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**Pilot short- and medium-term finance to
small-scale coffee farmers in Kenya**

Executive Summary of the final report

Background

1. This document contains the Executive Summary of the final report of the project entitled 'Pilot short- and medium-term finance to small-scale coffee farmers in Kenya' (CFC/ICO/20) which was submitted by the Kenya Planters' Co-operative Union Ltd (KPCU).
2. A copy of the full report is available on request from the Secretariat.

Action

The Council is requested to take note of this report.

**PILOT SHORT- AND MEDIUM-TERM FINANCE
TO SMALL-SCALE COFFEE FARMERS IN KENYA
(CFC/ ICO/ 020)**

I. PROJECT SUMMARY

**Objective and scope
of the project:**

The central objective of the project was 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 comprised 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.

Project Executing Agency:	United Nations Office for Project Services (UNOPS)
Location of Project:	Kenya
Duration of Project:	Five years
Estimated Total Cost:	US\$3,044,900
Financing sought from CFC:	US\$1,444,900 (Grant) US\$1,000,000 (Loan)
Counterpart co-financing:	US\$600,000 from KPCU

II. EXECUTIVE SUMMARY

A. BACKGROUND

Previous efforts for streamlining financing mechanisms for small-scale coffee growers through concessional credit schemes could not encourage the banks and financial institutions to sustainably extend credit assistance to small-scale coffee farmers. Continued absence of credible institutional credit support resulted in the neglect and deterioration of coffee plantations, leading to decline in coffee productivity, quality and incomes. The issue was comprehensively deliberated in various regional forums which recommended that projects to evolve structured input credit schemes with an inclusive, consultative and bottom-up

approach be assisted. The International Coffee Organization (ICO) and the Common Fund for Commodities (CFC) also supported this view and agreed to assist a pilot project in Kenya with an understanding to replicate its success in other coffee-growing regions.

The pilot project

Against this backdrop, the KPCU, then the largest coffee miller and marketing agent in Kenya, submitted the proposal. The CFC, with consent from the ICO, sanctioned financial assistance comprising a technical assistance grant, and loan fund components to implement the pilot project in Kenya. The lending under the project was due to commence in October 2006. However, due to non-availability of CFC loan funds for want of certain formalities, the CoDF stepped in to provide loan funds in 2007. The CFC however financed the technical component.

Project objective and expected outputs

The objective of the pilot project was to demonstrate how access to institutional input credit services can be provided to small-scale coffee growers on commercial terms in combination with other non-credit services on a sustainable basis for enhancing coffee productivity and quality in coffee growing regions. The expected outputs under the project were:

- A farmer and crop centric credit plus product and delivery system for supplying input credit to coffee farmers.
- A location specific package of good production and processing practices supported by quality farm inputs, training, extension and supervision services.
- Sensitized and motivated stakeholders and intermediaries, trained farmers and implementing staff, comprehensive systems and procedures, customised IT system, technical manuals and training and extension resources.
- Efficient system of organization and management, field supervision, credit monitoring, coffee tracking and payments and loan repayment.

B. ACHIEVEMENTS AND LESSONS LEARNED

Loans delivery

Smallholders account for about 60% of coffee production in Kenya and without credible arrangements for supplying them with production credit, the coffee sector was likely to be trapped in a vicious circle characterized by '*low capital-low input-low production-low income*'. A good response from farmers to the credit product and positive results achieved in terms of enhancing coffee productivity and quality highlights the importance of a credit plus product and well-structured, inclusive, participatory and flexible lending methodology for providing input credit to small-scale coffee farmers.

Project loans were disbursed to farmers in three phases in accordance with the coffee calendar. The loan was disbursed in two forms, i.e., supply of farm inputs as in-kind component and cash loans for labour costs. Exact quantities of fertilizer and other inputs required by individual farmers were compiled from the loan applications, group-wise. Aggregate requirement of inputs under the project was procured in bulk jointly by society, groups and PIU for smallholder farmers and by SACCOs and CIGs for estates. SACCOs directly paid a consolidated amount to the input suppliers. The Society then issued inputs to smallholder farmers based on their phased requirement as per the loan application form and the relative amounts were raised as loans to individual farmers. Cash loans against the labour component were also issued to individual farmers and estates in phases.

