Zoom Microfinance 44

April 2015

Guarantee funds - a response to agricultural credit risk

THE LATIN AMERICAN GUARANTEE FUND

Introduction | Risk issues in agricultural financing | The Latin American Guarantee Fund | A largely positive assessment over 10 years | Aspects to work on | Conclusion

© A. Kennes – SOS Faim.

Introduction

High risk levels is often the justification given for the small sums available for agriculture credit in the Global South. Setting up a guarantee fund is one of the ways of managing and sharing these risks between the different stakeholders as well as facilitating greater involvement of financial institutions in the rural sphere. This entails both promoting the deployment of their activities as well as facilitating the tailoring of their products to expressed requirements. With this in mind, SOS Faim created a guarantee fund for the Andean countries in close collaboration with local producer and microfinance organizations.

Risk issues in agricultural financing[1]

Covariant risks render a joint surety tool ineffective.

There are two types of risk in agriculture financing: those directly related to the activity and those that stem from products which are insufficiently tailored to the specificities of agriculture.

Risks that are specific to agriculture

- **Climatic hazards** (droughts, floods, etc.) are covariant risks, in the sense that they affect an entire population in a given area. In this context, a tool like the surety often used in microfinance, is ineffective. This type of risk has a major impact on the smallholder economy as production and therefore revenues are at risk for an entire year. It can also lead to a loss of productive capital (e.g. livestock), which gets more difficult to rebuild as the intervals between lean years shorten, particularly due to climate change.
- **Health hazards**, such as animal diseases or parasites are also a covariant risk that can be reduced through effective support services (animal health, locust control).
- **There are numerous economic risks** due to the imperfection and uncertainties of agricultural markets, the rising cost of agricultural inputs, and disruption to local markets by imports which price out local producers. Much of the control of these risks lies outside the agricultural stakeholders' sphere and concern international markets and coherent national and international public policies.

1 This analysis is largely based on a feasibility study for West Africa by Professor Betty Wampfler on behalf of SOS Faim.

© G. Turine – SOS Faim.

Setting up a guarantee fund enables risk to be shared between the different stakeholders.

- **Household risks** (health problems, death) are greater in rural areas because of poverty levels. They can lead to significant and unforeseen costs and destabilize smallholder household budgets in a major way. They temporarily or permanently deprive the farm of part of its workforce.
- **The political risks** in agriculture relate to potentially unfavourable policies dealing with land, the organization of markets, inadequate financial systems, etc.

This set of risks is systemic in nature and requires understanding at three levels:

- Micro-level - family farms;
- Meso-level - established farmer organizations;
- Macro-level - public agricultural policy.

Funding that is ill-suited to the specific needs of agriculture carries two types of risk.

- **Financing facilities and tools** are not well designed: this may mean financial products that are not suited to agriculture, a flawed assessment of the quality of loan portfolios or a poor understanding of the realities and socio-economic risks of the intervention areas.
- **The rural finance institution** has limited strategic choices, especially where there is excessive concentration of risk in a single crop in a specific region.

Creating a guarantee fund is one tool for managing these risks, amongst a wider palette, such as mortgages, guarantees, surety, agricultural warehouse receipts, mutual guarantee company, etc.

Setting up a guarantee fund enables risk to be shared between the different stakeholders: the financial institution, the borrower and the guarantee fund itself. This fund may exist as part of a project, be implemented by a donor or an agricultural organization, be an institution itself or, as part of public policy established by a State.

