



MANAGING RISK IN FINANCING AGRICULTURE

Expert Meeting Convened and co-sponsored by
AFRACA, FAO, the Land Bank of South Africa, and the World Bank

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Proceedings¹

Sound risk assessment and management is a fundamental element of sustainable agricultural finance at the level of the farm, the financial institution, and throughout the agricultural value chain. The risks involved in financing agriculture can be broadly classified into three categories. The first relates to agricultural production and includes natural factors, such as weather, pests, diseases, and market factors, such as the price of seeds, fertilizers, and pesticides. The second type of risk relates to the farmer and his or her well-being, assets, skills, and ability to bargain effectively with input suppliers and buyers of produce in local markets. The third type of risk relates to financial institutions and their capacity and the regulatory environments in which they operate. Risk management instruments are required in all three categories. These include a range of insurance products, price risk management tools, good banking practices and business advisory services, market facilitation, and certification services to increase market access. Initiatives to foster financial literacy can also contribute to more effective risk management. Appropriate commercial and financial regulations can mitigate risk that results from policy uncertainty. All of these were discussed at length during the Expert Meeting on Managing Risk in Financing Agriculture in Johannesburg in April 2009.

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1. Background

The Expert Meeting on Managing Risk in Financing Agriculture convened in Johannesburg, South Africa, from April 1 to 3, 2009. The meeting was co-organized and co-sponsored by the African Rural and Agricultural Credit Association (AFRACA), the Food and Agriculture Organization of the United Nations (FAO), the Land Bank of South Africa, and the World Bank. More than 40 experts from different parts of the world were invited to share their experiences and to discuss key issues. The participants came from a variety of national, international, public, and private organizations that are involved in providing and facilitating the provision of financial services in the agricultural sector.

Section 2 provides an overview of issues and tools related to risk management in agricultural finance. Section 3 summarizes the presentations made at the meeting. Section 4 presents a summary of meeting findings.

Objectives

The primary objective of the expert meeting on integrated risk management was to review practices and instruments that are used to manage risks and to examine the factors that make some of these effective in providing farmers and other agents in agricultural value chains with access to financial resources. These agents typically have very limited, if any, access to financial services in developing countries, which represents a major constraint to rural development. Without access to these services, rural income varies widely from season to season and from one year to the next.

The expert meeting aimed to foster better understanding about farmers' demands for risk management products and the kinds of products being developed to help them cope with emerging and unique risks, including opportunities for alternative risk vehicles. Participants sought to gain insight into various investment opportunities in agricultural production and processing that can help to reduce poverty. Additionally, consideration was given to how stakeholder mapping could be used to assess the potential for high-level risk management applications in Africa.

Meeting structure

In preparation for the meeting, a Concept Note (Annex 1) was developed by AFRACA in consultation with its partner sponsors. The Concept Note set out the background, objectives, and expected outcomes of the meeting, and was circulated in advance to experts. A list of issues for expert consideration and guidance was circulated and is provided in Annex 2.

The three-day meeting started with an overview of risks for financial institutions, as well as agriculture. This was followed by five plenary sessions and two parallel sessions over three days. In the final session, a summary of meeting findings was presented by the workshop facilitator to participants, in which additions and deletions had been made, based on participant input. This, as well as a list of 14 findings was adopted as meeting findings. Twenty-one presentations were made, all of which are accessible at www.ruralfinance.org. Each session closed with a Question & Answer session. Days 1 and 2 closed with discussion panels. Days 2 and 3 started with a recap by the meeting facilitator of the previous day discussions.

2. Risk Management in Financing Agriculture: An Overview

The complexity of managing agricultural risk carries important implications for managing risk related to financing agriculture. Both formal and informal, and both ex-ante and ex-post, risk management strategies apply at the various levels between that of the household and that of the society. Informal risk management strategies are generally more prevalent at (i) the household level, where they are, for the most part, used to mitigate risk, and (ii) at the community level, where they are mainly used to share risk. Formal risk management generally applies at the level of the market, where it is mostly used to share or transfer risk, and at the level of public policy, where it is mainly used to either transfer or to absorb risk. Figure 1 presents a matrix that classifies these types of formal and informal risk management strategies. Figure 2 applies this schema to weather-related risk specifically, the weather being a major source of risk to smallholder farmers. The strategies used vary with the severity of the risk.

Figure 1 : Informal and formal risk management strategies

Informal Risk Management Strategies		
	Farm Household-level (mitigating risk)	Community-level (sharing risk)
Ex-ante	Savings Buffer Stocks Enterprise diversification Low risk, low return cropping patterns Production techniques	Food crop sharing Common property resource management Social reciprocity Rotating savings/credit
Ex-post	Sale of assets Reallocation of labor Reduced consumption Borrowing from relatives	Sale of assets Transfers from mutual support networks

Formal Risk Management Measures		
	Market-based (share/transfer risk)	Publicly-provided (transfer/absorb risk)
Ex-ante	Contract marketing Financial hedging tools (options) Traditional insurance Weather-index insurance Contingent funds for disaster relief	Pest/disease management Physical crop/food stocks Price guarantees or stabilization funds Input subsidies Public insurance
Ex-post	Savings Credit	Disaster assistance Social funds Cash transfers Waiver (cancellation) of crop loans

based index such as rainfall or temperature, payout is triggered by low or high rainfall. In an area-yield based index, payout is triggered by a fall in area-yield below a particular level. This reduces the risk of moral hazard, adverse selection, and transaction costs.

- The *micro insurance* products generally refer to life, health, and asset insurance products that are provided to low-income individuals with micro finance loans.

Indemnity insurance. Of the estimated US\$10 billion global agricultural insurance market in 2008, about 96 percent of the global agriculture insurance market is comprised of traditional indemnity insurance products. Of this proportion, multi-peril crop insurance (MPCI) products make up about 60 percent. Nonetheless, this type of product is characterized by highly complex underwriting and operational requirements, as well as the limited aligned interests of farmers, insurers, and banks. MPCI products rely on strong government support and on the cooperation of all stakeholders concerned. Swiss Re, a major global reinsurance company, has successfully developed traditional indemnity products for smallholders with farms of three hectares and smaller in Ethiopia and Mauritius. In Ethiopia, the product is sold at the micro level through farmers' cooperative unions.