A multi-agency and participatory supervision system was the hallmark of the project. Aspects such as utilization of loan, use of inputs, good production practices and movement of coffee were supervised by the PIU, societies, farmers' groups, CRF and SACCOs, extension and cooperative officers, etc. Involvement of farmers' groups made the monitoring process inclusive and peer monitoring proved to be efficient, transparent and cost effective. Farmers were issued with passbooks which provided comprehensive information about the farm management, inputs use, labour hired, production, payments received, extension, training, etc. Participatory supervision brought down the direct supervision cost of SACCOs. Review meetings were held at SACCOs with the participation of the PIU and PIA, whenever required. Various field records and monitoring reports also helped in monitoring. The senior officials of the PEA, PIU and PIA also paid periodic visits to the field.

Credit plus product

The results of the pilot project proved that supply of credit alone was not the solution to the problems of the small-scale coffee sector. Credit plus features of the product and delivery mechanisms under the project generated a paradigm shift in the manner of financing to smallholder coffee farmers. Important features of the product and lending methodology were: i) Financing of the entire production cost based on scientifically recommended agronomic practices, recommended input use and labour requirements for different activities based on the number of trees and coffee varieties; ii) Phased disbursement of credit as per the calendar of operations; iii) Timely supply of quality inputs i.e. fertilizers, pesticides and fungicides in required quantities; iv) Training and extension support to farmers; v) Close supervision on individual farms by groups and project staff to ensure good production practices; and vi) Coffee tracking, separate processing of project coffee and adoption of good processing practices, etc. The cumulative impact of these measures was reflected in a significant improvement in yields and quality of coffee, farmers' income and loan repayment performance under the project. A group mechanism used in dissemination of training and extension inputs, field supervision was another distinctive feature which proved very effective. The use of a passbook by each farmer to record all their farm activities also greatly aided loan use monitoring and supervision. Thus, credit plus features enhanced the effectiveness and productivity of farm credit.

Subsidized versus supervised credit

All earlier externally funded coffee credit schemes put emphasis providing subsidized credit to coffee growers at interest rates much lower than the commercial lending rates. These credit products were security-oriented and therefore smallholder farmers had restricted availability of credit. There was no technical guidance to farmers and farmers often misused credit in the absence of effective supervision. There was neglect of plantations, decline in coffee yields and quality resulting in poor loan repayment performance. Subsidized credit distorted the credit market and commercial lenders did not adopt these lending models as a business proposition. Positive results from the pilot project established financial viability of a credit product for extending production credit to small-scale coffee growers on commercial terms and market interest rates. The lending methodology with credit plus features also proved to be a sound business proposition for financing agencies.

State participation

An important contributory factor to the success of the pilot project was the committed support extended by the Government of Kenya. Major stakeholder ministries – the Ministry of Cooperative Development and Marketing and the Ministry of Agriculture – took an active interest in the project, maintained close coordination with the project management and, more importantly, allowed freedom to project implementing agencies to design and implement the project in a professional manner, avoiding undue interference. This brought innovativeness and flexibility to project implementation. Moreover, the ministries were a reliable source of leadership in the regular meetings held by the project management agencies, besides resolving the dilemma of sources of funds to lend to farmers as CoDF, a government instituted fund, was enjoined to provide resources for on lending, substituting CFC loan funds.

Scientific credit needs assessment

An important feature of the credit product was assessment of credit needs of smallholder and estate farmers by taking into account the scientifically recommended inputs and labour requirement for production and primary processing (for estates) for both traditional and Ruiru 11 varieties. Credit needs were assessed for different plantation models and loan disbursement was planned in three phases based on the calendar of coffee operations. Inclusion of the labour component in the loan amount was an additional feature. This approach to credit assessment ensured availability of adequate and timely credit to project farmers to meet production expenses.

Group approach

The most innovative part of the credit product was the adoption of a group approach for product delivery and monitoring which brought several benefits. These were:

- Groups served as a convenient unit for completing loan applications, appraisal and sanction process and delivery of credit and inputs to member farmers
- Groups proved to be an effective vehicle for dissemination of training and extension inputs to all the project farmers in a cost effective manner
- Group members supervised important activities at the farms of individual members. Peer monitoring made field supervision a participatory and cost effective process. The response of farmers to peer monitoring was positive as they learned from each other
- Group approach helped in reducing the cost of transactions at all levels of project implementation
- Groups brought transparency to the project activities
- Groups increased social cohesion in the project area besides helping in loan monitoring.

Training and capacity building

Conscious efforts were made under the project to build the right capacities in farmers and project partners. This was important so as to sensitize them to the innovative features of the credit product and delivery methodology. Efforts were directed towards bringing about attitudinal change in farmers and agencies towards the project and product. Training of farmers was aimed at educating them on the importance of input use and agronomic practices in enhancing coffee production and quality, imparting technical knowledge on critical crop husbandry practices and advising them on the proper use of credit and repayment discipline.

