World Council of Credit Unions

USAID Competition:
Innovations in Financing Value Chains

a. Activity, Product or Model Name

Value Chain Finance Methodology

b. Contact Information

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c. Donor

United States Agency for International Development (USAID)
Office of Microenterprise Development

d. Name of Implementer

World Council of Credit Unions (WOCCU) with the support of Peru's National Credit Union Federation (Federación Nacional de Cooperativas de Ahorro y Crédito del Perú [FENACREP])

e. Total Cost and Length of Program

Three-year, $1.3 million program, including three components 1) value chain finance, 2) product development and institutional strengthening, and 3) the creation of a national shared branching credit union network.

f. Award category of the submission

Pioneering/Ground Breaking

I. Executive summary

In partnership with Peru's National Credit Union Federation (FENACREP), World Council of Credit Unions (WOCCU) is working with rural credit unions in Peru's Andean and Amazon regions to develop and pilot test an integrated methodology for providing value chain finance (United States Agency for International Development [USAID], 2006-09).

Credit unions are using the innovative methodology to identify at which point in the value chain, from production to commercialization, the delivery of credit has the most value for producers and is a good investment for the institution. The four-phase approach mitigates the risks often associated with value chain financing by thoroughly evaluating the viability of financing opportunities, bringing together all value chain actors to forge market linkages, designing custom products based on the producers' need for financing, and ensuring the process is mutually beneficial for all value chain actors.

Thus far, five credit unions have used the methodology to finance 13 distinct value chains through 20 financing agreements. In total, credit unions have disbursed 350 loans to 2,762 rural producers, producer groups and other value chain actors, totaling approximately US$560,000. Six agreements have matured with zero delinquency, and one had 1.96% delinquency that was paid off within a few days.

WOCCU's replicable methodology has gained traction. Some credit unions have already begun financing additional value chains without the need for WOCCU's technical assistance. The model is adaptable to other financial institutions as well.

II. Background, Rationale and Objectives

Due to the complexity of relationships and the many risks, costs and partnerships associated with value chains, many financial institutions have been hesitant to engage in the analysis that's required to effectively and profitably lend to any but the most secure clients. In fact, much of the existing value chain finance comes from actors within the chain. While this type of lending may be appropriate in some situations, it offers little transparency and puts significant constraints on financing due in part to the actors' limited liquidity and lending knowledge.

Credit unions make promising partners in value chain finance initiatives due to their community ties, strong presence in rural areas and lending experience with low-income and poor individuals as well as small firms. With funding from the Office of Microenterprise Development at USAID and support from FENACREP, WOCCU and credit unions in Peru have collaborated with local producer groups to develop market-driven and mutually beneficial models of value chain finance. WOCCU's new methodology enables credit unions to identify at which point in the value chain, from production to commercialization, financing brings producers the best value and represents a good investment for the institution as well. The methodology is adaptable to other financial institutions interested in value chain finance.

WOCCU's specific program objectives include:

- Increasing the income and assets of poor households by improving access to financial services and facilitating greater market access for their products.
- Expanding the depth and outreach of financial services provided by the credit unions.
- Providing credit unions with the appropriate evaluation tools to measure the market potential and risk of lending to different value chains.
- Developing financial products that fit the needs of producers and are profitable for the credit unions.

III. Description of Financial Product (including delivery channel(s), product term, fees and interest rates charged, product profitability, delinquency, delivery risks and mitigation)

WOCCU designed a four-phase value chain finance methodology to mitigate specific risks associated with each rural value chain (both agricultural and non-agricultural). See Annex 1 for a diagram of the process.

1. *Evaluate value chain financing opportunities*
   - Ensure market demand for specific products and the producers' ability to adequately meet the market needs in terms of quality, price and volume.[1]
   - Analyze the strengths, weaknesses, opportunities and threats of the targeted value chains with a focus on market demand and potential.
   - Identify points along the value chains where providing access to finance could bring the greatest value to small producers and would represent a good investment for the institution.
   - Rank each value chain using a scorecard tool and create a map of potential financing options.

