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Coffee Finance in Kenya: How to Undermine Rural Finance and Development[1]

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A. From unsustainable input credit to sustainable rural finance

"Once the credit system is in place, it is hoped that there will be no need for further international assistance with respect to Input Credit."
(CFC, Nairobi Workshop, 4/2001)

"The need for new approaches to the provision of financial services is obvious."
(Price Waterhouse, 1997)

1. The issue: lack of input credit!?

In the introduction to the *Proceedings of the Workshop on Structured Short and Medium Term Finance to Small-Scale Farmers in Africa, organized and financed by CFC and KPCU,* it is stated succinctly that,

> *agricultural input finance has been declining since the early nineties when countries started to liberalise and dismantle the commodity marketing boards, which used to provide input credit to small producers. This decline or lack of input finance has led to reduced agricultural production, reduced yields, reduced quality control, reduced investment in the sector and reduced income for small producers… increasing poverty in most commodity dependent countries in Africa. Most of the banks which went into the sector to cover the gap left by the Marketing Boards lost money because there was no system of collecting loans advanced to small producers. The purpose of the workshop thus was to develop new structured credit schemes for small producers that are suitable for the liberalised commodity markets.* (p. 2)

The workshop was expected to come up with a solution, as spelled out in the opening address:

> *A blueprint for action: an effective structure for credit extension.* (p. 6)

Is it that simple – given the fact that *coffee industry in Africa has suffered from many negative factors for many years* and *coffee producers in Africa are among the poorest*? (ICO, in KPCU 2001: 8).

Donor funds for input credit have been provided in the past. They failed to create a sustainable and durable system – and might even have undermined its emergence. A key question is thus,

> If lack of input credit is a problem, is the availability of input credit a sufficient solution?

A broader goal is spelled out in the address of the CFC: *sustainable development*. This requires: enhancing productive capacity, quality, post-harvest measures, horizontal and vertical diversification, marketing, financing and strategic partnerships (CFC, in KPCU 2001:11). Sustainable financing, in turn, requires:

> *to identify the main elements of a sustainable credit system before providing fresh loans. Once the credit system is in place, it is hoped that there will be no need for further international assistance with respect to Input Credit because there could be enough liquidity in the local market.* (CFC, in KPCU 2001:11)

To what extent have the requirements for sustainable development in the coffee sector been present in the past; and how can they be created in the future? These requirements may include:

- A sustainable commodity chain embedded in competitive institutions with adequate services, operating in a prudentially regulated environment
- Sustainable financial services provided by healthy financial institutions with a diversified portfolio and adequate risk management
- Sustainable coffee farmer households with well-balanced, risk-adjusted income-generating activities.

2. Sustainable rural finance: an infrastructure for sustainable input credit

In the proposal to the Fund, a hypothetical framework has been presented, placing input credit into the wider framework of a sustainable rural financial infrastructure, which is in turn intricately related to the development of a diversified rural economy, comprising coffee and a range of food and cash crops as well as other income-generating activities. This view has been confirmed by Price Waterhouse (1997), an impartial arbiter, which has presented the most thorough available analysis of the coffee sector in Kenya.

2.1 A hypothetical framework

Past failures in agricultural credit: Input credit schemes and other agricultural finance programs, managed by development finance institutions or special government projects, have dismally failed in many countries. Many agricultural development banks have collapsed; the credit schemes were abandoned, "without continual impact." Major donors who were originally involved in designing the agricultural credit institutions and financial technologies such as subsidized directed credit have all but pulled out – leaving behind countries saddled with external debts and impoverished farmers.

Recent reforms in rural and agricultural finance: In recent years, new evidence has come up that reform of agricultural finance is feasible. This has led to the *Rome Initiative at AgDB Reform* of FAO and IFAD, joined by the World Bank (J. Yaron) and GTZ (D. Steinwand), the establishment of a *Working Group on AgDB Reform* at CGAP, and workshops by NENARACA, AFRACA and APRACA. Proponents of the new move were (a) Richard Roberts as Chief of the FAO Rural Finance and Marketing Division and prime mover of the joined project *Agricultural Finance Revisited* of FAO and GTZ; and (b) this consultant in his capacity as Rural Finance Advisor at IFAD, based on his working experience with BRI/Indonesia and BAAC/Thailand since 1987 and NABARD/India since 1994, which are all successful reformers in the field of rural finance and agricultural credit; to these, Centenary Rural Development Bank in Uganda and Equity Building Society Ltd. In Kenya (in the context the present consultancy) have been added recently. A new consensus is emerging, expressed in the IFAD Rural Finance Policy and the enunciations of the microfinance community, on the principles and strategies of sustainable rural and agricultural finance.

The need for a wider framework for input credit in Kenya: Donor-supported input credit schemes in Kenya seem to have faced many of the pitfalls of conventional agricultural development finance and have to be analysed in this wider framework. Fluctuations in world market prices notwithstanding, input credit schemes fail if agricultural credit fails; they succeed if rural and agricultural finance succeed. Therefore, an analysis of schemes in Kenya cannot be narrowly focused on operational issues, but has to take design, policies, institutional infrastructure and institutional performance into account. It is only on that basis that it can be both critical and constructive.

The objective of support: sustainable access: A constructive review and criticism of agricultural and input credit schemes in Kenya has to keep in mind what might emerge as the objective of future support for credit schemes, based on the new consensus in rural and microfinance:

> Sustainable access of coffee farmers to input finance as an integral part of a full range of sustainable financial services to the commodity (coffee) supply chain and to households with diversified economic activities around coffee farming

Past (and future) performance has to be measured against this objective.

Dimensions of agricultural credit and rural finance: In light of the sustainability of access to agricultural credit and input finance in the future and the lack of such sustainability in the past, the following dimensions need to be included in the analysis:

- Financing agricultural inputs vs. financing the commodity supply chain (including financing for inputs, production, processing, and marketing)
- Debt financing vs. comprehensive financing (including credit, savings for self-financing, and insurance for loan protection, tied savings-cum-credit products)
- Viability of the household: Financing a single activity vs. financing the household as a diversified economic entity (with coffee farming as the main, but not sole, activity)
- Viability of the rural financial institutions involved including: resource mobilization; interest rate margins and profitability; loan recovery and risk management; portfolio diversification; lending for agricultural, off- and non-farm activities, consumer purposes, emergencies; financial products for a differentiated market of commodity producers
- Sustainability of financial services to coffee farmers, contingent upon the viability of coffee farmer households and rural financial institutions, the policy environment (including the political and macroeconomic environment), protection against price fluctuations
- Beneficiaries vs. market segments: Are coffee farmers beneficiaries of government-sponsored credit programs or market segments of viable financial institutions, which may be donor-assisted but not donor-driven?
- Related issues: Consultancy and business development services for coffee farmers, government policy, donor coordination and cooperation, opportunities for co-financing.