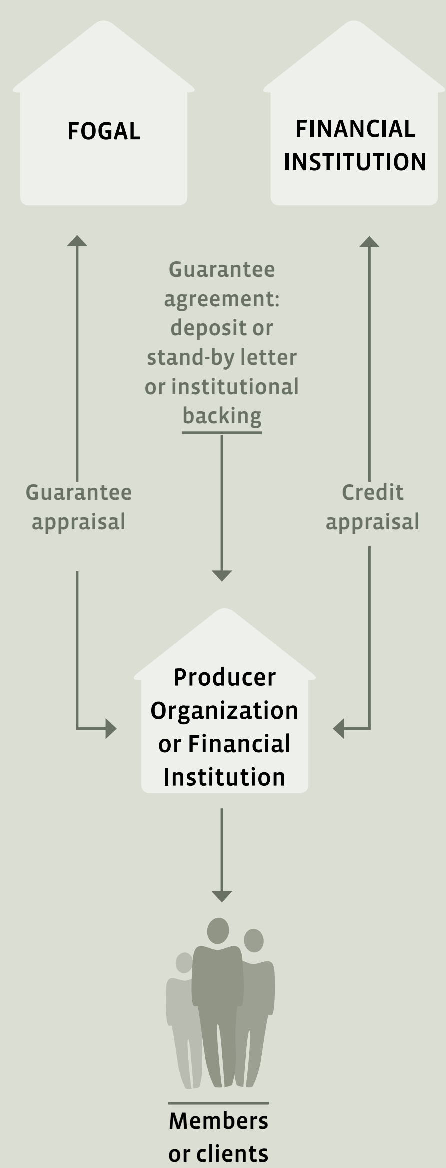
The tool is not actually new and has been severely criticized: many subsidized public guarantee funds for agriculture were set up in southern countries, particularly in the 1970s and 1980s.Most of these were centralized funds that experienced serious difficulties in management and governance (bureaucracy, corruption, laxity, etc.).

Three models have emerged in the second generation of guarantee funds, which succeeded public guarantee funds:

© C. Rasquin – SOS Faim.

- The individual model is characterized by a direct agreement between the individual beneficiary of the guarantee, the guarantor and the financial institution. An agreement is concluded between the financial institution and the bank for the allocation of risk, on a case by case basis.
- The portfolio model: in this case, the fund will provide guarantees for a specific group of potential borrowers from a particular financial institution. Criteria are set, such as the ceiling and the use of credit, selection procedures, the risk percentage, the collateral realisation process … In this model, the relationship between the guarantee fund and its beneficiaries is limited or non-existent.
- The intermediary model: in this approach, the guarantee is granted for an intermediary, either a financial institution or a producer organization, to manage. This enables the intermediary to manage a credit line on behalf of its customers or its members, according to the statute.

Diagram of the intermediate guarantee



The Latin American Guarantee Fund

It is against the aforementioned, relatively critical background that SOS Faim launched a guarantee fund for Latin America (FOGAL) in the early 1990s, initially in the form of a project. Ten years after it was set up, the fund was converted into an institution and is currently a Peruvian legal entity that combines a Peruvian producer organization and an Ecuadorian microfinance institution.

From the start, FOGAL opted for the intermediate model, as it offers both the advantage of reducing transaction costs and generating a real increase in loans granted to categories of beneficiary that would not have access without the guarantees. In addition, this model helps mitigate one of the criticisms often levelled at guarantee funds: that they encourage borrowers not to repay because the latter are aware of the existence of the guarantee. This is generally not the case in the intermediate model. The risk of end borrower laxity is therefore limited. [See diagram]

The types of actors:

The “beneficiaries”: two major categories have existed since FOGAL launched:

- Producer organizations in various industries: coffee, cocoa, bananas, quinoa, grains, anise, peanuts, etc.
- Microfinance institutions that specialize in rural and agricultural finance.

