Enabling Access to Finance for Coffee Cooperatives in Ethiopia

A case study of a risk-sharing facility between IFC and NIB Bank

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Smallholder farmers are increasingly being recognized as important contributors to enabling global food security. However, smallholder production is fraught with a multitude of challenges, including low yields, low quality of crops, and lack of access to markets, including credit markets. Securing capital to purchase inputs like seeds and fertilizer, invest in machinery, and pay for transport to sell outputs is a challenge that smallholder farmers face every harvest season. Globally, the demand for smallholder agricultural financing is estimated to be $450 billion, with less than two percent of this demand currently being met.\(^1\)

This issue is of particular relevance to Ethiopia, where agriculture accounts for close to half of the country's GDP of $105 billion and 80% of total employment.\(^2\) Many of these farmers grow coffee, which is the country's major export crop and contributes approximately 10% to the country's GDP. While the government has been actively promoting marketing cooperatives to commercialize agriculture since the mid-2000s, many of these cooperatives face constraints in securing capital from local public and private banks due to the perceived high risks of default and lack of collateral.\(^3\)

This research report assesses the constraints to financial inclusion in Ethiopia and examines the role of a risk-sharing facility, managed through a partnership between the International Finance Corporation, NIB Bank, and TechnoServe, as a mechanism for enabling access to finance for coffee cooperatives. In sum, risk-sharing facilities can be a critical tool in enabling access to financing for farmer organizations in the short term, but additional measures to build the capacity of local banks to engage in agricultural lending after the end of the facility’s life are necessary to ensure that this access is sustainable.

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Access to finance in Ethiopia

The data paint a picture of low levels of access to finance in Ethiopia compared to regional averages for Sub-Saharan Africa (SSA) and a large gap in access within the country between urban and rural areas. According to the World Bank Agribusiness Indicators, approximately 2.9 bank branches are available per 100,000 adults nationwide in Ethiopia compared to the SSA average of 7.2 branches (Figure 1). Moreover, less than 1 bank branch is available for 100,000 adults in rural areas. In a similar trend, while 14% of households nationwide have a bank account, only 1% of rural households own one. Since access to a bank account is a prerequisite for obtaining credit for most banks, 1% of rural households have received credit for agricultural activities. Overall, only 0.2% of the population borrows from banks, compared to the SSA average of slightly less than half of the population. In addition, while borrowers from commercial banks have risen dramatically in SSA since 2010, it has remained stagnant in Ethiopia.

Examining firm level data from the World Bank’s Doing Business survey, access to finance is cited as the major barriers to doing business by one fifth of surveyed Ethiopian firms – more so than access to land, taxes, or electricity. Disaggregating the data by business size, we find that only 3% of small firms, which have less than 20 employees, report having access to a line of credit and 40% cite access to finance as a major constraint vs. 30% of medium-sized firms with 20-99 employees and slightly less for larger firms with more than 100 employees. One major barrier to accessing finance is the high collateral requirement, with 85% of loans requiring collateral of more than twice the amount of the loan. Facing these constraints, investments are mostly financed internally and less than 6% of working capital requirements are financed by banks.

Multiple supply-side constraints have led to the unmet demand for capital. Commercial banking is tightly regulated by the National Bank of Ethiopia (NBE), with foreign ownership and bank operations prohibited by law. This creates an uncompetitive market, with the dominant player, the state-owned Commercial Bank of Ethiopia (CBE), owning 70% of total commercial bank assets. While the number of private commercial banks have increased to 16 in 2013, collectively they constitute less than
30% of market share (Figure 2). The dominance of CBE is apparent when we look at the number of bank branches – while CBE has close to 560 branches in 2012, none of the other banks have more than 100 branches individually.\textsuperscript{v}

Moreover, commercial banking is highly regulated, with private banks required to hold 27% of new loan disbursements in NBE bills. This requirement caused many banks to shift their portfolio to long\textit{term} loans, but private banks must restructure their portfolios to have 40% consist of short\textit{term} loans by early 2015.\textsuperscript{vi} In addition, due to the shortage of foreign exchange in the country, foreign currency transactions by private banks must be approved by NBE. With this background, commercial bank lending in Ethiopia has focused largely on industry, international trade, and housing and construction, which require longer\textit{term} loans and have the potential for foreign currency earnings. Only 15% of commercial bank lending in 2011/12 went to agriculture, which contrasts with its share of almost half of Ethiopia’s GDP.\textsuperscript{vii}

\textbf{Risk\textit{sharing} facility as a solution}

A risk\textit{sharing} facility is a loan finance instrument in which parties share the risks on a portfolio of loans up to a certain level of exposure and for a period up to the term of the loan. The reduction of credit risk through the risk\textit{sharing} and portfolio approach enables the funding of riskier but credit worthy projects.