Index-based weather insurance. This type of insurance product pays out based on the value of an 'index' as opposed to actual losses measured in the field. Examples of indexes are rainfall, temperature, regional yield, river levels, etc. Index-based weather insurance works best for spatially correlated risk, and effectively lowers program costs by offsetting the need for loss assessment. Because it is based on an independent index, it is more objective, allows faster payout, and is more amenable for reinsurance. It does, however, have certain limitations. For one, it generally covers very specific risks, such as rainfall deficit, excess rainfall, pests, and temperature. It may also lead to potential mismatches between the actual loss and the amount of the payout. When it is introduced as a new product, it requires extensive training of both insurance sales personnel and clients. Index-based weather insurance also relies heavily on the quality of data that is available, both historic and "real time" which, in turn, depends on the number of weather stations in the areas covered. In spite of these qualifications, index-based weather insurance has been effectively applied at the micro, meso, and macro levels. At the micro level, it has been extended to smallholder farmers through intermediary institutions with substantial rural outreach. At the meso level it is provided to rural financial institutions that lend to farmers. And at the macro level it is extended as a weather-indexed line of credit by governments and international organizations that use it to provide a social safety net to the poor. It can also be used to meet -- or to partially meet -- the collateral requirements of lenders.

Microinsurance in rural areas. Microinsurance can significantly reduce the vulnerability of rural households, and can promote investment to increase productivity in smallholder agriculture. However, only 0.3 percent of the population in Africa has access to insurance. Where they are available, micro-insurance products can be used as life insurance, health insurance, and insurance against asset losses. While some financial institutions, including those represented at the meeting, already offer them to their clients, a number of challenges remain in making them more widely available. Few countries have modified their insurance regulations to accommodate the specific needs of microinsurance providers. Microinsurance requires customized regulation to cover a variety of issues, such as entry requirements, demarcation between life and non-life lines, detailed product regulation, and the capping of commissions. Among financial institutions that provide insurance, many board members and managers that lend to the agriculture sector remain unaware of potential

uses of microinsurance to mitigate risk. Few such institutions provide training to staff or actively market microinsurance products.

2.2 Price Risk Management Tools

For those who purchase and resell commodities, including many producer organizations, two types of price risk are concerned. In the first type, the risk arises when the commodity is purchased or the purchase price is agreed to before it is sold in a market. The second type arises when the sale is made or the sale price is agreed to before the commodity is bought from the producer. When for instance the price falls during the period between the purchase and the subsequent sale of the commodity, buyers and processors may react in a number of ways. They may avoid or postpone making sales in order to avoid incurring the loss, or they may make the sale and incur the loss. They may not have enough cash to continue paying farmers, or be forced to lower the purchase price they offer to farmers. They may default on sales because they are unable to procure enough product, or go out of business altogether. These actions impact all players in the value chain, and can have significant macroeconomic impacts, particularly if the country is highly dependent on income from the commodity involved. Recent examples include the experiences of Burkina Faso and Senegal in 2006, both of which incurred substantial debt as a result of a decline in cotton prices.

Options and futures contracts are the principal instruments that enable agents to manage price risk. A futures contract is a financial agreement between two parties that stipulates the purchase or sale price at a specified time. An options contract is a financial agreement between two parties that gives the buyer the right, but not the obligation, to buy or sell at a given price at a specified time. These instruments help financial institutions to improve their risk assessment capabilities and their credit monitoring. They offer risk management solutions to a broad range of actors in a value chain including producers, lenders, traders, and processors. Like insurance products, these instruments can be used to increase access to credit, reduce the cost of borrowing from banks, and stabilize earnings by securing minimum operating margins. However, regulatory restrictions -- the relatively high unit cost of transactions involving options and futures contracts, and the limited capacity of most value chain actors to enter into such transactions -- have limited the use of these instruments by institutions that lend to agriculture sector agents. These factors have limited their use in lending to smallholder farmers, in particular.

2.3 Credit Risk Management in Agriculture Finance

Credit risk -- the risk that a borrower may default -- resulting in losses to the lender, is among the most important risks that financial institutions face. Credit risk is generally considered to be higher for loans to agriculture because of the inherently high level of risk the sector itself faces.

As part of its ongoing work on lending for agriculture, the World Bank conducted a survey of 15 financial institutions in five African and Asian countries to understand how these institutions manage their credit risk (Nair, 2008). The survey brought a number of findings to light. The absence of well functioning national identification and credit information systems limited the ability of all 15 financial institutions to assess their clients' credit-worthiness. None of those that made small loans used traditional forms of collateral or conventional credit assessment systems, in which the approval

decision is based on the detailed financial analysis of an individual applicant or project. Some of the financial institutions used simplified financial analysis, in which the applicant's capacity to successfully undertake an activity is assessed based entirely on cash flows. Others used parametric, area-based scales that were standardized to fit certain crops in a given geographical area. Some required evidence of land ownership, but without requiring mortgage or any other form of collateral.

Some of the financial institutions that made small loans accepted joint liability by groups of between 5 and 20 individuals, and the loans were made either to individual members of the group or to the group collectively. Others delegated credit risk assessment to third parties – either individuals with local knowledge or field officers of partner organizations, such as a commodity buyer. All of the financial institutions surveyed continued to use traditional credit-risk assessment tools for large loans. While the use of insurance products and other instruments to manage financial risk is not common, two of the organizations studied bundled credit with life insurance, and one of them bundled credit with life insurance, health insurance, and area yield-based crop insurance. None of the organizations reported using financial price risk management instruments, such as futures or options. Six banks used risk-based pricing for institutional and large individual borrowers, but not for small loans. Three out of the four development finance organizations examined did the latter.

Most of the financial institutions studied, which had large agricultural portfolios, had significant expertise in agriculture, both at the loan officer level and at the senior level. Most of these organizations also had diversified loan portfolios -- across sectors, across geographies, and within the agricultural portfolio. The share of the agricultural portfolio in banks' total credit portfolios ranged between 10 and 20 percent. In two of the development finance organizations (such as state development organizations and microfinance institutions (MFIs)), this ratio ranged between 30 and 40 percent, while the other two had nearly 100 percent of their credit portfolio in agriculture.