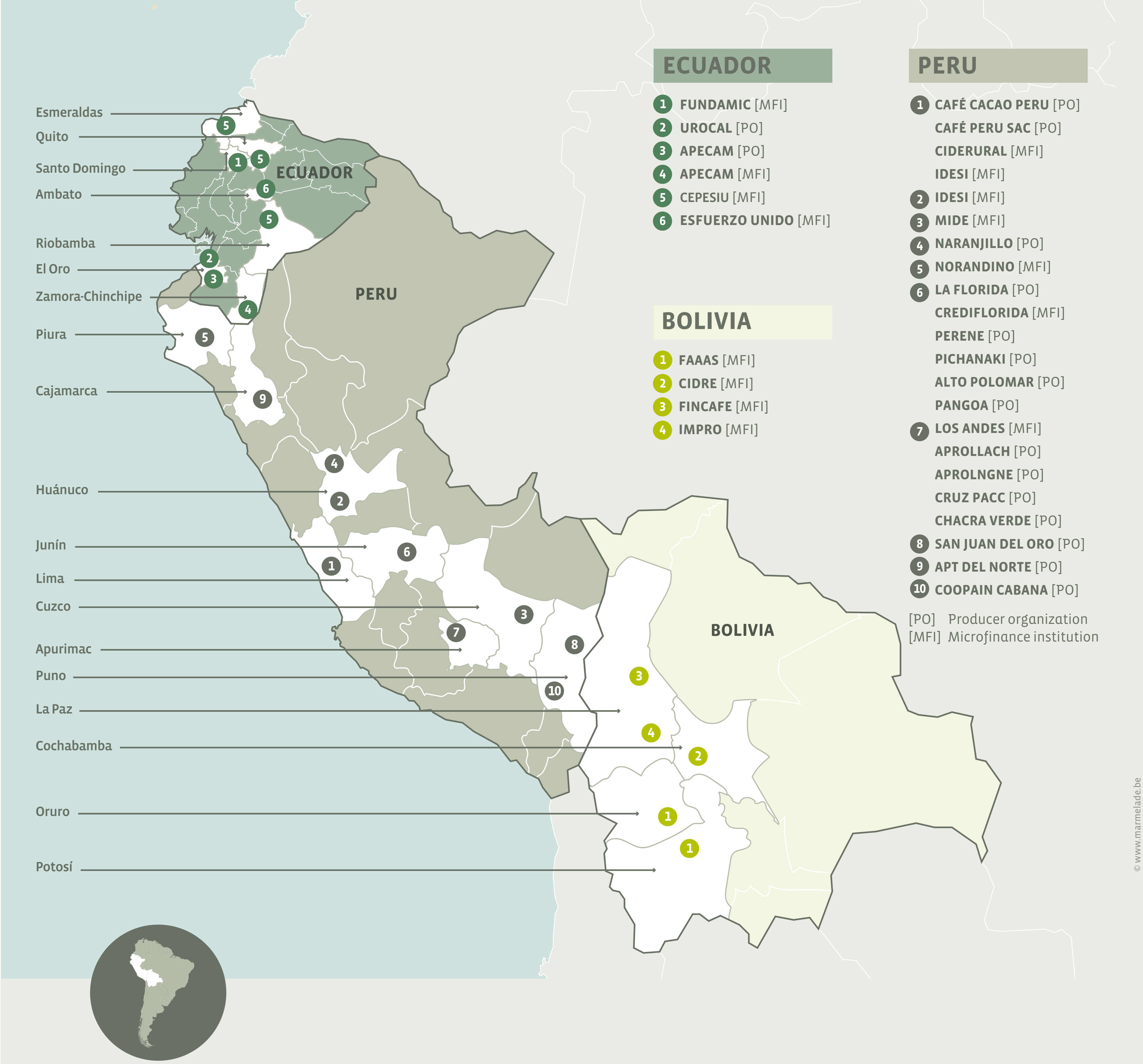
Funding institutions: FOGAL developed by focusing on two types of players at this level: local commercial banks (especially in Peru) and ethical funding entities in the Global North, among which the main ones were the cooperative, ALTERFIN (Belgium) and ETIMOS (Italy).