2.2 Price Waterhouse: the crucial role of sustainable financial institutions

Price Waterhouse with their coffee sector study and their analysis of SCIP is presented here as an impartial arbiter over what when wrong and what went right in coffee input credit in Kenya. Their highly complex analysis can be brought down, regarding finance, to one point: the issue of donor-driven directed credit vs. savings-driven and profit-making financial institutions.

According to Price Waterhouse (1997:62-63), **sustainable development** requires:

> “a sustainable rural finance sector that contributes to providing the rural population, and especially those segments of it that are economically and socially disadvantaged, with permanent access to relevant and affordable financial services, thus contributing to the increase and diversification of their economic activities, improving the productivity of these activities and bringing about sustained improvements in their standard of living.” (PW 1997: 62)

Deterring commercial banks with cheap money:

> “The interest of commercial banks in servicing small farmers is undermined by the fact that smallholders have historically had access to donor finance credit on subsidised terms, with low interest and soft appraisal, and have thus come to expect low cost credit.… It is reasonable to expect that commercial banks would extend credit and savings services to some small farmers if these farmers were prepared to accept the full costs of providing financial services.” (PW 1997:62)

The failure of donor and government programs:

"Donors and governments over the years have taken considerable interest in rural finance and allocated substantial funds to credit programs. Many of these programs have performed below expectation, and many have collapsed, generally for the following reasons: poor macro-economic and sector policies; reliance on easily accessible government and donor funds rather than savings deposits; subsidized interest rates for lending; obligation to implement credit programs which are too large, without adequate efforts to build institutional capacity; and unskilled management. The need for new approaches to the provision of financial services is obvious…" (PW 1997:62)

The crucial importance of savings and demand-driven services:

"Sustainable finance institution development requires viable demand-driven financial services, comprising both credit and savings services. Savings have been the forgotten half of rural finance, partly because donor-supplied external credit facilities tend to reduce incentives, effort and ability to mobilize savings. The neglect of local savings mobilization has had several negative implications:

- firstly, financial institutions have failed to provide a service for which there is often a huge demand in rural areas;
- secondly, by neglecting savings, financial institutions have not contributed efficiently to an improvement of resource allocation:
- thirdly, by relying on donor and government funding rather than local savings, financial institutions have not been exposed to sufficient prssure to ensure prudence in lending and efficiency in loan collection, and have not been accountable to the rural population; and,
- fourthly, the cost advantage in combining credit and savings has been forgotten." (PW 1997:63)

Interest rates matter:

"Interest rate margins should be maximized by withdrawing subsidies on lending rates if financial viability is to be attainable at all. Nevertheless, subsidized interest rates are still more the rule than the exception." (PW 1997:63)

Finance in the hands of financial institutions!

"In principle, non-financial institutions (eg marketing cooperatives) should not get involved in formal financial services. The provision of financial services must be considered as a highly specialized activity not easily incorporated into an organization with different purposes and background. However, there may often be a role for informal trade credit supplied by private enterprises who develop strong trading links with small farmers." (PW 1997:63)

B. Basic data on previously implemented credit schemes

1. Shortcomings in the availability and consistency of information

This section with basic information on loans to the coffee sector is presented with a triple qualifier: of inadequate sources of information, incoherent project implementation, and inconsistent World Bank policies on beverage crop projects.

1.1 Inadequacy of sources of information

Available sources were grossly inadequate. This problem concerns not only this consultant but also the World Bank itself, as indicated by the uncertainty and inaccuracy of its own review of June 1998, relying on dated sources (*Table 1*)[2]. One certainty expressed by the World Bank concerns the outcome of SCIP 1: "unsatisfactory." None of the specific data requested by the CFC are provided in the Implementation Completion Report (12/1998) prepared by an FAO team on SCIP 2. Furthermore, there are numerous contradictions between various sources on the data reported.

Table 1: Overview of Bank Operations in the Kenyan Agricultural Sector (excerpt), 1998

Appraisal Year	*Number*	*Project Name*	*Disburse-ment ($)*	*Disbursement Approval (%)*	*Outcome*	*Sustain-ability*	*Institutional development*	*Bank Performance*	*GOK Perf.*
1979	C914	SH Coffee I	10.5	39	U	Uc	Mod.	*	*
1989	C2062	SH Coffee II	30?	82?	*	*	*	*	*

Source: The World Bank 6/1998: 7

As this problem was already expressed by the CFC on 22-1-2002, the consultant, in his offer of 28-1-2002, proposed to search in the archives of FAO, IFAD, EU and GTZ. It now appears that the only promising source would have been the archives of the World Bank in Washington.

However, a detailed exposition of the terms and conditions of the loans is of little benefit, as these were grossly disregarded under SCIP 1, which then led to a chain of unending indebtedness of the farmers and their cooperatives and impeded the effectiveness of SCIP 2 as shown in the report in detail.

1.2 Incoherent project implementation

It appears that project documents and agreements – characterized by the World Bank as part of an *approval culture* - had only limited bearing on how the projects were implemented. Two examples: in SCIP 1, according to appraisal, 14 new wet-processing coffee factories were to be built; the actual figures turned out to be 183. In SCIP 2, input credit (FILS) was provided in the amount of $22m – as against $7 projected. This limits the significance of the original terms and conditions, which are hence not reported in detail by any of the reviewers, from the FAO team to PriceWaterhouseCoopers.

1.3 Inconsistency of World Bank policy on beverage crops

In January 1973 the Bank decided to avoid investment in beverage crops in countries receiving IDA assistance. This policy was only repealed in 1993. Yet the Bank financed two coffee smallholder projects in Kenya during that period. Concerning these projects, a Bank report noted that "the Bank did not understand the complexity of the industry – especially the payments system – and was slow to address issues that now constrain producers." (World

[2] World Bank Report No. 18088: The World Bank and the Agricultural Sector in Kenya. An OED Review, June 1998, Table 2.1, p. 7.

Bank 6/1998: 11) The second SCIP loan – attributed to an “approval culture” - was also in contrast to the Bank’s decision in the late 1980s to switch to reform of the whole financial sector (with a $120m Financial Sector Adjustment Credit), on which progress has been reportedly slow (ib. p. 31, p. 14). All this has not contributed to transparency and rigor in the design and implementation of the SCIP loans and, subsequently, the supporting Stabex funds of the EU.