The findings of the review suggest that all financial institutions interested in starting or scaling up lending to smallholder farmers and small rural enterprises should consider: (i) the use of innovative means, such as biometrics, for uniquely identifying clients; (ii) alternatives to traditional financial analysis, such as the use of cash flows rather than balance sheets; (iii) alternatives to traditional forms of collateral, such as tripartite arrangements and group lending; and (iv) developing agricultural expertise at credit officer and senior management levels. Further case studies of selected financial institutions revealed that basic banking tools and processes, as well as market facilitating institutions playing a key role, are the foundation for good agriculture.

2.4 Cross Cutting Topics

Financial literacy is “the ability to process financial information and make informed decisions about personal finance...” Financial literacy is important at different levels. Among individuals, the lack of financial literacy leaves people more vulnerable to the effects of emergencies and more likely to become heavily indebted and be taken advantage of by overzealous or fraudulent retailers. Misinformation also breeds distrust of formal financial service providers, and misinformed consumers tend to make poor clients whose lack of understanding represents a source of increased risk for financial institutions. At the market level, misinformed or under-informed consumers are unable to monitor the performance or trustworthiness of financial service providers, or to play an active role in discouraging or weeding out bad practices. Kenya has developed a comprehensive

approach to financial literacy that includes both public and private actors. The Financial Sector Deepening Trust and the Swedish Cooperative Center are examples of institutions that have played a facilitating role in promoting financial literacy.

Business development and market facilitation services. Agricultural credit and insurance are not stand-alone activities. Well functioning value chains are important to the successful operation of agricultural and insurance markets. Effective agricultural advisory services, suppliers of good quality inputs, and well-functioning produce markets are among the key elements of value chains. Nonfinancial instruments can link different stakeholders who may organize into formal networks and strategic partnerships. These, in turn, can play an important role in the development of value chains that benefit smallholder farmers. Two case studies in the following section demonstrate how business development and market facilitation services contribute to risk management.

Leasing. A noteworthy alternative to credit is leasing. A lease is a contract between two parties: the lessor, who owns an asset, and the lessee, who makes periodic payments to use the asset for a predetermined period of time. The arrangement separates the use of an asset from the ownership of that asset. Financial leasing is a leasing product that amortizes most of the cost of an asset over a medium term and allows for ownership transfer at the end of this period. In some countries, this is a good alternative to credit for financing productivity enhancing assets – both from the perspective of financial institutions and from that of their clients. Leasing carries important advantages for the purpose of agricultural and rural finance, and particularly in environments in which there is no asset to be collateralized and in which poorly functioning credit-registries and interest rate ceilings make transaction costs very high. A survey and a set of case studies conducted by the World Bank on rural leasing found that: (a) leasing is a means to acquire productive assets; (b) rural enterprises of different sizes benefit, but providers may not be able to serve all markets; (c) non-farm enterprises account for a significant portion of rural leases; (d) rural leasing can be profitable but may require initial donor or government support and (e) rural-only leasing companies may not be viable (Nair and Kloeppinger-Todd, 2006).

3. Risk Management Case Studies

While a few of the presentations seen at the Johannesburg Meeting addressed policy-related and conceptual issues in risk management, most of the attendees were practitioners, and their presentations focused on practical institutional experiences in managing risk. This section presents a summary of these presentations.

3.1 International Experiences

Cooperative banking in a developed economy - Credit Agricole, France. Crédit Agricole is a market leader in France with over 26 million clients. It has an 80 percent share of France's farmer financing market and a 28 percent share of the country's personal banking market. Crédit Agricole's risk management approach is based on the identification and understanding of all risks from the point of view of farmers and other clients, and addressing them through tailor-made products and services. Major categories under which risks are identified include the farmer, factors of production, natural resources, inputs, inventories, investments, sales, cash, regulations, and social risk. Products and services offered include an integrated farm machinery financing facility offering lending and leasing

solutions, a range of insurance products (crop, vehicle, health, life, livestock, farm equipment, and weather), soft-commodity hedging services, and advisory services. Crop insurance is an indemnity product that covers losses occurring from 11 types of climatic events. Crédit Agricole has a comprehensive risk policy that categorizes combinations of loan sizes and risk ratings with types of guarantees required and decision levels. The risk ratings are based on a ten-point scale with corresponding probabilities of default. Using this broad package of services, Crédit Agricole succeeded in reducing its ratio of non-performing loans to 5 percent in 2008 from around 8 percent in the early 1990s, while increasing the portfolio from around €25 billion to nearly €33 billion.

Cooperative banking in a transition economy - ACBA, Armenia. ACBA has nearly three-quarters of the market share of agricultural credit market in Armenia. Approximately US\$253 million of its loan portfolio in 2008 was in the agricultural sector. The non-performing loan ratio in the agricultural portfolio is only 0.15 percent. The principal risk management mechanisms used by ACBA includes: (i) a credit policy that is based on the gradual increase in the amount and terms of clients' liabilities and on the credit history of the borrowers; (ii) a risk analysis method is chosen based on the amount of the loan and on the borrowers' credit history; and (iii) permanent control over the disbursed loans by the loan specialists. Other features of ACBA's risk management approach include flexible collateral policy, mandatory field visits, restrictions on credit to certain sectors, and credit decision levels based on loan size.

Development banking - Aiy Bank, Kyrgyz Republic. Aiy Bank is a publicly owned development bank that is in the process of being privatized. In 2008, the bank had a loan portfolio of US\$67 million. About 87 percent of its lending portfolio relates to agriculture, and more than 90 percent of this amount involves loans for livestock. The non-performing loan ratio is less than 1 percent. The Bank categorizes loans into four categories based on loan size. Its credit risk assessment processes and credit risk management requirements are tailored to these categories. The bank regards the availability of good veterinary services as a key non-financial factor that mitigates its credit risk.

Livelihood financing - BASIX, India. BASIX is a pioneering rural microfinance institution that has a large agricultural loan portfolio. It employs a Livelihood Triad risk mitigation strategy to address risks in financing agriculture. The strategy includes: (i) institutional development support by organizing farmers into groups and cooperatives to improve their bargaining power through aggregation; (ii) Livelihood Financial Services, which offers savings services, livelihood insurance, and credit; and (iii) business development support for agriculture - where advice on proper agronomic practices for risk mitigation is provided. BASIX provides microinsurance along with microcredit and has a pilot commodity risk mitigation program. It partners with several insurance companies to develop and retail customized microinsurance products to its clients. BASIX has demonstrated that if farmers are offered all these methods of risk mitigation, then the "perceived risk" in financing agricultural value chains declines and leads to an increase in financing from the private sector.