Two new players have emerged in recent years: public banks and institutions and local financial entities:

- Local financial entities such as the FUNDA-PRO Foundation and the CIDRE Financial Institution for Development in Bolivia; savings and credit cooperatives in Ecuador and Jardin Azuayo FORTALECER, CREDIFLORIDA and LOS ANDES in Peru.
- Banks and public entities such as Banco de la Nación (Peru) or Corporación Nacional de Finanzas Populares (Ecuador).

Working with these new types of players has had an impact in recent years, diversifying approaches (as we will see later) and producing multiplier effects.

FOGAL is currently active and has offices in three Andean countries



The terms:

- A predetermined portion of the debt incurred by the entity that benefits from the guarantee is covered on behalf of the financial institution by FOGAL.
- FOGAL and the financial entity consider each loan application.
- The credit line can be used to finance loans to clients or members of the financial institution. In the case of producer organizations, the most common use of funds is to partially pre-finance the sale the of members' harvest prior to a group marketing process.

FOGAL's **vision** is to be a reference in all matters concerning financial solutions for small rural producers in Latin America. Its **mission** is to provide innovative, efficient financial solutions tailored to the needs of small rural producers through their organizations, rural finance institutions and other development actors.

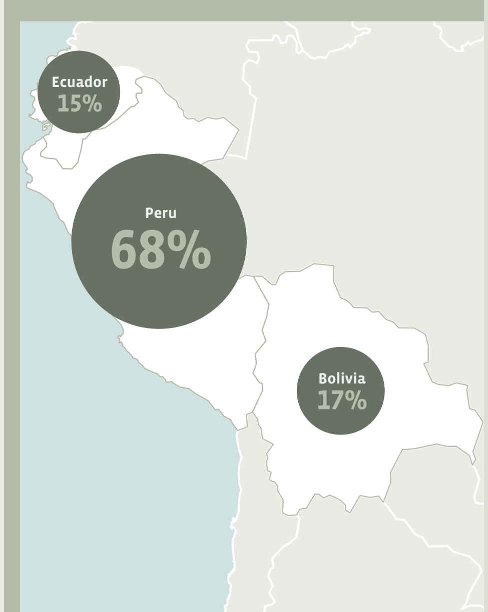
FOGAL in figures (in US dollars[2])

While FOGAL's main business, its main purpose, is the provision of guarantees, the organization has also developed a direct credit activity in recent years that ensures its financial equilibrium.

Key growth indicators, 2010 - 2014

	2010	2014	Growth 2010 - 2014
Assets	3,398,028	4,577,951	+ 34.7%
Total portfolio	3,201,959	4,695,238	+ 46.6%
Guarantees	2,398,765	3,074,511	+ 28.2%
Loans	803,194	1,620,727	+ 101.8%
Financial income	144,071	262,894	+ 82.5%
Operational costs	86,138	179,492	+ 108.4%

Geographical distribution of FOGAL's activities (2014)



- Guarantees account for 65% of the total portfolio, loans account for 35%.
- The entire portfolio is composed of rural credit, of which over 90% is in agriculture.

Distribution between producer organizations and financial institutions (2014)

	Volume of guarantees	Number	Volume of loans	Number	Total loans and guarantees	Total number
Producer Organizations	39%	8	46%	12	42%	20
Financial Institutions	61%	15	54%	6	58%	21
Total	100%	23	100%	18	100%	41

In 2014, FOGAL's operating expenses rate amounted to 4%, which represents the ratio between operating costs and the average portfolio size. Operational self-sufficiency totalled 140% and return on equity was 2.15%.

The average multiplier effect achieved on the guarantees amounted to 2.47. But there are wide disparities ranging from 1 to 10. Local commercial banks are the most cautious in employing leverage.

2 FOGAL is a Peruvian company and its accounts are provided in New Peruvian Sols. The exchange rate used was 3 Peruvian Sols per US$ 1.

© C. Rasquin – SOS Faim.

The intermediate model allows for cooperation between different types of stakeholder.

A largely positive assessment over 10 years: a sustainable, high value added fund with a proven track record.