2. Purpose and objectives of the loans[3]

2.1 Objectives of SCIP 1 (1980-1986) of the International Development Association of the World Bank were: improving the quality of coffee produced by smallholders and processed by cooperatively owned factories; expanding factory wet-processing capacity by constructing 14 new and rehabilitating 400 existing factories; and providing farm inputs targeted at 70,000 very small farmers who had neglected coffee. It also included a comprehensive coffee subsector study, completed in 1987.

2.2 The main objective of SCIP 2 (1990-1998) of the International Development Association of the World Bank was: “to raise the incomes of coffee smallholders, small estate owners, and farm workers through increased productivity and quality improvements.” (World Bank 8/1989: i) It is also stated that SCIP 2 was put in place to alleviate problems identified during implementation of SCIP 1, resulting i.a. from the over-indebtedness of cooperatives and their members caused by the excessive costs of factory construction under SCIP 1.

Related objectives included: “(a) Increase Kenya’s foreign exchange earnings and help it maintain its position as an efficient high quality coffee producer; (b) strengthen the institutional capacities of the key participating agencies.” (ib.)

2.3 Objectives of EU Stabex loans:

These continued in the footsteps of SCIP II, with scope for a redefinition of purpose and objectives. A financing agreement in support of SCIP 2 was concluded on 1 April 1996. It is only now (May 2002) that the EU is in the process of reviewing these objectives, with an orally stated interest to cooperate with the CFC.

3. Terms and conditions under which the loans were advanced by the World Bank to the Government of Kenya

Borrower is the Republic of Kenya. Beneficiaries are the Ministry of Cooperative Development (MOCD), the Ministry of Agriculture (MOA), Cooperative Bank of Kenya, and Kenya Planters’ Cooperative Union. Terms are standard, with 40 years maturity. (World Bank 8/1989: i)

3.1 SCIP 1

Project costs were estimated at $62.2m, of which $27m were to be provided by IDA, $15m by CDC and $20.2m by GOK and farmers. The final project costs at completion amounted to $36.4m. The decrease was due to a devaluation of the Ksh by 50% and the failure of the farm input component.

[3] The granting of SCIP 1 and 2 was in contrast to the World Bank’s policy since January 1973 to avoid investments in beverage crops in countries receiving IDA assistance. The policy was repealed in 1993. (ib., p. 10).

Table 2: Estimated and actually disbursed funds, SCIP 1

Item	*Estimated*		*Disbursed*	
	Amount	Percent	Amount	Percent
Factory development	$46.0m	74.0	$34.4m	94.5
Farm input credit	$13.4m	21.5	$2.0m	5.5
Other	$2.8m	4.5		
Total	*$62.2m*	*100.0%*	*$36.4m*	*100.0%*

3.2 SCIP 2

Cofinancing was originally proposed through the Commonwealth Development Corporation, but did not proceed, and was provided instead through the EU's Stabex funds facility. Appraisal targets were as follows:

Table 3: Appraisal targets, SCIP 2 (in million US$)

Item	*Local*	*Foreign*	*Total*
Cooperative sector:			
Coffee factories	15.6	6.4	22.0
Farm inputs	1.0	6.4	7.4
Improved payment system	27.2		27.2
Estate Sector	2.6	1.7	4.3
KPCU coffee mill	14.2	6.1	20.3
MOCD project coord. & management	3.8	1.7	5.5
Training	2.6	0.6	3.2
Contingencies	12.1	4.7	16.8
Total project cost	*79.1*	*27.7*	*106.8*

Source: World Bank 8/1989: ii

Of the total costs of $106.8m, IDA was to bear 43.8%, CDC 16.9%, Coop Bank 11.3%, cooperatives 10.5%, KPCU 9.9%, small estates 0.7%, MOA 1.5% and MOCD 5.4%. There are wide discrepancies between appraisal targets, project cost estimates and actual disbursements:

Table 4: Targets, estimates and disbursements, SCIP 2

	Amount in US$
Appraisal target	$ 106.8m
Project cost estimate[4]	$ 68.2m
Approval 9/1989	$46.8m
Actual disbursement[5]	$ 48.1m

Source: FAO 12/1998: 6, 3

The project comprised the provision of credit finance for cherry advance payment systems (CAPS); farm input credit; factory improvement and construction; and training and institutional support to the coffee industry:

[4] The difference to the appraisal target is mainly due to the fact that the proposed KPCU coffee mill and the component for assistance to the small estate sub-sector did not proceed (estimated costs $29.3m) due to CDC's withdrawal from the project; and the factory rehabilitation component was less extensive than anticipated; and a significant depreciation of the KSh occurred during implementation.

[5] The higher amount disbursed is due to variations in SDR/US$ exchange rates.

Table 5: Items financed by SCIP 2

Item	*Amount in Kshs*
Capital (CAPS)	800 million
Farm input loan scheme (FILS)	2,440 million
Factory development Loan Scheme	527 million
Total	*3,767 million*

3.3 Stabex (in support of SCIP 2)

In April 1996, EU and GOK agreed on the utilisation of Shs 660m of Stabex resources in support of SCIP 2 as follows:

Table 6: Utilisation of Stabex resources in support of SCIP 2 (in million Kshs)

Item	*Amount*	*Percent*
Cherry Advance Payment System (CAPS)	190	28.8
Farm Input Loan Scheme (FILS)	425	64.4
Coffee Factories Development Scheme (CFDS)	35	5.3
Support to the training centre at the Coffee Research Foundation	10	1.5
Total	*660*	*100.0*

4. Role of project partners and structure of implementation of the loan

In both SCIP loans, implementing agency and financial intermediary is the Co-operative Bank of Kenya (Coop Bank), which lends to cooperatives of coffee farmers. The cooperatives are either final borrowers, as in the case of factory construction or rehabilitation loans, or they on-lend to their members, as in the case of cherry advances and farm input credit. In this sense, both Coop Bank and the coffee cooperative societies are regarded by the World Bank as *executing agencies*. The cooperative members are ultimately liable for obligations incurred by their cooperatives.[6]

SCIP 1 was to be managed by a coordinating unit with the assistance of two coordinators from MOA and MOCD. This turned out to be ineffective and was replaced, after a mid-term review in1982, by a semi-autonomous Project Management Unit under the chairmanship of the Office of the President and a Project Working Group. In 1986, the Office of the President withdrew, which resulted in a slowing down of implementation and eventually required an extension of the four-year project period.

SCIP 2 is implemented through a Project Steering Committee (PSC) and the PCMU, the latter established in the MOCD by upgrading the PMU of SCIP 1. It is alternately chaired by the Permanent Secretaries of MOCD and MOA. The PCMU is expected to train and build up experience in concerned agencies (such as Coop Bank) which are expected to take over PCMU's responsibilities after project completion (eg, project appraisal and supervision by the Coop Bank).