3.2 Bank Experiences in Africa

Cooperative banking - Co-op Bank, Kenya. Co-op Bank is a publicly listed company majority owned by cooperatives in Kenya. It has an asset base of nearly US\$1 billion, and provides services to around seven million clients, either directly or indirectly through cooperatives. Risks in financing agriculture include price volatility, weather risk, poor market access, loan diversion, lack of crop and animal

insurance, poor governance structures of cooperatives, and inadequate monitoring mechanisms. The Co-op Bank applies the following measures to manage these risks at the time of loan application: (i) tripartite agreement between the buyer, the borrower, and the Bank; (ii) delivery statement including the net value, quantity and grade; (iii) collateral; and (iv) other official documents. Additionally, Co-op Bank of Kenya uses credit monitoring methods after a loan is approved and disbursed. The methods include daily monitoring of outstanding loan, branch-to-branch communication, and regular visits to clients.

Social banking - Centenary Bank, Uganda. Centenary Bank, majority owned by the Catholic Church, is a major micro finance provider in Uganda with over 700,000 depositors and 90,000 borrowers. In 2008, it had US\$172 million in deposits and US\$144 million in loans. Of the loan portfolio, 74 percent was microfinance and around 14 percent was agriculture-related. The bank focuses on lending for commercially oriented farmers in order to mitigate risk. During a credit assessment, a holistic approach is used whereby all sources of the applicant's household income are appraised. The bank has learned that training credit officers in agriculture can be one of the risk mitigation measures. A number of operational approaches yield better results in mitigating risk in agriculture finance. These include: (i) quick and timely loan processing, so that the loan would be available for the required season; (ii) formulating payment schedules based on the farmer's cash flow; (iii) diversification of portfolio beyond agriculture; (iv) developing portfolio monitoring systems; (v) networking with other stakeholders; and (vi) product diversification and opening more branches.

Microfinance banking – Opportunity International Bank of Malawi. OIBM has around 203,000 clients, of which 38,800 are borrowers, and a loan portfolio of around US\$30 million. In early 2009, it had around US\$7 million in its agricultural portfolio of approximately 6,500 loans. In collaboration with the Insurance Association of Malawi, OIBM has been piloting the use of rainfall-index insurance since 2005. The pilot involved activities at the micro, meso, and macro levels. The lessons from the pilot are that: (i) farmers need practical solutions for their problems; (ii) weather-index insurance gives a safety net to both the farmer and the bank; (iii) it provides cover for the specified index only; (iv) weather-index insurance is best sold when bundled with credit and not as a stand-alone product; (v) weather-index insurance provides a win-win situation to all the players; (vi) with weather-index insurance, no physical presence is required to assess damage; and (vii) while weather-index insurance is not the ultimate solution for challenges the farmers face, it is clearly part of the solution. In 2009, OIBM insured around 2,500 farmers and had a portfolio of US\$2.4 million.

Development banking – CNCA Senegal. With US\$224 million in assets, CNCA, a public development bank, is the eighth largest financial institution in Senegal and the largest lender in rural areas. CNCA developed a risk management mechanism at different levels and stages in the lending cycle. At the time of credit assessment, a flexible criteria approach is adopted: all borrowers need to have a deposit account as a group of farmers and /or individuals, and loans are provided to the group of farmers. Training is provided to farmers and their organization members. The staff of the CNCA is also actively engaged in the meetings and trade exhibitions of farmer originations. Partnership with government at the macro level is also essential. Modern banking instruments, such as warehouse receipts, group crop collateral, and agricultural insurance may be necessary.

3.3 Non-Bank Experiences in Africa

Financing contract farming – Malawian Union of Saving and Credit Cooperatives Ltd. MUSCCO has a membership of 70 Savings and Credit Cooperatives in Malawi with around 85,000 members. It provides a farm input financing scheme for smallholder tobacco producers through associations of smallholder farmers, such as the National Smallholder Farmers' Association of Malawi. MUSCCO uses a solidarity group-lending methodology. Other risk mitigation tools it uses include: (i) submission of formal documents and agreements at the time of loan approval; (ii) credit monitoring at the farm level; (iii) monitoring of sales; (iv) compulsory credit life insurance for all smallholder farmers; and, (v) letters of partial-guarantee by produce buyers. It also does loan-aging exercises periodically to establish loan loss provisions and diversification of portfolio among cash and commercial crops, and to ensure that loans are also diversified across different maturity periods. MUSCCO has also piloted the use of weather-index insurance to mitigate the risk of high or low rainfall.

Facilitating risk-mitigating tripartite linkages – DrumNet, Kenya. DrumNet is a bridging mechanism to facilitate interaction between producers, input sellers, produce buyers, and financiers to add value to their business transactions. It links commercial banks, smallholder farmer groups, produce processing companies, and retail providers of farm inputs through a cashless credit system using mobile phones, SMS and email. The DrumNet facility acts as the intermediary between producers and buyers to negotiate contracts, and ensures that farmers grow in accordance with the requirements of the buyers. The risk mitigating measures used include: (i) buyers, sellers, and agro dealers must have bank accounts with the same financial institution for cashless transactions; (ii) farmer groups must be existing legal entities; (iii) a formal contract between the buyer group and the producer group, confirming price, quality, and quantity; (iv) a farmer group solidarity guarantee; (v) a farmer group Transaction Insurance Fund of 25 percent; (vi) a group bank account with bank credit approval, and, (vii) a tripartite line of credit agreement between the farmer group, the bank, and the buyer. In its primary program, DrumNet works with Equity Bank, a major microfinance bank in Kenya, and BIDCO, a cooking oil refinery.