As the following examples will show, the intermediate model allows for a variety of arrangements and approaches that facilitate cooperation between different types of stakeholder; in some situations, these relations have developed between actors established in the same region to promote local economic development.

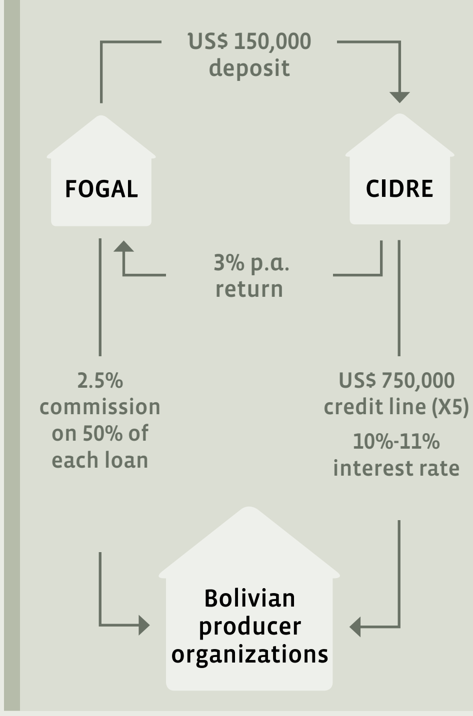
A sustainable guarantee fund.

When FOGAL was established in December 2004 the challenge was clear: to maintain the value of the fund set up by SOS Faim with financing from the Belgian Development Cooperation (DGD) and the European Union.

Since its inception, the fund has accumulated profits of 1,342,684 Peruvian soles (equivalent to US$ 443,086). This sum has strengthened the fund's capital base. This combination is essentially the result of a two-pronged strategy:

- Detailed risk analysis and management based on outreach work to identify and monitor partners of the guarantee fund, while maintaining a lightweight structure.
- Gradual diversification of activities: a few years after being set up, FOGAL launched a direct credit line, which with its higher returns have ensured the financial sustainability of the institution. This activity must not account for more than 40% of revenues; currently, it produces 35%. The credit is for two types of 'customer': guarantee fund partners with a problem free credit history, but also very small producer organizations requiring financial resources of the order of US$ 10-15,000 for an economic activity. These associations generally cannot access loans at conventional financial institutions, even with

Deposit at a local operator



a guarantee. In 2014, this prong focused particularly on three associations of milk producers and an anise producer association. FOGAL supports these lenders with management and accounting assistance, which it is able to provide thanks to non-repayable funds from Belgian Cooperation and SOS Faim. The interest rate charged on the loans ranges from 9% to 10% on an annual basis.

- Another form of diversification concerns the guarantees themselves: in some cases, a local financial operator is identified and an amount is deposited as security: this approach can result in a significant multiplier which has a positive impact on the commissions generated by the guarantee. The example presented of CIDRE in Bolivia illustrates this. [See diagram]

High value added

FOGAL has become well established in Andean rural and agricultural spheres, both by developing its own network and through synergies implemented with key partners of the fund such as SOS Faim, ALTERFIN or ETIMOS.

One of the main areas it adds value is the role the institution plays in intermediation between producer organizations and financial institutions. In some cases, FOGAL accompanies a producer organization in negotiations to reduce the well known asymmetry of information between financial institutions and producer organizations.

Another element of value added is the choice made by FOGAL to focus on partnerships with smaller-sized microfinance institutions and producer organizations, so as to add value and have a more significant impact. In terms of producer organizations, generating direct and indirect employment is a priority selection criterion. And in all cases, environmental compliance issues and the importance given to the balance between men and women in the organization are considered.