Coop Bank has the largest role, implementing coffee factory development, input credit and the improved payment system. In collaboration with PCMU, it appraises each proposal for factory investment. At the field level, coffee cooperative societies as representatives of coffee smallholders are responsible for implementing the three components.

[6] As of 1996, 50.4% out of 240 existing coffee societies were still found to be SCIP I debtors with loans overdue.

The Coop Bank, in collaboration with the PCMU, appraises each proposal for factory investment prepared by District Coffee Working Groups (DCWG). Coop Bank is responsible for determining the creditworthiness of the borrowing societies. IDA reviews the first six investment appraisals on the basis of improved criteria; thereafter, appraisals are reviewed only during IDA's supervision missions. The DCWGs are also in charge of supervising the tendering, awarding and execution of contracts, while factory staffing, management and training are the responsibility of the societies. Further details of the cooperation with DCWGs in factory development are described in chapter 7.3.

The Coffee Research Foundation implements the training program under the project.

Project monitoring and evaluation are the responsibility of PCMU and prepares semi-annual progress reports; Coop Bank monitors its own components.

5. Terms and conditions on which the Coop Bank obtained the SCIP 2 loan from the Government

The Government would onlend $43.8m equivalent to Coop Bank for (a) investments in coffee factories ($22.9m) and seed money for an improved payment system ($12.1m) at 10% and 8%, respectively over 10 years with 2 years of grace; and (b) incremental farm inputs ($8.9m) at 8% over 2 years with a grace period of 1 year. The remaining funds ($2.9m) would be retained to finance the costs of technical support for the Project Coordination and Management Unit (PCMU) and training.

Coop Bank is guaranteed a minimum margin of 5% and lends to the cooperatives at an interest rate of 15% for factory investments and 13% for farm input loans and cherry advances. The cooperatives receive a margin of 2% and provide input loans and cherry advances at 15% effective p.a. - compared with market rates above 30%. In the case of delays of payments, Coop Bank charges commercial rates of interest on the amount overdue, fluctuating mostly around 32% p.a., reportedly up to a peak of 36% p.a.

Table 7: Subsidiary loan agreement between GOK and Coop Bank under SCIP 2

Component	*Financing source*	*Onlending terms from GOK to Coop Bank*	*Onlending terms from GOK to cooperative societies*	*Onlending terms from cooperative society to members*
1. Coffee factories	IDA through GOK for 100% of foreign costs and 85% of local costs excl. taxes & duties	10%. All other terms and conditions the same as terms to final borrower	15%. Maximum loan period 10 years. Grace period 2 years.	Not applicable
2. Farm inputs	IDA through GOK for 100% of total costs	8%. All other terms and conditions the same as terms to final borrower	13%. Maximum loan period 2 years. Grace period 1 year.	15%. Maximum loan period 2 years. Grade period 1 year.
3. Improved payment system	IDA through GOK for 40% overall of required financing	8%. Maximum loan period 10 years, grace period 2 years.	13%. Maximum loan period 1 year.	15%. Maximum loan period 1 year.

Source: World Bank 8/1989: 86

The preferential interest rates created an excessive demand, to which the project responded by making IDA and Stabex funding amounting to $22m available for FILS alone as against an appraisal estimate of $7m.

The cooperatives appoint Coop Bank as their commission agent, which recovers repayments from sale revenues realized through auctions at the Nairobi Coffee Exchange and received from the Coffee Board of Kenya by Coop Bank on behalf of the coffee farmers. In the same manner, Coop Bank recovers its commercial loans to cooperatives for operational expenses and farm inputs provided to farmers as credit-in-kind.

The SCIP 2 project became effective in 1990; but preparation of the credit schemes took longer than anticipated. Their implementation was delayed until 1991 in the case of CAPS and FILS disbursements and 1993 in the case of CFDS.

6. Terms and conditions of on-lending to final borrowers

6.1 Cherry Advance Payments System (CAPS)

Through CAPS, small-scale coffee farmers obtain cash advances during the picking period, amounting to 20% of the expected coffee payments, which are recovered from the first coffee payment. The interest rate charged to farmers is 15%, which is less than half the market rate. Furthermore, as the CAPS borrowing rate is at times below the T-Bill rate, societies have used CAPS funds to invest in Treasury Bills instead of lending to farmers: not only at a profit but also at no risk.

CAPS are paid based on farmers' monthly cherry deliveries to cooperative factories. Access to CAPS has been quite uneven. Eg, in 1995, Muranga and Nyeri districts (with the two strongest cooperatives) used 79% of all CAPS, but produced only 29% of smallholder coffee (PriceWaterhouse 6/1997:73). The Central Province as a whole, to which Muranga and Nyeri belong, used 65% of CAPS but produced only 55% of the cherry (1991/92-1994/95).

6.2 Farm Input Loan Scheme (FILS)

FILS loans are given at least 20% in cash and at most 80% in kind. The loan period is two years. During the first year, only interest is paid; principal and the remaining interest are paid in the second year. As in the case of CAPS, the interest rate charged to farmers is 15%. The funds recovered are entered into a revolving fund and re-lent to farmers.

FILS loans are reportedly paid on the basis of acreage, which is no longer checked against KPCU records, which has lost its milling monopoly. There is evidence of undue influence, which might explain the gross inequality in access to FILS loans, with the Central Province absorbing 76% of funds (1991/92-1994/95). (PriceWaterhouse 1997: 74)

6.3 Coffee Factory Development Scheme (CFDS)

The CFDS component started in 1993/94, with initial targets of constructing 65 new and rehabilitating 275 coffee factories. Funds are also available for electrification. The loans are given to coffee cooperatives at an interest rate of 15%. Maturity is 10 years, with a grace period of 2 years. The societies are to contribute at least 15% of project costs. CFDS loans appear to be handled quite flexibly and without rigid controls as to size and costs.

7. Mechanism used for assessing the ability of the borrowers to repay the loan

7.1 CAPS advances of 20% of expected receipts for cherries actually delivered are disbursed to farmers in the form of an overdraft facility about one month after delivery of cherry to factory and recovered from first coffee payment. Coffee proceeds received from the Coffee Board are credited to this account until the overdraft is fully liquidated. When enough credit has accumulated, other payments are made to repay FILS and CFDS loans and to pay the farmers. As Coop Bank deducts payments at source, the recovery rate is 100%.

Credit for financing the improved coffee payment system are only made (a) to cooperative societies which are creditworthy and have the capability of making prompt payments to farmers in the month following delivery; (b) after MOCD's Inspection Committee has satisfied itself that all societies within a union had adequate bookkeeping and accounting systems in place; and (c) in the form of an annual incremental working capital loan, and not as a standing overdraft facility.