Microfinance for agriculture – Association of Ethiopian Microfinance Institutions. The Ethiopian microfinance industry has grown rapidly in recent years: as of September 2008, the industry served around 2.2 million clients, and had a savings balance of around US\$160 million and a loan balance of US\$460 million. About 66 percent of the loan portfolio in Ethiopia is estimated to be in agriculture. However, MFIs in Ethiopia do not have appropriate products that can provide sustainable financing for agriculture. Capacity of the staff of the institutions to adequately assess the credit risk involved in agriculture is also weak. The agriculture sector in Ethiopia is affected periodically by droughts and high price fluctuations. Nevertheless, MFIs have managed to lend to rural clients using several credit risk management mechanisms that include group lending; avoiding high risk/vulnerable clients; rescheduling loans; portfolio diversification; insurance; credit guarantee schemes supported by the government; property collateral for larger loans; and promoting savings.

Horizontal and vertical partnerships - Réseau des caisses populaires du Burkina, Burkina Faso. RCPB is a federation of financial cooperatives in Burkina Faso. The network has over 550,000 members, 30 percent of whom are women, US\$87 million in deposits, and US\$80 million in loans. An estimated

40 percent of the loan portfolio is agricultural. RCPB's experience in risk management suggests that: (i) creating partnerships with non financial service providers that can technically support farmers is critical; (ii) creation of an agricultural support center within financial institutions is helpful in identifying risks and understanding returns in agriculture, leading to proactively mitigating risks. RCPB also co-finances projects with banks to reduce risk. It also believes that some actions by the government, particularly in cushioning price fluctuation in key commodities, helps lenders mitigate their risk. The experience demonstrates that microfinance can be a tool in financing agriculture. Organizing farmers into groups and having a tripartite arrangement between farmers, technical service providers and financing institutions are some of the prominent lessons drawn from the RCPB risk management experience.

4. Summary of Findings

The summary was arrived at by a sub-group of the participants and validated during the final plenary session. As guiding principles, issues of cross-cutting interest across the various presentations were considered. These included: (i) policy, legal and regulatory, public/private partnerships; (ii) structural, organizational, and agriculture chain – stakeholder linkages; (iii) technical, analytical, risk assessment tools and practices; and (iv) financial instruments, insurance, price risk management. The following 14 findings were adopted by the participants through a consultative process as the key findings from the presentations and discussions at the expert meeting:

- 1 *Financing for agriculture is viable and sustainable* if supported by sound risk assessment and risk management at all levels, including at the farm, the financial institution (commercial risk), and the agricultural value chain.
- 2 *Cooperative financial institutions and mutuals* are often well positioned and effective in providing financial services for agriculture, and other financial institutions can draw valuable lessons from their experiences.
- 3 *Mutually beneficial partnerships* through which risks and benefits are shared lower risk by creating holistic solutions and by enabling cost-efficient delivery of packaged financial and nonfinancial products and services.
- 4 *Aggregation* of clients can facilitate the development of, and access to, risk management services, such as price risk management and insurance, as well as other services, such as collective input purchasing and output marketing.
- 5 *Good banking practices*, combined with understanding of the agriculture sector and the client, are the core of sound institutional management and operations for financing agriculture.
- 6 *Government policy and intervention* should be oriented towards public goods and infrastructure (physical and non-physical), aiming to promote an enabling environment for the development of agriculture finance and insurance services, through public private partnerships.
- 7 *Well designed and qualified technical assistance*, taking into consideration existing local knowledge built on the understanding of effective demand for financial services, is key to the development of efficient and well performing agriculture finance.
- 8 *Insurance* is one tool in an overall risk management strategy to promote agriculture finance at all levels (micro, meso and macro). There is a need for continuing development of insurance products and services adapted to developing countries, in particular those that are addressing agricultural production and livestock losses.

- 9 *Innovations in agriculture finance* could build on and improve existing products and processes to deliver new and more efficient services. Investment costs of innovation may deter good initiatives. Cost-sharing, through the development of partnerships (for example, with other service providers) is necessary, both to initiate and to scale up innovation.
- 10 *Price risk management* is very important and equally difficult to achieve, but could be promoted through aggregation. Hedging instruments have only limited availability in developing countries, particularly for smallholder farmers, and are only applicable to internationally traded commodities. Contract farming offers another approach to price risk management for smallholder farmers and their financial institutions.
- 11 *Innovative forms of collateral and collateral substitutes* can be employed in order to improve access to finance for farmers, who lack suitable conventional physical assets for loan guarantees.
- 12 *Financial literacy* is a particular challenge for financial institutions serving farmers and other clients in the agricultural value chain in developing countries. Financial literacy education will contribute to improving risk management in agricultural lending and is equally important both for staff and clients of financial institutions
- 13 *Leasing* offers the potential to reduce some of the risks of traditional loan provision for investment financing in agriculture. Leasing can provide an alternative financing solution for smallholder farmers and rural enterprises with limited collateral and credit history for the acquisition of equipment and other production assets.
- 14 *Certification* of agricultural producer organizations can allow improved access to national and international markets, and capacity building. Reduced market risks for farmers and financial institutions alike can enhance access to affordable finance.

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Nair, Ajai. 2008. "Assessing and Managing Credit-risk in Agricultural Lending: Findings from a Survey of Major Lenders in Five Countries." Unpublished report. World Bank, Washington, DC.

List of Presentations Made at the Expert Meeting on Managing Risk in Financing Agriculture

ABSA. "Agribusiness Risk Management."

ACBA Credit Agricole. "Integrated Risk Management for Increased Financing of the Agriculture Value Chain."

ARC-Agriculture Reinsurance Consultants. "Traditional Insurance in Agriculture Development"
Association of Ethiopia Microfinance Institutions (AMFI). "Credit Risk of the Microfinance Institutions Industry in Ethiopia."

BASIX Group. "Financing Agricultural Investments: Leasing as Credit Alternative."

Centenary Bank Uganda. "Integrated Risk Management."

Cooperative Bank of Kenya. "Managing Risk in Financing Agriculture"

DrumNet. "DrumNet Supply Chain System and Risk Mitigation."

Food and Agriculture Organization (FAO). "Risk in Agriculture."

German Development Cooperation (GTZ). "Microinsurance as a Risk Management Tool in Rural Areas."

Grameen Crédit Agricole Microfinance Foundation. "Risk Management in Agricultural Finance"
Land Bank. "Price Risk Management Agricultural on Banking."

Malawi Union of Savings and Credit Cooperatives Ltd.(MUSCCO). "Risk Management: Malawi Experience."