2. *Facilitate and leverage market linkages*
   - Facilitate a workshop for value chain actors to build relationships and to discuss the effectiveness of their value chain.
   - Discuss impediments along the value chain that prevent a mutually beneficial arrangement.
   - Seek commitments from each actor to find solutions to manage constraints along the value chain.
   - Reach agreement among producers and buyers on a fair purchase price for the producers' goods.
   - Gather production and financial data needed to design appropriate loan products.

3. *Determine financial feasibility and design the product*
   - Analyze potential cash flows based on information gathered during the workshop.
   - Design a loan product tailored to meet specific financing needs discussed at the workshop.
   - Establish loan disbursement and repayment schedules according to production cycles. (Terms may be longer for infrastructure and equipment loans.)
   - Determine the best combination of collateral and signed contracts to mitigate risk.[2]
   - Calculate a fair interest rate to cover all costs, provide some margin for profit and remain competitive in local financial markets.

4. *Grant, monitor and recuperate the loans*
   - Disburse the loan in cash or as a voucher that permits the borrower to obtain inputs or equipment from another value chain actor at a discount, which generates economies that benefit the supplier.
   - Leverage relationships with farmer associations and technical assistance providers to help with production monitoring.
   - Establish upfront policies for renegotiating agricultural loans that may be impacted by external factors, such as weather or crop failure.
   - Recuperate the loan from the end-buyer, who channels his payment to the producer to via the credit union. The credit union deducts the producers' full loan payment (principal plus interest) from the sale amount and deposits the remainder into the individual's or producer association's savings account.

After financing a value chain once, a financial institution will not have to implement the same in-depth analysis to grant subsequent loans; however, it should reestablish the market argument for the

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[1] Using this methodology, financial institutions may discover that access to finance is not a constraint and that there are other problems that are limiting competitiveness.

[2] Special attention should be given to the legal environment and the ability to recover collateral. Social guarantees may be the most effective.

investment. As a financial institution gains more experience and confidence in the methodology, it can make modifications to enhance flexibility, efficiency and risk tolerance.

Specific Product Characteristics

The methodology enables a financial institution to design a variety of products with different characteristics to meet the various needs for financing along the value chain. Annex 2 includes a sample credit product design for financing production. Key characteristics include:

- *Delivery channels*: If a producer association is well organized, the credit union lends to the association. If not, credit unions lend directly to individual producers.
- *Financing*: A credit union will finance up to 70% of the amount needed.
- *Product term*: Length of the growing season or production cycle, up to nine months.
- *Interest rate*: 2% per month (varies by credit union).
- *Guarantee*: Depends on the loan amount; may include a combination of personal guarantee, equipment, mortgage, certificate of land ownership or property title.

Delivery Risks and Mitigation

WOCCU's value chain finance methodology is a road map for institutions interested in providing financing to established value chains that have already received some type of technical assistance.[3] The credit unions do not receive any grants, subsidies or guarantees; they assume full risk of the loans they make. Lessons learned in the implementation of the value chain finance methodology have shaped and fortified the approach.

The success in reducing risk is reflected in the credit unions' low delinquency rates. Of the 20 value chain finance arrangements, six have completed payment with zero delinquency, and one showed a delinquency of just 1.96% but was paid off within a few days.

Profitability

The methodology has been proven to reduce risk, improve loan recovery rates and be profitable for the credit unions. WOCCU intends to do further profitability testing and tracking to see if the cost of using the methodology actually does decline as the credit unions become more experienced in using this approach.

IV. Impact on the Value Chain

A key focus of the methodology is to make the financing arrangements mutually beneficial for all value chain actors in order to increase sustainability and create market-driven financing arrangements. The presence and willingness of the credit unions to provide financing has strengthened the value chains and positively impacted all of the actors:

<u>Producers</u>
Elimination of farmer dependence on expensive intermediaries; access to appropriate financial resources according to the needs of the producer throughout the agricultural cycle; commitment to use inputs and production technologies that maximize productivity; greatly improved access to technical assistance; access to credit, savings, insurance and money transfer services as credit union members; increased prices for production; and negotiation and veto power.

<u>Buyers</u>
Elimination of the presence of intermediaries; guaranteed quality products; no longer have to provide direct financing to producers; producer loyalty; and improved market position.