Under the Improved Payment System, payments to farmers are made by cooperative societies within a union in the month following delivery of coffee cherry by farmers. Payments are credited to the accounts of farmers at SACCOs, UBSs or other banking institutions. Inadequate bookkeeping systems of cooperatives and financial institutions may be remedied by an MOCD Inspection Committee before being given approval. Establishment of such a committee is a condition of Credit effectiveness.

7.2 FILS loans are provided against the anticipated production to support the production and sustain the coffee quality. Coop Bank pays directly, through a Banker's cheque, to the supplier of inputs upon authorization by the receiving society. Coop Bank has to satisfy itself as to the creditworthiness of the borrowing cooperative. Onlending by the cooperative society to its members is restricted by the following risk management precautions: (a) an upper limit of borrowing of 50% of that member's average coffee crop deliveries over the last 3 years; or the total indebtedness of that member not exceeding the value of expected deliveries of coffee cherry for the current season; (b) the amount of the total loan for farm inputs paid out in cash to the member which would be at least 20%. FILS loans are recovered by Coop Bank from cooperatives as in the case of CAPS.

Credit in kind does not always prevent loan diversion. To obtain quick cash, farmers have been observed selling the inputs, with resultant effect on quality and future cashflows. There are also cases of farmers selling their produce through middlemen to avoid the proceeds being deducted by their cooperative to liquidate outstanding loans. The effects of these abuses are the increased risks of non-recoverability of loans by societies, build-up of interest charges, and decline in coffee quality and sales value. (PriceWaterhouseCoopers 12/2001: 11)

7.3 CFDS is granted through direct payment to the contractor upon presentation of authorized invoices and a certificate from the District Engineer. Coop Bank has to satisfy itself as to the creditworthiness of the borrower and the observance of the guidelines. The guidelines for factory investment in SCIP 1 were substantially revised in SCIP 2, placing greater emphasis on determining the financial viability of each individual investment. The following improved procedure was established: request for factory improvement originating from a union or society; pre-feasibility selection by the District Coffee Working Group (DCWG)[7] in each district; completion by the DCWG of form 2 of the revised guidelines outlining the processing constraints, a processing capacity checklist, and their preliminary choice (with reasons given) between a rehabilitated factory, re-sited factory or new factory or rejection of the request; forwarding the request to the PCMU; full feasibility study by the PCMU assisted by the DCWG examining processing constraints, processing capacity requirements, facilities and equipment needed, capital and operating costs; expected benefits; financial rate of return; and the factory cash flow after financing.

The society will then make provision in its budget for the proposed investment and apply to the Commissioner for Cooperate Development (CCD) for authority to incur expenditure on the basis of the feasibility study. If approved by the CCD, the DCWG and the PCMU will assist the society to prepare a project loan application to Coop Bank, subject to the following review procedure: The donors will review together with the PCMU the first 6 loan applications. If there are serious shortcomings in the feasibility procedures, the donors will make detailed recommendations and review a further 6 applications, and so on until the shortcomings have been adequately addressed. After a final review by the PCMU, the loan

[7] Consisting of the District Agricultural Officer and the District Cooperative Officer as alternating chairmen¸ the district coffee extension officer, the GM of the District Cooperative Union; the secretary of a non-affiliated society; the credit-coordinator in the DCO's office; the crops officer, the water bailiff, a representative of Coop Bank, the district development officer and the district works officer, with co-option of the provincial or district coffee factory engineer and the technician.

applications are submitted to Coop Bank. 3-6 loan applications are reviewed by the donors during project supervision missions.

In addition to these facilities, societies borrow through overdrafts from Coop Bank and other financial institutions to meet their working capital requirements, including the coffee processing and transportation costs to the millers which are charged to, and paid for directly, by the Coffee Board. These overdrafts are charged at commercial interest rates, with the usual penalties. These rates have ranged from 23% to 45% (PriceWaterhouseCoopers 12/2001:9). **No credit registry** exists to control multiple borrowings.

8. Risk management and arrears prevention

In the case of input credit and cherry advances, Coop Bank has relied on deduction at source, which has assured full repayment. However, this has reduced the receipts of the farmers to an extent that many cannot afford inputs any longer; and that, at the given low international price level, coffee is no longer profitable.

In the case of factory construction or rehabilitation loans, cooperatives are liable to repay loans for investments which in many cases are inflated due to exorbitant costs. Repayment ultimately comes from the receipts of coffee farmers, who are already heavy indebted. Both the cooperatives and Coop Bank are reluctant to enforce timely repayment, as this would totally incapacitate the farmers and their cooperatives, respectively. Capacity of farmers and cooperatives to repay factory loans is further curtailed by the primacy accorded to the repayment of cherry advances and input credit, the latter reportedly based to an unknown extent on exaggerated information about farm size as the basis of credit allocation. Farmers also have direct access to commercial credit from Coop Bank, which further increases their indebtedness. As a result, all three parties carry a growing burden of debts beyond their capacity.

Coop Bank imposes penalties on defaulters at the commercial rate, which more than doubles the effective interest rate. This adds, month after month, to the debts of cooperatives which cannot repay their factory loans, leading to technical insolvency. In actual fact, this has resulted in the liquidation of an increasing number of cooperative unions, which have dissolved into their constituent primary societies – many of them too small to be viable. However, while assets are normally revalued and liabilities restructured in the course of bankruptcy, Coop Bank has used its clout to prevent this and to see to it that the debts of the union are assumed fully by the emerging societies. Their health is thus impeded both by debts carried over from the past and by negative economies of scale.

Members of cooperative societies have reacted to this situation by leaving their societies in increasing numbers, which means that the debt burden has to be shared by an ever-smaller membership.

9. Undermining the health of the coffee sector through credit: the paradox of the substitution of external funds for local savings

The picture of the size, terms and conditions of external credit to the coffee sector would be incomplete without examining alternative sources of funds. This leads us to the basic paradox of coffee finance in Kenya: the substitution of external loans for existing cooperative savings. As stated by PriceWaterhouse (1997: 76):

> "The savings of coffee farmers are far higher than their borrowings… (but) are not used as the source of funds for coffee loans and this is mainly because cheaper donor funds are available through SCIP II."

Eg, in June 1996, total SCIP 2 funds available for individual smallholder loans (ie, FILS and CAPS) were Ksh 1.4bn, while total savings in the coffee-based UBS and rural SACCOs were Ksh 2.3bn, of which Ksh 1.7bn were invested in TBs and other banks. A scenario for transferring coffee smallholder financing to rural SACCOs has been presented by PriceWaterhouse (1997: 77-82), with a change in the role of Coop Bank to that of

> "promoting local self-financing and increased rural SACCO institution building," arguing that "direct lending to individual small farmers is not generally commercially viable for the Cooperative Bank."