In recent years, FOGAL has also sought to develop links between the public and private sectors:

- Small loans enabled Peruvian milk producer associations (CRUZPACC and APROLNGNE) to raise the capital required to access non-repayable funding from the state (AGROIDEAS).
- As part of the state funding for school breakfasts (Qali Warma programme[3]), in 2013 FOGAL guaranteed a loan from the savings and credit cooperative LOS ANDES to the Chumbivilcas grain producers cooperative (Cuzco), which allowed it to supply more than 100 schools with a "turnover" of 6 million soles (US$ 2 million).Lack of transparency of access to this type of programme is still a hurdle to overcome, as are the requirements to be met in terms of quality and product delivery time.

In recent years, FOGAL has also sought to develop links between the public and private sectors.

A proven track record

In terms of scope: over 10 years, more than 100 producer organizations and microfinance institutions in 3 Andean countries (Bolivia, Ecuador and Peru) have benefitted from FOGAL's services. This support has enabled them to access more funds with which to carry out their economic activities (in the case of producer organizations) or to supply their members and clients with rural and agricultural credit (in the case of MFIs).

In terms of improving conditions: FOGAL's support has also been a key factor in helping to access financing on better terms: in some cases, the interest rate commercial banks demanded from coffee grower cooperatives was reduced by several points (2 or 3) as a result of sharing the risk with FOGAL.

In a recent case, in 2014, a producer association was able to access funding for an investment because of the FOGAL guarantee. This was an association of "tara" (tannin) producers, working within an ambitious reforestation programme. This association has 152 active members. The credit granted by Belgian cooperative, ALTERFIN, involves an amount of US$ 160,000 over a 4 year period. FOGAL's guarantee covers 62.5% of the initial loan and will enable 40 hectares to be purchased, of which 30 hectares will be planted (18,750

3 Qali Warma means "strong child" in Quechua.

© N. Demartin – SOS Faim.

plants in total). FOGAL intends in the future to reproduce this type of intervention, which is a type of investment credit, one of the least common types of agricultural loan.

Two other interesting developments are noteworthy:

- Microfinance institutions that have received initial support from FOGAL have integrated into the refinancing market and thus diversified their funding sources. Some, such as LOS ANDES cooperative have even become lenders within the framework of guarantee fund's activities.
- Recipients of FOGAL's guarantees are gaining confidence in the entity and are increasingly willing to accept institutional guarantees: a commitment to pay in the event that the beneficiary defaults, without prior deposit of funds. This allows a greater the gearing of capital, but increases overall risk for the fund.

Finally, guarantees given by FOGAL also allowed producer organizations to integrate into the export value chain (especially coffee, but also cocoa, bananas, etc.) or even into local markets, with a positive impact on food and nutrition security. The Qali Warma programme mentioned above is just such an example.

Three cases are briefly presented below:

- The revival of coffee producer cooperatives in the Junin region of Peru during a crisis period.

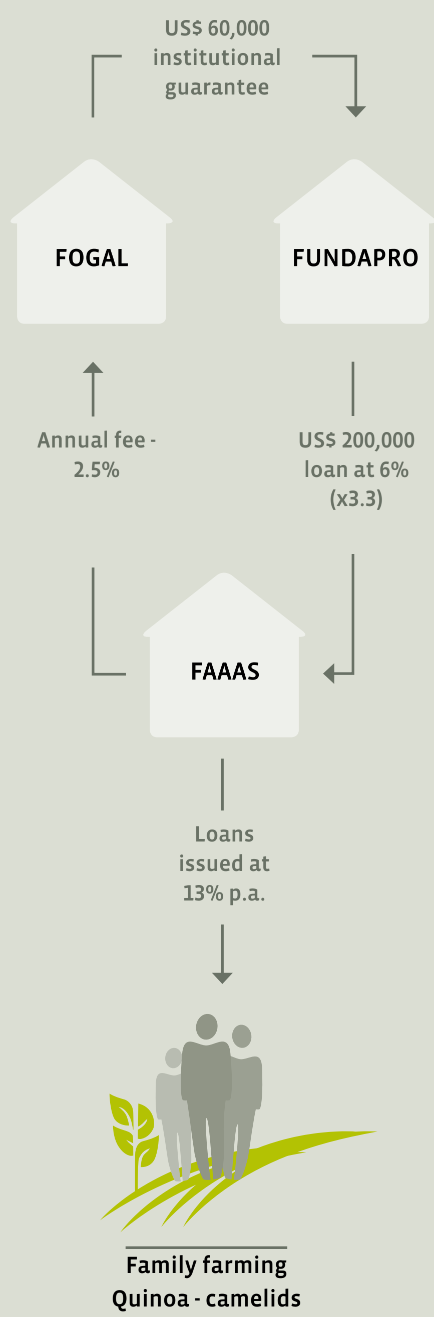
Many coffee producer cooperatives in the region were greatly weakened in the 1990s because of the presence of movements like the Shining Path. A number of leaders were assassinated; and buildings and equipment were destroyed. This was the situation when FOGAL started its activities, in particular with the three cooperatives La Florida, Pangoa and Satipo, which enabled them to access commercial bank loans once again and revive their coffee harvesting, processing and export activities.