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[3] WOCCU and the credit unions have worked with value chains that have received technical assistance from international donor-funded projects, local governments and producers associations.

Suppliers
No longer have to provide direct financing to the producers; assured sales levels; and improved market position.

Technical Assistance Providers
More stable market for technical assistance services;[4] and link to other value chain actors.

Credit Unions
Rural market penetration with products and repayment mechanisms that minimize risk; increased credit union membership; economic and social impact with profitable products that benefit the rural sectors; and increased technical capacity within the institution.

V. Outreach (Innovation)

The innovation of the program has been the creation of a methodology that provides financial institutions, traditionally hesitant to finance rural activities, with the technical and operational capacity to put resources into rural finance while maintaining an adequate financial margin and low risk of loan default. In addition, bringing together the producers, technical assistance providers, suppliers, processors, buyers and financier permits these parties to enter into mutually beneficial, market-driven commercial relationships. The structured methodology, as described in Section III, is easy to apply, adaptable and has a relatively low implementation cost.

The methodology includes tools for evaluating opportunities, designing products and administering loans—crucial to financial institutions that are interested in financing value chains but do not have access to subsidies, grants or guarantees to reduce the risk. While the methodology is easy to follow, it does require the presence of someone who is able to bring together and facilitate relationships that will lead to an improved value chain, as well as meet the individual goals of the actors.

Key Results and Outreach Indicators

- Five credit unions trained in the methodology.
- Thirteen distinct value chains: industrial oats, milk, kiwicha, guinea pig, trout, alpaca fiber, purple corn, coffee (3 different chains), cacao, potatoes and tropical flowers.
- Twenty unique value chain financing arrangements. Some of the 13 value chains have received more than one loan or have been financed by two credit unions.
- 350 value chain loans disbursed, totaling approximately US$560,000.
- 2,762 rural producers have benefited from loans and access to other financial services.
- Average loan per finance agreement is approximately US$28,000 and per loan is US$1,600.
- Six agreements have matured with zero delinquency and one with 1.96% delinquency for a few days before being paid off completely.

VI. Sustainability (Validation/Context)

Just two years after the program start, credit unions in Peru began expanding the methodology on their own, financing additional value chains with limited monitoring or support from WOCCU. Continuity of financing operations into the future will depend on the progression of relationships among the value chain actors and continued profitability (internal factors) as well external factors.

Internal Factors

- Thorough evaluation of the value chains before providing financing.
- Fulfillment of agreements and commitments by each of the value chain actors.

[4] Producers who have received free technical assistance through development and government projects have indicated that they are willing to pay for technical assistance when the projects end. At that time, producers will need to evaluate if the activity will continue to be profitable with the additional costs, and the credit unions will need to reevaluate the capacity to pay.

- Complete and timely loan repayment.
- Equal access to market information for the producers.
- Commitment and participation of all actors to create value along the entire chain.
- Application of corrective measures for actors that do not fulfill their commitments.

External Factors

- Basic rural infrastructure.
- Existence of secure legal frameworks for enforcing contracts and agreements.
- Level of control that financial authorities and entities have over indebtedness in rural areas.
- Presence of programs with subsidized interest rates.
- Free trade agreements that impact competitiveness as well as supply and demand.

VII. Replication and Scalability

The methodology is easy to replicate and can be adapted to diverse contexts and environments provided the following preconditions are present:

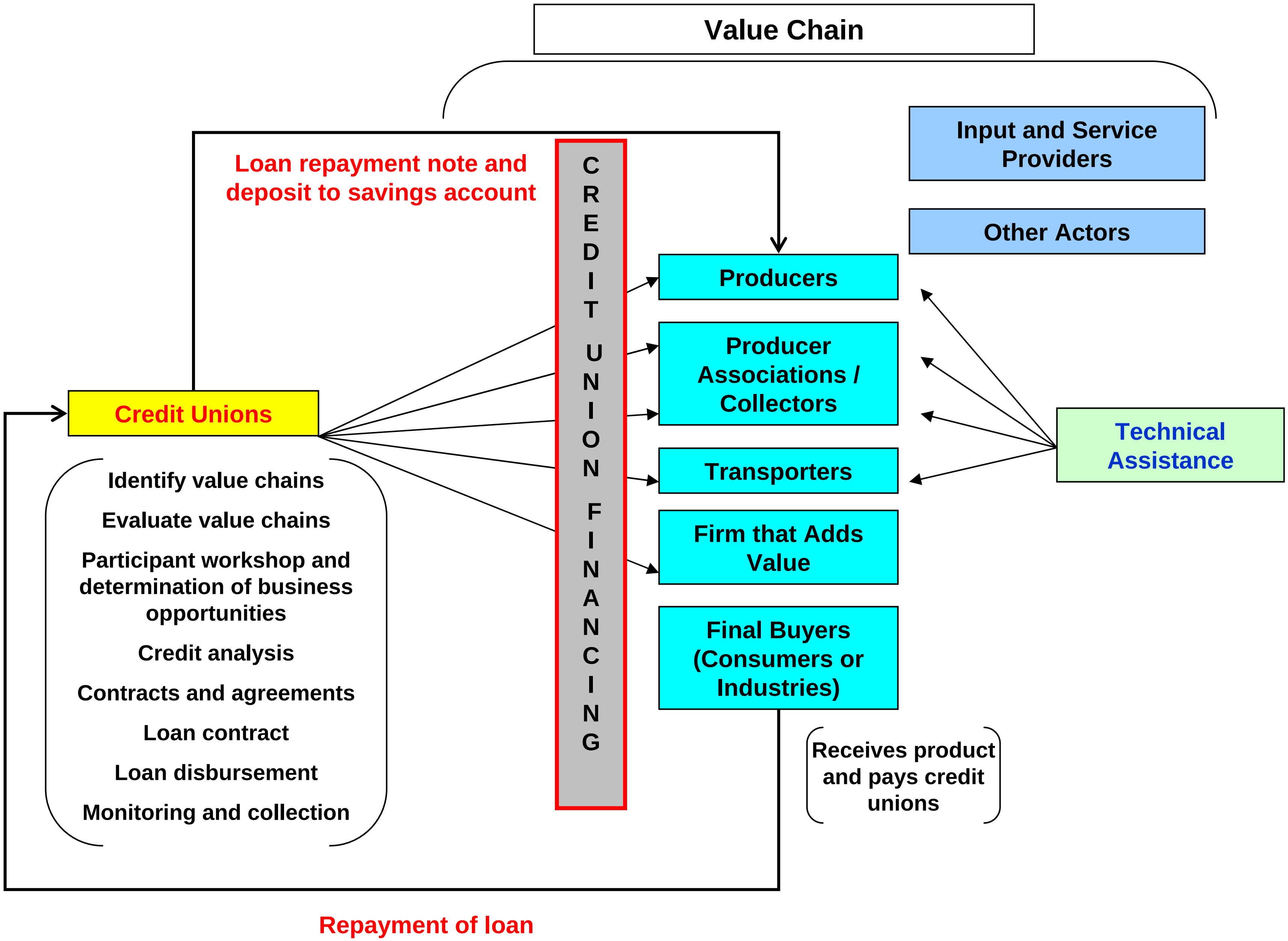
- Legal system that enforces contracts and provides some type of land ownership documentation (not necessarily a title).
- Basic infrastructure including roads, irrigation, electricity and telephone.
- Solid financial institutions that are committed to the rural sector and have offices near the producers.
- Organized groups of producers with market potential.
- Final buyers who are willing to actively participate in the value chain.
- Human resources that meet a basic profile to operate as value chain analysts.
- Projects or private providers of technical assistance.
- Access to basic, reliable market data either through public sources or other value chain actors.

Based on lessons learned, elements of successful value chain financing include:

- **Trust.** Financial institutions need to see that the methodology works before assuming the risk of increased lending. As they see positive results, they become more willing to take on the additional risk and to look for new value chain financing opportunities.
- **Credibility.** The market determines the success or failure of the value chain financing. Financial institutions should select buyers who have experience and good reputations in the market.
- **Commitment.** Open conversation about each participant's objectives ensures a market-driven arrangement. All participants sign contracts that include penalties for not fulfilling responsibilities. While this is not a 100% guarantee, it reduces the risk of abuse by any one participant.
- **Diligence.** The risk dramatically increases if the credit union skips any of the four phases of the value chain assessment process. Loan officers and their managers should be trained to understand the importance of following through with each phase.