One the basis of these figures, one may conclude that in a healthy coffee sector, SACCOs owned by coffee farmers (and similar local financial institutions) must play a crucial role as financial intermediaries between savers and borrower-investors – as we will advocate in our final chapter.

C. Assessment of previous experience with input credit schemes in Kenya

1. The first *Smallholder Coffee Improvement Project* (SCIP I) (1979-1987): Did the World Bank learn from the experience?[8]

"That is the project that made us poor..
it impoverished the region and caused the present defaulting."
(A view from the field, 4/2002)

(a) A view from a World Bank report:

In preparation of SCIP II, the World Bank (8/1989) included a review of SCIP I in its appraisal report.[9] Given the importance of *learning from experience*; and further given the consensus that SCIP I was not a success, two questions are of particular interest:

- Was the assessment adequate?
- Which conclusions were drawn, and how were the shortcomings of SCIP I addressed in SCIP II?

SCIP I, co-financed by the World Bank and the Commonwealth Development Corporation and implemented through the Cooperative Bank, was appraised in 1978, became effective in 1979 and was completed, after three extensions due to disbursement problems, in 1987. A Project Completion Report (*not available*) was prepared in 1988.

The main **objectives** of SCIP I were to improve the quality of coffee produced by smallholders and processed by cooperatively owned factories, and to rehabilitate neglected smallholder coffee farms. It also included a comprehensive coffee subsector study, prepared not at the beginning, but upon the closing of the project in 1987. Project costs were estimated at $62.2m (43% by IDA, 24% by CDC, the rest by GOK and farmers). But due to a substantial devaluation and the failure of the farm input component to disburse, actual project costs amounted only to $36.4m.

The two main **components** were:

- The construction and rehabilitation of wet-processing coffee factories, amounting to 74% of the originally estimated project costs
- A farm input component expected to reach 70,000 smallholders on very small holdings, who had neglected coffee farming, amounting to 21.5% of estimated costs.

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[8] SCIP was preceded by the Co-operative Production Credit Scheme (CPCS), a credit scheme for cooperatives during the 1960s and 70s funded by Scandinavian donors, forming part of a wider program of establishing and promoting the cooperative sector and laying the foundation for the rural cooperative sector as it exists today. Subsidized credit-in-kind was provided through cooperative unions. With cooperatives in a monopoly position, preferential interest rates and input price controls, the interlocking system functioned smoothly. Payments due were channelled through Coop Bank, which financed the stocking by cooperative unions, and deducted at source Repayment worked well. No documents were available on CPCS. The program was generally regarded in positive terms by our discussants.
The transformation of cooperative union banking services into independent SACCOs was proposed by SIDA experts during the early 1970s, but found little sympathy with union management, which preferred a direct influence on cooperative finance.

[9] Other World Bank documents on SKIP I were no longer available at the World Bank Office in Nairobi, nor from any other source.

The failure of the factory component: Concerning the first component, there are wide discrepancies between the planned and actual figures, with a massive increase of new constructions and resitings from 14 to 183.

Table 8: Number of planned and actual constructions and rehabilitations of coffee factories under SCIP I

Coffee factories	*Planned*	*Actual*
New constructions	14	183
Rehabilitations	400	280
Total	*414*	*463*

WB 8/1989:12 attributes the failure of this component to:

- Incomplete and loosely applied technical and economic criteria for selecting proposals
- A tendency to invest in new factories rather than renovating existing ones.

The political circumstances of the massive increase in new factories remain unexplained in the review; and the consequences in terms of massive nonperforming loans affecting the Cooperative Bank, the cooperative societies and the farmer-members until today are not analyzed.

The failure of farm input credit: The farm input component, to be channelled through the Cooperative Bank, turned out to be illusory. Only $2m out of the projected $13.4m were spent, proving once again the failure of supply-leading schemes. Farmers who had neglected their coffee holdings were expected to respond positively to the supply of input credit and rehabilitate their farms, but failed to do so: ***money alone does not suffice.***

Project management problems: Joint management by MOA and MOCD proved to be ineffective. It was replaced in 1982 by a semi-autonomous Project Management Unit, supported by a steering committee under the Office of the President. This was reportedly “more successful”, but only until 1986 when the Office of the President withdrew.

Assessment: According to WB 8/1989:11-12, nothing seems to have gone right with the project, but a lot has gone wrong:

- Inadequate project management
- Uneconomic investments and low utilization rates of factories
- Continued weak factory management
- Low and uneven impact on coffee quality
- Low disbursement rates.

The lessons learned from this experience in designing SCIP II (WB 8/1989:12) are vague and with little operational specificity:

- Improved project and cooperative factory management
- More precise and rigorous lending criteria, favoring factory rehabilitation
- A better focus on the farm inputs component
- Better access to budget and project funds
- Streamlining of disbursement mechanisms.

Lessons ignored: A number of issues of SCIP I are not addressed (WB 8/1989:11-12):

- The appropriateness of the Cooperative Bank as on-lending agency, though it is stated elsewhere in the appraisal report (p.8), with diplomatic care, that:
  - "its policies and operations were largely influenced by the Government";
  - "The Coop 'Bank has not in the past served the cooperative movement as well as it might";
  - "the financial needs of viable cooperatives were not always fully met";
  - "the value of the shareholders' investments had deteriorated with a build-up of arrears";
  - "the bank's institutional capacity had not kept pace with the growing services and demands" – expressing optimism at the same time (in 1989!) for a change to "an independent and autonomous banking institution." (p. 8-9)
- The politicized circumstances by which the cooperatives agreed to substantial loans for new factories, far beyond their repayment capacities
- The resulting permanent indebtedness of the cooperatives and their farmer-members (who have to pay for the new factories and their excess capacities) and the huge bad-debt portfolio of the Cooperative Bank
- The failure of SCIP to contribute to the objectives of the agricultural adjustment program such as intensification of production, income distribution, employment and foreign exchange generation.
- The failure of supply leading credit under government management.
- The overall negative impact of SCIP: making the country, the cooperatives and the farmers poorer, rather than richer – the country having to repay the loans to the World Bank and the CDC; the cooperatives having to repay the Cooperative Bank; and the farmers having to repay their cooperatives and SACCOs.