- Two financial institutions benefited from FOGAL guarantees at the beginning of their existence and for several years afterwards. They have now become reference institutions in terms of rural credit in their countries.

CONFIANZA credit house (based in Huancayo, Peru) was supported with a US$ 75,000 FOGAL guarantee up until 2005. Currently, this entity has more than 350,000 savers (with

© V. Pissoort – SOS Faim.

Diagram of the institutional guarantee



US$ 290 million savings) and 222,000 borrowers (with a US$ 474 million loan portfolio)[4]. FOGAL's first guarantee to CONFIANZA allowed the latter to gain the confidence of international social investors and facilitated exceptionally rapid development.

FIE, in Bolivia, followed a similar path. FIE also received a US$ 75,000 guarantee from FOGAL during its first years of existence. Today FIE has turned into a bank whose loan portfolio exceeds a billion dollars, with more than 238,000 active borrowers. Deposits collected amount to US$ 853 million; it provides accounts for over 824,000 savers.

> A microfinance institution created by the National Association of Quinoa Producers (ANAPQUI) in Bolivia focused solely on production-related loans and smallholder farms.

FAAAS[5] is a community financial entity (CFE) created by ANAPQUI in 2010. Each member contributes capital equivalent to a quintal of quinoa (700 Bolivianos or 101.3 dollars). The current financial portfolio varies between 2 and 2.5 million dollars through the agricultural season and is mainly directed at the production of organic quinoa and the rearing of camelids. The interest rate FAAAS charges its members is 13% per annum.

A collaboration with FOGAL was established: private foundation FUNDAPRO, in Bolivia, benefits from a guarantee along the lines of the classic intermediary model. [See diagram]

Aspects to work on

The difficulty with local commercial banks

This item has been highlighted above: although in some cases, a better interest rate is obtained as a result of the guarantee, local commercial banks are still the most cautious in allowing credit leveraging. In recent years, FOGAL has made efforts to develop an alternative approach with rural financial institutions (MFIs, cooperatives, foundations) that are more open to negotiating a multiplier effect.

The management of risk concentration

The examples clearly show that sectors oriented towards the international fair trade market, such as coffee and cocoa, offer more opportunities for financial arrangements involving guarantees. This led FOGAL to focus a significant portion of its business in those areas, admittedly with cooperatives of small rural producers, but with a concentration of risk that makes it vulnerable to any covariant factor affecting the industry: as is currently the case with coffee in Peru where coffee rust disease is present. As a result, for the last 2 to 3 years, FOGAL has pursued an active policy of diversifying its commitments.

Three operations have resulted in a guarantee being drawn upon

Despite the precautions taken, after a default free nine years, three guarantees were called upon at the end of 2014, for a total amount equivalent to US$ 250,000 (US$ 150,000 for coffee producers; US$ 100,000 for an international microfinance institution). These failures are nevertheless moderate in percentage terms in relation to the cumulative number of years of activity and capital committed by FOGAL. They are in fact the equivalent of 5.4% of FOGAL assets in 2014.