Many credit unions outside of WOCCU's program in Peru have sought access to the methodology.

ANNEX 1: WOCCU's Value Chain Finance Methodology Diagram



ANNEX 2

Sample Credit Product Design and Policy for Financing the Production Phase of an Agricultural or Non-agricultural Value Chain

Category	Description
Type of Operation	***Production Credit Product for Value Chains***
Loan type	❑ Working capital for production, acquisition of supplies or labor for harvesting agricultural products on a short cycle. ❑ Working capital for production or acquisition of supplies for non-agricultural products (crafts, textiles, jewelry, etc.)
Directed to	❑ Small agricultural producers linked to a value chain with high market potential. This includes small producers that have up to five hectares of farmland. ❑ Small non-agricultural producers or microentrepreneurs who are linked to a value chain with high market potential. ❑ Producer organizations/associations, including associations that are legally constituted by law, or a group of producers that has some kind of legal recognition from a judge.
Amount	**Individual:** Maximum 70% of the production costs for up to five hectares (in the case of agricultural products) or maximum 70% of the production costs of the non-agricultural activity. **Group:** Up to S/1,000,000 (US$333,333) per value chain per growing or production cycle.
Origin of funds	Credit union resources
Term	❑ Length of the growing season, up to nine months, including a grace period for commercialization. ❑ For non-agricultural products, length of the production cycle, up to nine months, including a grace period for commercialization.
Interest Rate	2.0% per month, flat rate (varies by credit union)
Delinquency Interest Rate	3.0% per month for the delinquent amount (varies by credit union)
Guarantee	Varies depending on the amount disbursed. Possibilities include: ❑ Property title ❑ Certificate indicating land ownership ❑ Mortgage ❑ Equipment ❑ Personal guarantee ❑ Mixed (combination of the above)
Disbursement	❑ Multiple disbursements may be made (i.e., for planting, taking care of the fields, and harvesting) in accordance with the production cycle, cash flow needs of the producers and the technical report from the value chain analyst. ❑ At the beginning of the production process for non-agricultural products.
Amortization	❑ Payment of capital and interest in one payment at the end of the term. ❑ The final buyer makes payment directly to the credit union, which deducts the amount that corresponds to the capital and the interest and puts the remaining amount in individual savings accounts for each producer-member.
Other charges	Administrative costs, S/13 (US$4.33)
Life insurance	0.50% of the amount disbursed
Refinancing	Only for natural causes

Category	Description
Deduction from loan disbursement	S/15.00 (US$5.00)
Analysis	The value chain credit analyst is responsible for carrying out the technical analysis of each value chain to determine the borrowers' capacity to pay.
Credit Bureau Score	A normal or CPP score (credits with potential risk of becoming delinquent) for the borrower and personal guarantor
Levels of Approval	In accordance with the amount: ❑ Credit Manager or Branch Administrator: up to S/15,000 (US$5,000) ❑ Credit Manager and Business Manager: from S/15,001 to S/25,000 (US$5,001 to US$8,333) ❑ Credit Committee: from S/25,001 to S/80,000 (US$8,334 to US$26,667) ❑ Board: above S/80,001 (US$26,667)
Reserve	For every S/20, there must S/1 in a share account reserve. The amount is financed in the beginning as a part of the loan.
Periodic Share Requirements	S/10 per month, financed in the beginning as a part of the loan, based on the loan term.
Documentation required for the analysis	❑ Technical files of the producer(s)'s activity presented by the technical assistance provider ❑ Certificates from the authorities of the zone where the beneficiary lives (from the Irrigation Committee and/or the President of the Community), receipts for supply purchases, sales receipts and other related documents ❑ Stamped certificate for the producer association and the technical assistance provider for the value chain ❑ Official identification documents from the spouse and/or personal guarantor ❑ Sketch of the residence, the production area and/or the land parcel ❑ Contract for future sales purchase ❑ Technical evaluation by the value chain finance analyst
Documentation required for the disbursement	❑ Legal documentation in the case of guarantees ❑ Promissory note and credit contracts