(b) A view from Price Waterhouse:

Price Waterhouse (1997:71) finds only fault with SCIP I:

- 50% of cooperatives were still SCIP I debtors by 6/1996, the debts resulting mainly from the factory loans component
- A deficient payment system, with a long chain of middlemen, long delays of payment, arbitrary and unexplained deductions, and low payments to farmers
- Due to poor revenues and delays in payments, the smallholder farmer had lost interest in coffee production.
- Disappointing impact on production, which continued to decline

(c) Views from the field:

Our discussants mentioned the following flaws of SCIP I:

- A top-down approach, ignoring the farmer
- Centrally imposed design and costing of factories (without regard to size of society and actual demand for processing capacity)
- More charity and politics than viability.
- Factory loans were confused with relief and mistaken as grants
- Many white elephants.
- Partial funding of many factories and projects, leaving them incomplete
- Excessive costs of factory construction, at approximately four times the costs of locally designed and implemented factories. Long-term loans were pushed onto the cooperatives. The management of some of the cooperatives was made to believe that this was "free money". There were hints of collusion between government officials and cooperative management who shared in the benefits of exaggerated

costs. This resulted in excessive debts of the cooperatives and their members, which in turn contributed to the large non-performing portfolio of Coop Bank.
- Spiral of non-repayment: The repayment of SCIP I coincided with a downturn in the coffee sector. As cooperatives went into arrears, Coop bank shifted their loans from the preferential to the commercial category using its own funds, increasing interest rates from 15% to 30% and above.
- SCIP I loans are no longer serviceable.

The most scathing criticism comes from the Murata SACCO. The management explained that:

- The main emphasis of SCIP I was on factory construction and renovation, responding to a preceding increase in production and the expectation that production would increase further (up to 300,000t in 2000).
- The factory projects were not originated by the societies, but dumped on them; the societies were not given a voice.
- Many societies assumed that the money provided through Coop Bank was a grant.
- Blueprints for the construction of new factories were centrally provided.
- The costs of building a factory before SCIP I were around Ksh 300,000; once the World Bank and the government were involved, construction costs skyrocketed: initially they rose to about Ksh 3m and subsequently to Ksh 5-13m.
- The debts incurred through Coop Bank are still in the societies' books, resulting in their inability to repay their loans to the SACCOs, while Coop Bank deducts what is due directly from the coffee returns.
- At the same time, the societies are unable to pay the farmers their full share.
- The farmers, in turn, are unable to save.

And the Murata SACCO management's conclusion:

- *"That is the project that made us poor."*
- *"Everything was wrong."*
- *"It impoverished the region and caused the present defaulting. We have not recovered from that."*

2. The Second Coffee Improvement Project (SCIP II) (1990-1997): Did it have an impact on production, income and sustainable access to credit?

"The World Bank project has impoverished the farmers."
(A view from the field, 4/2002)

a) A view from the FAO project completion report:

The main **objective** of SCIP II (1990-1998) was to increase the incomes of smallholder coffee farmers through increased coffee production and improved quality, It also aimed at foreign exchange earnings, employment creation and capacity building of key participating institutions. Main project components were (with allocations in parentheses):

- The development of an Improved Payment System, which is now generally accepted
- Three credit schemes, comprising:
  - CAPS – Cherry Advance Payment System (Kshs 800m)
  - FILS – Farm Input Loan Scheme (Kshs 2420m)
  - CFDS – Coffee Factory Development Scheme (Kshs 527m).

The project was approved in 1989, became effective in 8/1990, and activities on the ground started in 1993. With a one-year extention, the project closed in 6/1998. A mid-term review was undertaken in 2/1995; a completion report was prepared by FAO in 10/1998. Project costs were estimated at $59m; actual disbursements amounted to $48.1m. This was far below the appraisal target of $106.8m, as the proposed KPCU coffee mill and the small estate assistance component did not materialize; the factory rehabilitation component turned out to be smaller than expected; and the Ksh was devalued during implementation.

In its completion report, FAO (10/1998) reported that:

- The project was instrumental in introducing an Improved Payment System for coffee farmers, thereby reducing the payment time lag significantly, bringing the time between harvest and final payment to smallholders down to 6-9 months, compared to up to18 months before.
- The Factory Development Loan Scheme (FDLS) was drastically reduced, due to the recognition in 1993 "that additional capacity was not immediately required and the project's emphasis should be on factory renovations"; or more clearly, because of excess capacity (factory capacity utilization in 1997/98: 56%) and the "increased financial overheads of the societies due to debt service obligations".
- Electrification of existing factories (later also supported by Stabex funds), "which has reduced operating costs, reduced losses due to breakdowns… (and brought) electricity in more remote locations for other purposes."
- Input credit amounting to $15.3m was provided through FILS on subsidized "affordable" terms – "in a general environment of high commercial interest rates":
  - FILS, with its lower interest rates, practically replaced CPCS
  - Levels of input use did not rise to optimal levels, reportedly because of the time lag between coffee price changes and input application and because of the limited availability of subsidized funds during the rise in demand in1995.
- Training and institutional strengthening seems to have had a mixed impact:
  - The Coop bank adopted sound accounting practices and improved its capacity for loan examinations
  - The training facilities of the CRF were strengthened, benefiting mainly factory managers, but significantly less so extension officers, who were found to concentrate "on food crops at the expense of giving advice on coffee production and tree management".
- PCMU became a semi-autonomous unit with competent and motivated staff

- Disease-resistant varieties (Ruiru 11) were encouraged, reducing negative environmental effects of fungicide spraying.
- Small estates were ignored, despite their increasing importance, until the last year.
- The decision of KPCU in 1990 not to expand their milling capacity induced CDC to pull out of the project and led to private sector investments in milling, with deleterious short- and medium-term effects on peace and order in the cooperative sector.
- Weather conditions, fluctuating and falling international coffee prices and uncertainties originating from the liberalization of the coffee sector announced in 1992 undermined the intended impact of the project on production and quality.
- Reform of the coffee sector should have preceded financial assistance.
- Since the onset of liberalization in 1992, there is no clear vision for the future structure of the industry, the marketing system and the financing of the coffee sector. This had led to uncertainty and division among coffee growers, with negative effects on production.
- The future of the SCIP II portfolio is uncertain; and the risk of defaulting is a matter of major concern to Coop Bank

Despite the generally positive tone of the evaluation, the two final conclusions of the FAO evaluation of SCIP II are that,

- "A rise in incomes of small holder coffee producers, and the resulting foreign exchange earnings, through increased production was not realised under the project";
- The sustainability of the credit component remains an unresolved issue.[10]

(b) Views from the field:

On factory construction and electrification:

- Additional funds invested into factories and continued creating overcapacities.
- Many factories were built for reasons of political equity, without concern for actual need
- Costs of factory construction continued to go up. According to a report from Nyeri SACCO, the cost of one particular new factory was Ksh 9m; this would have cost Ksh 4m to 5m six years ago – and much less before the advent of SCIP.
- Payments due on loans for factories construction or renovation created additional overhead costs – in an economic situation coffee production declined, adding to the societies' debt burden.
- SCIP loans were given for electrification; but in many cases, electrification was not completed. Eg, electrification remained incomplete because of insufficient funding; or, all the wiring was done, but the main grid was not laid.
- SCIP payments were not made according to schedule.