In 2010, TechnoServe, a nonprofit organization providing technical assistance to smallholder farmers and cooperatives across Africa and Latin America, together with the International Finance Cooperation (IFC) and NIB Bank, a private Ethiopian bank, structured a risk sharing facility to provide coffee cooperatives with working capital financing to manage wet\textit{mills}. Cooperatives use the working capital to purchase coffee cherry from their members, pay the salaries of staff running wet\textit{mill} activities, and transport green coffee for grading and storage before export. The wet\textit{mills} allow cooperatives to process the coffee cherry that their members have harvested as fully washed coffee and obtain higher market prices. Recently, the Cooperative Bank of Oromia also started the provision of short\textit{term} working capital and longer\textit{term} investment capital to select cooperatives.

The $10 million risk\textit{sharing} facility between IFC and NIB Bank has provided working capital to approximately 60 cooperatives since the 2009/10 harvest season. Each cooperative obtains approximately $100,000 \textendash $200,000 from the facility, disbursed in 20% increments, depending on their estimated cherry target for the season. To be eligible for funds, the cooperative must be a new cooperative started with the support of TechnoServe. The performance of the cooperatives is reviewed annually, and the renewal of the facility is contingent on successful repayment on a portfolio basis.
Credit risk is shared between IFC, which guarantees 65% of the loan amount, and NIB Bank. NIB Bank is in charge of originating and funding the loans, and IFC receives a guarantee fee, which is added to the loans' interest rate, in exchange for risk sharing. Cooperatives create bank accounts at NIB Bank and receive payments from coffee exporters in foreign currency into these accounts, which are used to pay off the loans at the end of the harvest season. This enables NIB Bank to obtain foreign currency and alleviate a constraint faced by private commercial banks in Ethiopia, as mentioned above.

TechnoServe plays the critical role of intermediary, providing technical assistance to the cooperatives in agricultural practices, accounting, and financial management and supporting them in reporting to NIB Bank. In addition, TechnoServe assists NIB Bank in monthly and quarterly reporting to IFC and facilitates negotiations for facility renewal annually.

**Strengths and challenges of the facility**

Interviews with leaders of 15 coffee cooperatives receiving funds from the risk-sharing facility enable us to gain a deeper understanding of how financing from the risk-sharing facility meets their needs. We find that credit from the risk-sharing facility is the only source of formal financing available to TechnoServe-supported cooperatives and that current loan amounts meet 40% of the overall demand for working capital. On average, cooperatives report a need for $200,000 in working capital for one harvest season, 30% higher than the current average. Demand for financing has increased with increased profitability of cooperatives, due to higher cherry prices and volume processed. This has enabled 40% of interviewed cooperatives to purchase a second wet-mill machine, expanding their capacity to process cherry and need for additional financing. Individual farmers also experienced increases in income in the form of higher purchase price of cherry and dividends from their cooperative. In addition, environmental standards required by the IFC have facilitated investment in environmentally sustainable wet-mill site and wastewater management.

Other aspects that cooperative leaders found important in the terms of financing were the timeliness of disbursements and a larger first disbursement. 80% of interviewed cooperatives mentioned that the ideal timing for loan disbursements would be before the harvest season, in order to invest in preparation for the season by hiring workers to clean and set up the
wet mill site by constructing coffee drying beds. Another critical challenge is ensuring the long term sustainability of access to financing for these coffee cooperatives. The goal of the risk sharing facility is to catalyze agricultural financing by decreasing the risk perception of local banks towards agricultural lending through a demonstration effect. Due to the limited timeframe of the facility, a longer term solution is necessary to ensure sustainable access to finance for cooperatives.

Looking forward
Based on both macro and micro level analysis, we see that risk sharing facilities can be a highly effective instrument for enabling access to loans for coffee cooperatives facing barriers to accessing any form of formal financing. However, the facility is limited in its effectiveness as a long term solution. In order to enable sustainable access to finance for smallholder farmers in the long term, a local solution, potentially in the form of direct lending between the local banks and smallholders aggregated into cooperatives, must be developed. Our supply side analysis and informal interviews with local bank staff show that this is difficult due to banks still holding high perceptions of risk towards lending to the agricultural sector in general, and to cooperatives. In order to reduce this risk perception, capacity building on the bank side, to equip them with the skills to better manage associated risks, is necessary. In this sense, IFC’s advisory program on enhancing local banks’ capacity to engage in agricultural lending could be helpful and further expansion of the partnership could be explored.

ENDNOTES