Opportunity Bank Malawi. "Using Index-Based Weather Insurance: The Malawi Experience."

Reseau Des Caisses Populaires Du Burkina (RCPB). "The Experience of RCPB in Risk Management."

Senegalese Agricultural Development Bank . "Managing Risk in Financing Agriculture."

Swedish Cooperative Center. "Financial Literacy for Risk Management in Financing Agriculture."

Swiss Re. "Insurance Options in Facilitating Risk Management in Agriculture."

World Bank. "Agriculture Finance Support Facility: An Initiative to Jump-Start Agricultural and Rural Finance through Institutional Capacity Building. A Partnership with the Bill and Melinda Gates Foundation."

World Bank. "Financial Institutions in the Agricultural Sector: the Case of Aiyi Bank, Kyrgyzstan."

World Bank. "Financing Agricultural Investments: Leasing as Credit Alternative."

World Bank. "Index-Based Weather Insurance."

World Bank. "Managing Agricultural Risk"

World Bank. "Managing Risks in Financing Agriculture: Overview of General Risks for Financial Institutions"

World Bank. "Market Based Solutions for Community Price Risk Management"

World Bank. "Risk Management by Banks Financing Agriculture and Rural Enterprise: African and Asian Experience."

Annex 1: Concept Note

Background

Over 75 percent of Africa's population lives in rural areas where they are engaged in agriculture, both as a source of food and income. In Africa, as in other developing markets, there have been significant and sound developments in functional financial markets, as well as in the uptake of latest lending and other bank-related technologies. These improvements are, however, not vested in the agricultural sector to any large extent, even though investment in this sector is seen as the main engine of economic and social growth, especially in the Sub-Saharan African countries, for the years to come.

Rationale and Justification

Because of long-term neglect, the agricultural sector needs large investments by both the farmers and, through the provision of financing for such investments, by financial institutions in order to boost production. However, increased investing also means increased exposure to risks and, in many cases, this translates into exposure to new and little known-about risks. This adds a new and serious dimension to the issue of risk in agriculture and the need to manage risk. Improved and new risk management techniques and instruments must, therefore, accompany investments, both at the financial institutions and farmer levels, as well as along the whole value chain, i.e. the series of actors and activities that are needed to bring an agricultural product from production to the final consumer.

Risk Management

Major risks associated with agriculture can be divided into non-market related risk and production and market related risk. The non-market related risk refers to a variety of events, some involving human intervention, directly or indirectly. The risks include climate events, geological events, pollution, predation, theft, disease, health factors, accidents, infrastructure & environmental problems, management issues, consequential losses (inability to carry on business profitably), rising costs of capital, exchange rate movements, etc.

Production and market related risk refers directly to transactions in the economy. Examples are uncertainties about the availability of inputs, the price of inputs, the price of farm products, the availability of markets for farm outputs, the gross margins of agricultural enterprises, the revenue derived from farming operations, variability in production and yield.

Risk management practices in agriculture embrace a wide range of mechanisms, which are the foundation of sound farm management. These include policy issues; e.g., regulations relating to such matters as compulsory veterinary procedures, cereal production and handling. They also include on-farm physical measures, such as attention to structural maintenance of fences, cages, racks and housing, as well as daily monitoring for disease conditions, and both preventive and curative veterinary procedures.

Risk management can also involve financially based mechanisms, such as share-farming, farming partnerships and Islamic-type borrowing, where the lender shares the potential profit and the

potential loss, and forward sale of output and other types of contractual farming arrangements. Another form of risk management is crop and agricultural insurance.

Agricultural insurance, although one of the most often quoted tools for risk management in agriculture, can only play a limited role in managing risks related to farming. The applicability of insurance in any given situation is based on consideration of whether it is a cost-effective means of addressing a given risk. Insurance companies have (i) to gather significant amounts of data on climate, production conditions, yield distributions, and prices; (ii) the capacity to pay; (iii) to develop models to determine probable losses; (iv) to design appropriate contracts and set premiums and indemnity levels; (v) to establish and inspect, monitoring and claim adjustment processes; and (vi) to seek reinsurance. In the context of developing countries, those with (i) a dispersed client base, (ii) heterogeneous farm production systems, (iii) small insured value, (iv) unreliable and difficult-to-obtain data (v) high administrative costs as a percentage of premiums, will translate into premium levels that are seldom affordable to farmers.

There have been various studies and pilot projects on risk management facilitated by, among other organizations, the World Bank, which have worked to the advantage of both the risk bearer and the insured. For example, there are various indices (e.g., average level of rainfall during a given period), which facilitate the quantification of risk for purposes of insurance underwriting. The index-based weather insurance is an index-based financial risk transfer product that has the potential to help protect people and livelihoods against climate shocks and climate risk. The relative paucity of positive and long experiences with these types of product, in particular those aimed at the small-scale farmer, puts a serious limitation to its applicability as an efficient risk management tool.

Hedging is an approach to risk management, which uses financial instruments to neutralize the systemic risks of price changes or cash flows. In reducing risk exposure, hedging allows companies to focus on their core business. There are also specific financial instruments, which deal with futures and options.

While some financial institutions could, indeed, be interested in providing financial services or insurance services in support of increased investment in the agricultural sector, these institutions often do not have the expertise to analyze and quantify their risks.

Problem Statement

The investment needs in the agricultural sector are huge, but due to the high risks associated with the uncertainties that accompany agricultural practices, lending to the sector has remained insufficient and agricultural production has, as a result, continued to be much lower than its actual potential. Financial institutions have to consider carefully all the risks associated with farming and related activities, and develop accurate instruments and methods that will help them to evaluate, reduce exposure to, and mitigate effects of risks. However, the mere perception of high risk has often been a single factor that has dissuaded many financial institutions from entering the agricultural sector.

With emerging crises, new knowledge about risk-management business models that support the provision of finance and the banking industry is required. Presently, many financial institutions in Africa continue to lack adequate credit risk evaluation instruments and skills and management techniques to help them begin the radical transformation that will motivate them to establish agricultural lending as a profitable business segment, leading to significant increases in rural

households' access to financial services. Risk exposure reduction strategies and models are often inadequately assessed when appraising potential borrowers, and are seldom implemented correctly.