Quality control

With a view to enhancing the quality of coffee production, there was specific emphasis on the adoption of good agronomic practices by farmers and good processing practices in the primary processing. Experts guided the group members and farmers on aspects such as crop nutrition, disease control, canopy management, etc., while the PIU and CRF staff guided factory management and staff on good wet processing practices. Continuous efforts were also made to sensitize farmers on quality coffee production through farm visits, factory visits, field demonstration, training, etc.

Project IT software

Various modules of computer software were developed across the coffee value chain, specifically for the society, SACCO and KPCU, for efficient loan disbursement and project monitoring. Software was developed for maintaining farmer-wise data such as number of trees, input use, crop husbandry practices, loan operations, coffee production, coffee delivery, quality, and price realized, income, repayment, surplus, etc. Loan module generated loan

application/appraisal forms, repayment status, and farmers' pay slips, etc. The Society/factory level module maintained the details of cherry delivery, processing and delivery of coffee to KPCU.

Coffee tracking mechanism

Groups were entrusted with the task of monitoring that the cherries produced by the project farmers were delivered to the designated factories. The PIU, assisted by the groups, also closely monitored at field level to prevent any possible side-selling of the cherries by project farmers. At the factory level, the cherries delivered by project farmers were treated separately from those of non-project farmers at each stage. Project coffee was labelled as 'Project Coffee' while the rest was labelled as 'Non-Project Coffee' and delivered to the KPCU in separate lots. The KPCU also allotted separate out-turn numbers to project coffee against which proceeds were paid to society upon auction. The tracking mechanism almost completely checked side selling of coffee by farmers, which was reflected in a significant increase in cherries delivered to the designated factory.

Coffee payment and repayment system

While the system of payment and recovery of loans functioned well under the project (with repayments of over 90% in the first loan cycle), the project did receive a setback because of stoppage of coffee payments by KPCU to societies after its accounts were frozen by the receiver. This external factor choked the inflow of funds under the project and affected the repayment performance of about 18% of the farmers that had not yet been paid by the time of receivership.

Project sustainability

The farmer-centric credit plus product and the lending methodology developed under the project proved its utility for all the stakeholders beyond doubt. Farmers derived multiple benefits such as access to adequate, timely and hassle-free credit; quality farm inputs; cash loans against labour component; technical guidance, extension and training support; support from groups; increased coffee production with enhanced quality; higher incomes; better repayment capacity; better maintenance of coffee plantations; etc.

However, it would be necessary to put in place an appropriate post project framework to enable all the project partners to continue working together. Sustainability of the project can be ensured by further strengthening group mechanism and passing on the ownership of the credit plus product to societies, factories, SACCOs and groups, which were the primary beneficiaries under the project. Their managements have already been sensitized and staff trained on essential features of product delivery and project management. The product and project methodology can also be adopted by private coffee millers and marketing agents for implementation.

Project replicability

A larger goal of the pilot project was to roll out a credit plus product and lending methodology for financing to smallholder farmers for replication in all coffee growing regions. The results of the pilot project indicated that the credit plus product and lending methodology was practically feasible, financially viable and commercially sustainable. Coffee farmers have accepted the product which proved to be a viable and bankable proposition for them. All the major institutional stakeholders such as factories, societies, SACCOs and KPCU also benefitted as the product and the project methodology helped them in improving business levels, efficiency and tying over their business related challenges.

Social capital

Implementation of the pilot project has created valuable social capital at all levels. Importantly, there was a paradigm shift and attitudinal change among smallholder farmers. They experienced that appropriate input use and good production practices lead to higher yields, quality and incomes, which can then sustain commercial borrowing for coffee production. The tendency to neglect coffee and a mood of hopelessness in smallholder farmers was replaced by a determination to succeed. They found borrowing for coffee production a bankable proposition. They acquired insights and practical skills in commercial coffee production. Lending agencies started realizing that financing to smallholder farmers using credit plus product was a potential business. The apprehensive approach of credit staff was replaced by farmer-centric behaviour as they witnessed that farmers could repay loans from incremental incomes derived from enhanced coffee productivity and quality due to credit plus services.

C. CHALLENGES

International coffee prices

Besides the yield and quality of produce, the income from coffee also depends on the market price of coffee. Most of the coffee produced in Kenya is exported. Kenyan quality coffee commands premium prices in the world market. However, during the past few years, decline in coffee production in Kenya in general and that of a premium quality in particular has been a matter of concern. More than 80% of the coffee produced in Kenya is from the small farms. In the past, wide fluctuations in coffee prices have resulted in loss of income to farmers which forced some smallholder coffee farmers to even abandon coffee cultivation in favour of other comparatively more remunerative crops. The Government of Kenya has taken some measures to ease the problems being faced by the growers by bringing about some changes in the Coffee Act relating to coffee marketing and regulation of the intermediaries.