Sustainability built on grants

FOGAL's success in creating a sustainable tool for supporting rural and agricultural development was built with the help of grants. In other words, a free injection of capital was needed to start the business. As mentioned above, the fund balances its books but only produces a return on equity of just over 2%. This level of return may not interest many investors.

4 Mix Market consultation March 31, 2015.

5 Financiera Asociación Agropecuaria del Altiplano Sur

For over 10 years, the guarantee fund has worked with more than 100 organizations building a proven track record.

Conclusion

Guarantee funds are one of the solutions to reduce the risks related to financing agriculture. After a generation of subsidized public guarantee funds that ended in multiple failures, SOS Faim set up a fund that uses the intermediary model, where the guarantee is granted to financial institutions or producer organizations.

The result over 10 years has been largely positive. This fund, which became a company in its own right in 2004, has managed to sustain and even to build its capital base while demonstrating real value added, including the role of networking and creating partnerships between different types of stakeholder, from the worlds of finance to small rural producers.

For over 10 years, the guarantee fund has worked with more than 100 organizations building a proven track record: developing the economic activities of farmers' organizations; increasing the financial standing of rural finance institutions; and in both cases, providing access to financing at more attractive conditions, both in terms of loan duration as well as interest rates.

Challenges remain, including the negotiation of constructive collaborations with local commercial banks and increasing risk distribution both in geographical and sectoral terms.

© C. Soto – SOS Faim.

© C. Soto – SOS Faim.

SOS Faim

This issue of *Zoom Microfinance* was written by Marc MEES, head of knowledge management at SOS Faim.

SOS Faim Belgium and SOS Faim Luxembourg are two development NGOs active in the fight against hunger and poverty in Africa and Latin America. In favouring an approach based on partnership with local stakeholders, the two SOS Faim entities support family farming by providing farmers in the south with technical, organizational and financial support, and by raising the awareness of and mobilising people from the North around issues relating to poverty and food security.

Apart from *Zoom Microfinance*, SOS Faim publishes *Farming Dynamics,* which provides analysis on the aims, models and implementation conditions of aid to microfinance institutions. This publication is available for download in French, English and Spanish on SOS Faim's website: www.sosfaim.org.

The most recent issues of *Zoom Microfinance* have dealt with the following topics

- **n° 43 The effects of regulation on microfinance in West Africa**
- **n° 42 An ever greener microfinance industry: trend or fad?**
- **n° 41 Paidek: 20 years to build a strong and appropriate response to financing needs in Kivu.**
- **n° 40 Developing rural finance through public-private sector cooperation**
- **n° 39 Social performance management – Lessons from Ethiopia's Specialized Financial and Promotional Institution**

Editor
Freddy Destrait,
4 rue aux Laines,
B-1000 Brussels
(Belgium)

Coordinator
Marc Mees
mme@sosfaim.org
T 32-(0)2-511.22.38
F 32-(0)2-514.47.77
info.be@sosfaim.org
www.sosfaim.org

Graphic design
www.marmelade.be

Zoom Microfinance is printed on recycled paper

Zoom Microfinance is published with funding from the Belgian Directorate General for International Cooperation.

The authors alone are responsible for the opinions expressed in this publication.

THE BELGIAN DEVELOPMENT COOPERATION .be

SOS Faim - Agir avec le Sud
4 rue aux Laines, B-1000 Brussels (Belgium) |
T 32-(0)2-511.22.38 | F 32-(0)2-514.47.77 | info.be@sosfaim.org

SOS Faim – Action pour le développement
88, rue Victor Hugo, L - 4141 Esch-sur-Alzette (Luxembourg) |
T 352-49.09.96 | info-luxembourg@sosfaim.org