Given that the main financial risk facing rural financial institutions is credit risk, what *are* the main common credit risk management techniques used and *what* are the factors that contribute to a successful credit risk management? To answer this question, one would, in the first place, need to analyze the experiences of some successful agricultural lenders with high asset loan portfolio quality maintenance, high portfolio growth, and sustainable profit margins.

Instruments for risk management techniques that will enable risk exposure reduction, risk coping by way of transferring risk to third parties, or risk retention through adequate loan reserve provision must become readily available. It is also important to build skills and provide motivation for staff and equip them with reliable information about the potential clients. If this is done, we may see support reaching more agriculturally oriented financial institutions -- support that will allow them to grow their client numbers even in geographical outreach. This may, in turn, attract larger institutions into investing in rural economic activities.

Objective

The expert meeting will share information, discuss, and agree on knowledge and actions that are required to obtain best practices on credit risk management. Common recognition and understanding of core issues will be developed and agreed upon. This knowledge will then be disseminated to facilitate capacity building in risk management strategies in local financial institutions in Africa, with the aim of fostering improved financial service delivery to households and enterprises in all sectors in that region. The findings will be formulated in such a manner that they will be applicable to financial institutions in other parts of world through adjustments to prevailing local conditions.

In particular, the meeting will support the development of strategies aimed at:

- establishing an understanding of opportunities for attractive and alternative risk vehicles;
- developing an understanding and awareness of specific emerging products and their application;
- gaining significant background insight into various investment opportunities that could be marshaled for agricultural production and processing and poverty reduction;
- fostering a better understanding of products for emerging and unique insurance risks;
- stakeholder mapping to capture the nuance in Africa for high-level risk management product applications;
- understanding further farmer risk management demands to help unlock access to credit and other financial services;
- realizing that traditional insurance products do not provide appropriate coverage for rural poor people.
- establishing the knowledge and understanding that protection from certain risks would put rural people in a better position to preserve their livelihoods and engage in activities that could increase their incomes.

Purpose

The proposed three-day Expert Meeting is intended to search practice effectiveness and availability of risk management approaches that are being used for rural finance intermediation in commercial banks, agricultural banks, and other financial institutions, insurance companies, marketing and commodity traders with up-to-date knowledge on risk management strategies. The meeting will also be a training platform and dissemination forum where some products, which have worked well in other countries such as Malawi, Thailand, and India, among others, will be shared.

An international expert in risk management will facilitate the meeting. AFRACA, the World Bank and FAO, who have been taking a lead in risk management research and piloting, will jointly identify this expert. The expert will, in addition to guiding the discussions, prepare, prior to the workshop, a short document that will lay the foundation for the discussions.

One representative of each category of participants will make a short presentation based on his/her own experiences, expectations, etc.

The expert-led, facilitated discussion will aim at debating and answering the following:

- World Bank experience on the effectiveness of pilot projects, using index-based weather insurance to manage risks related to financing for agriculture (Malawi, India, other countries)
- The results of the World Bank Research on Risk Management by Financial Institutions currently financing agriculture (case studies of agricultural banks in Africa, the Caucasus and Central Asia).
- Approaches to rural finance in Africa by Rabobank and its affiliates/subsidiaries, and by Credit Agricole or other financial institutions/intermediaries.
- Instruments and tools that are being used for integrated risk management within the banking industry (experiences from banks with hedging, contract farming, etc)

On insurance matters, the following key questions will need to be answered:

- What is the actual role of insurance in the management of risk in agriculture and for what types of risks could insurance be considered viable and relevant, especially for rural households?
- To what extent can insurance facilitate access to capital, which is necessary to support investment in the sector? In other words, can it impact, in a positive manner, financial institutions' capacity and interest in providing finance for investment in the sector?
- How can governments support the development of insurance without creating unnecessary tension between private and public sector interests? (Eg., India, where the current program of the Agricultural Insurance Company of India provides, as a compulsory and integral part of the crop loans, insurance coverage to some 18 million smallholder farmers at heavily subsidized premium rates.)
- What strategies need to be developed to link agricultural insurance with other risk management tools (such as warehouse receipts, forward sales, contract farming, and capital markets) along the value chain?
- What can we learn from existing or past insurance programs, such as India, Malawi, Ethiopia, Thailand, etc?

Expected Results

The following are the expected results:

- Guidelines on how to foster dialogue between the public and private sectors on sustainable ways to reduce risk in the agricultural sector.
- Dissemination of specific successful pilot projects on agricultural lending risk management strategies.
- Indications of the type of risk management material that would need to be developed as information for farmers, government, donors, communities etc.
- Identify areas for further research, such as understanding farmer risk attitudes, blending insurance with other financial products, using modern information technology to reduce costs, etc.
- Document the results of the workshop as “*Agricultural Risk Management Guide*” for financial institutions working with agriculture-based clients.

Annex 2: Issues for Expert Consideration and Guidance

- Demand side issues regarding agricultural credit and target client groups:
 - What should be the level of focus on commercialized, emergent or subsistence sectors?
 - What needs priority attention - cash or food crops, organized or free market crops and livestock?
 - What is the demand for credit in each sector?
 - What are the risks to borrowing from a client perspective?
- Supply side issues on the availability of agricultural finance:
 - Should the client base be targeting by sector?
 - What types of lending institutions exist?
 - Are lending institutions able or willing to reach all sectors, if not what are the constraints?
 - What is the role of supply chain actors, commercial banks, or development finance institutions in financing?
 - What are the key risks to lending from a provider perspective?
- Issues of distribution linkages and improving access to finance:
 - What is the role of supply chain actors in credit provision?
 - How can supply chain actors help to manage risks (for lender and borrower) and facilitate lending?
 - Can farmer groups help to mitigate risk and make lending possible (joint liability)?
 - What works best - integrated packaging of credit, contract farming or innovative bundling?
 - Who should be the stakeholders needed for agricultural credit and insurance?
- Risk assessment issues:
 - How do financial institutions assess credit risk?
 - What tools are used to measure and quantify different risks and clients?
 - How can technology be used to support risk assessment?
 - What use is made of this information in setting lending policy and decisions?
 - Can tools be developed for small as well as large financial institutions?
- Insurance and risk management issues:
 - What is acceptability as collateral to lenders – the different types of traditional or index crop or livestock insurance?
 - What are the technical, operational, and financial opportunities and constraints in developing agricultural insurance?
 - Under what circumstances (which sectors, what conditions) can insurance operate effectively and what linkages can support this?
 - Where/what are the entry points for insurance into the agriculture supply chain?
 - How scalable and sustainable are current (pilot) agricultural insurance products?
- Issues with innovative risk management tools, instruments and solutions:
 - What are some examples, and where have they been applied successfully?
 - How can capacity be built to apply simple but effective tools?
 - How can effective financial management be conducted through planned credit re-scheduling?
- Issues with the roles of public and private sectors:

- What are the legal and regulatory needs?
 - How should governments target interventions (other than subsidies) to support agricultural finance and/or insurance?
- Macro risk environment issues:
 - Food Price volatility;
 - Climate Change;
 - the Financial Crisis, investment/credit availability, and trade;
 - Profitability of cash and food crop production - financial viability of the enterprise to be financed.