Volatility in the market prices of coffee and the prices realized by coffee growers has been showing unfavourable patterns in the recent past. Analysis of the coffee prices over a 30 year period from 1977 to 2006 has revealed that fluctuations in coffee prices have been substantial. Generally, it was observed that the decline was followed by a rise in the next 1-2 years. However, there have been instances that the decline in prices continued over a longer period of 4 years (1998 to 2001) when prices reached such a low level that farmers could hardly recover the production costs from coffee revenues.

Variations in cherry prices

During the course of surveys and studies under the Pilot Project, data on the prices realized by coffee farmers during the three year period i.e., 2002-03, 2003-04 & 2004-05 in 16 factories across three farmers' cooperative societies in three different zones in Kirinyaga district was collected. A summary position of the price data collected is presented in a table below.

Coffee prices realized in Kirinyaga

Name of the factory	Average price realized in Ksh /Kg of cherry			% Variation in prices
	2002-03	2003-04	2004-05	
Baragwi Farmers Coop Society	11.09	16.08	20.72	86.8%
Mirichi Farmers Coop Society	5.75	14.68	16.95	194.8%
Karithathi Farmers Coop Society	20.80	21.88	29.73	42.9%
Average price in three FCSs	12.55	17.54	22.47	79.1%

It is observed from the data that variation between the average coffee prices realized in 2002/03 and 2004/05 was as high as 79.1%. It was also reported that during 2002/03, the coffee price realized by farmers in some of the factories had been even lower than the cost of production.

E. RECOMMENDATIONS

Price risk mitigation

Besides the yield and quality, ultimate income to farmers is determined by the market price of coffee. Coffee being a globally-traded commodity, its price is influenced by coffee prices in the international market. With a view to insulating domestic coffee farmers from price volatility and minimizing their risk, it is necessary to put in place credible price risk mitigating mechanisms such as minimum price guarantee, price insurance, price fluctuation reserve, forward contracts, loan repayment guarantee, etc. This would lend confidence to farmers in making borrowing decisions as also provide comfort to lenders. It is therefore suggested that various aspect of price risk mitigation mechanism in coffee may be

exhaustively studied in various coffee growing countries in Africa together with the measures already initiated in other developing economies. The ICO and the CFC may be best suited to take this initiative by engaging the services of an experienced consultant for the same.

Sustaining the project activities

It is important that participating SACCOs continue to extend credit support to participating smallholder and estate farmers as per the credit plus product established in the pilot, even after the project comes to an end. This would enable farmers to use the recommended inputs and crop husbandry practices and sustain higher productivity and quality of coffee. Interaction with the Kirinyaga SACCO revealed that SACCO has already adopted the credit plus product for extending credit support to coffee farmers outside the project area with the help of a separate line of credit from CoDF.

Replication in Kenya

Although the pilot project proved beneficial and was accepted by the farmers, estates, societies and SACCOs, its potential can only be fully realized when the project methodology is mainstreamed and widely replicated by SACCOs and other financing agencies outside the project area so that the benefits are extended to a large number of coffee farmers.

Replication outside Kenya

In most of the coffee growing countries in Africa, smallholder farmers and small estates face similar constraints in accessing adequate and timely institutional credit for coffee production. Coffee production and quality in the small-scale sector is therefore suffering in these countries. The credit plus product successfully piloted in Kenya may therefore be replicated in other African countries to boost coffee production and incomes in small coffee farms.

Adoption of credit plus approach in other commodities

Irrespective of the commodity produced, smallholder farmers in most of the countries, face difficulties in accessing the institutional credit for crop production due to non-availability of suitable credit products, credit plus services and risk perception of the lending agencies. The philosophy of the credit plus product for financing smallholder coffee farmers under the pilot project can be modified and extended to small scale farmers growing other crops.

LIST OF ACRONYMS USED IN THIS DOCUMENT

CFC	Common Fund for Commodities
CIG	Common Interest Group
CoDF	Coffee Development Fund
CRF	Coffee Research Foundation
FCS	Farmers Cooperative Society
ICO	International Coffee Organization
KPCU	Kenya Planters' Co-operative Union Ltd
PEA	Project Executing Agency
PIA	Project Implementation Advisor
PIU	Project Implementation Unit
SACCO	Saving and Credit Cooperative Society
UNOPS	United Nations Office for Project Services