cope with and adapt to new developments. In addition, to build sustainable relationships between banks and farmers and secure finance for the next season, ongoing communication and involvement is necessary.

### Financing scheme results

- Zero defaults from unions to banks; in some cases, union and cooperatives covered for defaulting members, showing their commitment to secure the credit facility and maintain the relation with the banks
- Farmers dependency on informal money lenders diminished and credit costs reduced
- Larger quantities of sesame are supplied to cooperatives and unions; increasing the volume and number of transactions at sesame spot markets
- Farmers received dividend from the marketing profit made by cooperatives, which is rather rare for most Ethiopian cooperatives
- The relationship between unions and cooperatives as well as between cooperatives and farmers improved; participating cooperatives attracted many new members
- Mutual understanding increased between banks, unions and cooperatives
- Banks encouraged farmers to open saving accounts and improved the repayment culture
- The importance and potential of the agricultural sector is better perceived by banks; ~50% of branch savings and transactions from sesame farmers
- The banks' reputation among farmers and their organizations, which are often shareholders, improved
- Strong farmer commitment despite challenging security situations

**Points for attention:**

- Timely start of negotiations, preparations and loan distribution according to the season
- Clarity of intentions, conditions and contracts
- Documentation requirements banks for loan application
- Financial position of unions and cooperatives (outstanding or multiple loans and audited)
- Loan capacity and marketing management of unions and cooperatives (objective criteria)
- Physical and social distance between end-users (small holder farmers) and bank branches
- High credit needs: loan demand is much higher than disbursed amount
- Capitalization strategy to replace temporary guarantee fund through members, profit and asset generation
- Banks' presence and investment in targeted area and level of agricultural knowledge
- Role of unions as aggregator or market linkage provider
- Impact of direct financing cooperatives excluding unions
- Market speculation of all borrowers

## Financing scheme lessons learned

*Verify the strategic interest of commercial banks in the agricultural sector.* The key question is if banks have objectives that go beyond the scope of the risk sharing scheme, which is meant to initiate, facilitate and risk-share the connections between banks and farmers' organisations. If not, there is a serious risk that the bank-farmer relation will not be sustainable.

*Start small and target a year by year increase of the loan amount, risk sharing percentage by banks and scope of borrowers*. Building the relationship and trust between the banks and borrower unions or cooperatives is a gradual process. It is important to move step by step and build a track record.

*Select unions and cooperatives carefully.* This requires tailored tools for profiling and assessment, based on eligibility criteria, that are underscored by both the banks and the farmers' organisations.

*Build capacity on loan management.* This requires modules for training unions and cooperatives on, loan application, disbursement and repayment processes. Thorough borrower assessment, loan product adjustments, phased disbursement and repayment monitoring enhanced the technical capacity of farmer organisations in managing loans and reduce risks.

*Build capacity for internal resource mobilization to build up alternative means as collateral to replace the guarantee fund*. For sustainability, it is important to start early with awareness creation and capacity building of borrowers on capitalization strategies, such as strengthening internal resource mobilization, to build up collateral.

*Engage bank staff at different levels.* Borrower assessment and selection, training and coaching, monitoring and evaluation should be done in close collaboration with banks. If banks leave these tasks to a third party and do not recruit or assign dedicated employees, the sustainability is at risk. This risk also exists when local branches are committed, but not sufficiently supported by higher management levels.

*Work with different partners, both at the bank and farmers' side.* Some level of competition among banks induces improved loan product offers. Some level of competition among cooperatives induces improved loan use and repayment.

*Define the loan contract terms and the loan application process clearly and facilitate the communication between banks, farmers' organisations and farmers.* Each bank has policies and regulations regarding loan duration, required collateral and other subjects. These must be clearly communicated to the borrower and facilitator. The requirements and timeline of the loan application process should also be clear. Long negotiations may delay loan provision. If these terms and steps are clear, loan application and provision can be more participatory. The farmers, cooperatives and unions need to agree on the repayment date of the loans. This is often a fine balance in distributing the marketing time between the different parties. Short term marketing credit loans of the unions can ease this problem.

*Invest in strengthening the capacities at different levels at the borrower side.* Topics may include supportive role of unions, financial management of cooperatives, internal communication, marketing strategies and compensation for the services of unions and cooperatives, farmers financial literacy training, saving culture, internal resource mobilization and others.

## Way forward

Recent trends seem to support the increase of agricultural finance. The financing scheme experience provides a promising starting point to further strengthen and scale bank interventions in the sesame sector.

- Potential of sesame sector for banks to capture market share in agricultural transactions and attract new customers to expand banking services
- Push of the National Bank to allocate a certain part of the portfolio to agriculture
- The financing scheme raised a lot of interest of banks and micro-finance institutions, government agencies, other projects and international capital providers; this may create opportunities to find sustainable solutions; especially, considering the increased openness for foreign capital injections

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**Agriterra** is an agricultural development agency founded in 1997 by Dutch organizations of farmers (LTO), young farmers (NAJK), cooperatives (NCR) and rural women (SSVO). Its mandate is to support and strengthen farmer organizations in Africa, Latin America and Asia.