Annex 3: Final Agenda

Day One: 1st April 2009

Time		Resource persons
09:0 – 10:00	Registration and refreshments	AFRACA Secretariat
Session 1.	Setting the scene	William Dick (Meeting Facilitator)
10:00 - 11:00	Welcome note	Land Bank of South Africa/AFRACA
	Overview	William Dick
	Risks for Financial Institutions	Renate Kloepfinger
	Risk from Agriculture	Ake Olofsson
Session 2.	Risk management approaches and tools	Ajai Nair
11:00 - 1:00	Index-based weather insurance	William Dick
	Insurance options in facilitating risk management in agriculture	Reinhard Kuschke
	Commodity price risk management	Craig Baker
	Traditional insurance in agricultural development	Erich Kasten
	Q&A	
13:00 – 1:00	Lunch Break	
Session 3	Credit risk in lending for agriculture	Jonathan Campaigne
1:00 – 15:00	Risk Management for banks financing agriculture and rural enterprise – African and Asian Experiences	Ajai Nair
	Risk Management for banks financing agriculture and rural enterprise – CNCA Senegal	Malick Ndiaye
	Q&A	
15:00 – 15:30	Health Break	
Session	Risk management approaches by international banks and T/A providers	Michael Hamp
15:30 – 16:30	Risk management Approach by Credit Agricole	Jean-Luc Perron
	Risk management strategies by the Co-op Bank, Kenya	Peter Ndegwa
	Q & A	
Session 5	Daily Discussion Panel	William Dick
16.30 – 18:00	All presenters of this day	
	Four panelists	Ake Olofsson, Dr. Wolday, Jonathan Campaigne, Michael Hamp
19:00	NETWORKING DINNER	SPONSORED BY THE WORLD BANK

Day Two: 2nd April 2009

08.30 – 09:00	Recap of day 1	William Dick
Session 6	Financial institutions approach for investments in the Agricultural sector – experiences outside Sub-Saharan Africa	Jean-Luc Perron
09:00 - 10:30	The Cooperative Banking model of ACBA - Armenia	Stepan Gishyan
	Experience from Kyrgystan	Ajai Nair
	Risk management strategies for financing the agricultural value chain	Subbash Jindal, BASIX, India
10:30 – 11:00	Health Break	
Session 7	Parallel Working Group Sessions Two parallel sessions – need two rooms – presenters will need to present twice!!! Alternative approaches to financing agriculture Banking experiences	Guus Rozendaal,
11:00– 13:00 Session A	Contract farming as a risk management approach – MUSCOO	Jonathan Zainga, Malawi
	DrumNet’s risk management strategies	Jonathan Campaigne
	Microinsurance as a Risk Management tool in rural areas	Brigitte Klein
	MFIs in Agriculture – The Ethiopian Experience	Ahma Wolday
11:00-13:00		M. K Sizwe
Session B	FCPB and risk management – The West African experience	Representative FCPB
	Price risk management in agricultural banking – The Land Bank of SA	Sindiswa Mzamo
	Risk management Experience, Centenary Bank Model	Kynyika Abdu, Uganda
	Risk management approaches by ABSA	William Malan
13:00 – 1:00	Lunch Break	
Session 8	Parallel Working Group Sessions Alternative approaches to financing agriculture	Susan Minae
1.00-16.00 Session A	B) Banking experiences	
	Contract farming as a risk management approach – MUSCOO	Jonathan Zainga, Malawi
	DrumNet’s risk management strategies	Jonathan Campaigne
	Microinsurance as a Risk Management tool in rural areas	Brigitte Klein
	MFIs in Agriculture – The Ethiopian Experience	Ahma Wolday
1:00 – 16:00		Erick Kasten
Session B	FCPB and risk management – The West African experience	Marie Pascaline Bonkougou
	Price risk management in agricultural banking – The Land Bank of SA	Sindiswa Mzamo
	Risk management Experience, Centenary Bank Model	Kynyika Abdu, Uganda
	Risk management approaches by ABSA	William Malan

16:00 – 16:30	Health Break	
16:30 – 17:30		
Session 9	Daily Discussion Panel	
16:30 - 17:30	All presenters of this day	Michael Hamp, Susan
	Four panellists	Minae, Craig Baker
	Agricultural Finance Support Facility – supported by BMGF	
18.30	Side Meeting	
	CABFIN MEETING, (WB, FAO, IFAD, UNCDF etc)	Renate, Michael, Brigitte, Ake, Makarimi

Day Three: 3rd April 2009

08:30 – 09:00	Recap of Day 2	William Dick
Session 10	Other approaches	Craig Baker
09:00 – 11:00	Using index-based weather insurance – the Malawi experience	Gift Livata
	Leasing for investment lending	Renate Kloeppinger-Todd
	The role of financial literacy in managing risks – Swedish C C Kenya	Charles Mutua
	Q&A	
11:00 – 11:30	Health Break	
Session 11	Synthesis on lessons learnt during the workshop and the way forward.	William Dick
11:30 – 13:00	Plenary meeting: How to scale up and out successful initiatives Next steps/ follow – up activities/Issues for further research Role of various institutions/individuals in the way forward	All participating Experts
13.00	Closing remarks, Farewell and Lunch	Meeting convenors
1.00	TOUR OF JOHANNESBURG	

Annex 4: List of Participants

Organization	Name	E-mail
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