On input credit:

- Input credit was disbursed generously, with a grace period of one year, "yours for the asking"; many farmers sold the fertilizer reveived as credit-in-kind at a discount – to the benefit of a few and the disadvantage of many. This resulted in declining production, lower incomes and further repayment problems.
- Cherry advance payments were made to farmers on the basis of inflated production figures. Large loans were provided by Coop Bank which does not have a record of a society's production. This led to excessively large loans which could not be repaid.
- Interest payments soared as interest rates on overdue loans increased from 15% to rates up to 36%.

[10] „The project satisfactorily assisted in the improvement of payment systems and, whilst the project injected much needed working capital, the impact of the credit schemes is short-lived... Sustainability of project activities should have been addressed better during appraisal and followed up during supervision." (FAO 12/1998:iv, v)

- There was an oversupply of chemicals to some societies and individual farmers, leading to expired stock.

Breakdown of information:

- Coop Bank failed to put control measures into place; it disbursed credit generously, without using the information available at the Coffee Board, KPCU and the SACCOs.
    - *"So many of us have lent to the same farmer for the same crop."*
- As a result, almost every farmer is indebted to his society, which deducts payments so that the farmer receives little income; in response, he neglects coffee production and concentrates on subsistence and other cash crops instead.

On project design:

- "The project has been poorly designed and irresponsibly implemented."
- The old interlocking system was abandoned, not improved.
- "Cheap money has created a mess."
- "Pumping funds through government institutions has created an inefficient infrastructure; in contrast, there are institutions like Equity Building Society which are working well without external support."
- "The coffee is not there to repay the loans."

Thiriku Farmers Co-operative Society:

- Factory ,built in 1967 was resited at a cost of Ksh 13m. "We were given a floor, but no ceiling, for bids and told to ignore bids below the floor. We were given standard plans which we could not modify. It looked like a grant to us."
- Electrification loans were given for factories which remained incomplete.
- "The debts are crippling the societies. Repayment of old loans will take a long time. Interest is compounded; this should be stopped."

Some expert views:

- There was an over-reliance on coffee; other credit needs were disregarded.
- The goal should be to minimize, not standardize, input credit.
- No sustainable system was created. With the withdrawal of the donor, effective functioning stopped

3. Stabex: Will it distort or strengthen rural and agricultural finance?

"The process of getting the Stabex money to the farmer is very wrong.
Low-interest Stabex funds benefit but a few."
(A view from a SACCO, 4/2002)

"Funds lent now through a flawed system would have little effect
as quality will not increase in the short run and prices will not increase
…culminating in the possible collapse of the programme."
(PricewaterhouseCoopers 2001: 4, 21)

Under the *Stabilisation of export earnings system (Stabex),* Kenya is eligible for financial compensation for loss of revenue incurred as a result of crop failures due to natural disasters or a drop in world market prices. Resources available under the 1990/91 transfers, amounting to €44m, were allocated to the coffee and tea sectors, but remained unprogrammed and undisbursed until mid-1997. In an effort to restructure and reprogram the Stabex facilities, the EU and the Treasury implemented a first project in 1997: a Coffee Strategic Sector Study.

(a) A view from PricewaterhouseCoopers (2001):

In June 1996, the EU, supplementing the initial IDA funding, provided Stabex funding of Shs 650m for credit facilities to be onlent by the Cooperative Bank to cooperative societies at concessionary interest rates of 15% p.a. By June 2001, the Stabex fund had grown from interest income to Kshs 914m[11], representing 40% of the total funding to the coffee sector by the Coop Bank. Coop Bank does not keep separate cash accounts and hence no running balance for the EU and IDA components of the CAPS, FILS and CFDS. By 30 June 2001, total funding from IDA and Stabex sources stood at Kshs 2.3bn[12]:

Table 9: IDA and Stabex funds, June 2001

	IDA	Stabex	Total
CAPS	377m	263m	640m
FILS	482m	601m	1,083m
CFDS	535m	50m	585m
Total	1,394m	914m	2,308m

Data on loan recovery are messy. Eg, PWC 2001 does not report arrears of Coop Bank, providing information from its own sample survey only, without drawing conclusions with regard to the universe of loans. (According to the Annual Report 2000 of Coop Bank, 55% of its portfolio are non-performing.) Problems pertain mainly to FILS (with a grace period of one year). CAPS are recovered by Coop Bank immediately on receipt of proceeds. CFDS loans, with a grace period of two years and a maturity of 10 years, are still viewed with optimism (PWF (2001:13); Coop Bank is confident that these loans are still recoverable and therefore does not (*or:* not yet) have to provision for them (PWC 2001:5). However, PWC (2001:13-15) takes a different view, listing several factors which hamper loan repayment:

[11] Loans outstanding: 456.9m
Undisbursed funds: 403.6m
Interest receivable: 82.1m
Management fee payable: (28.7m)

[12] This includes arrears for which Coop Bank does not provision.

- Low proceeds from exports, resulting in unavailability of funds to repay loans
- Decline in the quality of coffee from Muranga and Thika due to neglect of farms and poor weather
- Failure of some farmers to apply inputs to minimize production costs, producing low quality
- Some heavily indebted societies do not qualify for additional credit, resulting in further deterioration of quality, lower prices and further repayment problems
- Many societies have debts from previous years which overlap with new debts, exacerbating repayment problems
- Most societies split in 1997/98, resulting in changes of membership, negative economies of scale and a lack of viability (being unable to cover the running costs of their factories) and requiring working capital loans which further increase their indebtedness
- Collusion between Society officials and members has led to misallocations of inputs which were sold off, contributing to low production and defaulting.

PWC (2001:19-20) is at a loss concerning remedies to the problem of non-recoverable loans, recommending vaguely:

> "For action to be taken on any potentially bad loans the Co-operative Bank is to consult with the Government of Kenya on the appropriate action to be taken…. It will also involve establishing the root causes of the default, e.g., how much is attributable to the farmers and how much to the bank's lending and loan monitoring procedures. Provisions should also be made in the new funding agreement to cater for the possibility of farmers' and societies' inability to repay the loans… due to factors beyond their control and the possible resultant loss to the fund."

PWC (2001:4), which evaluated the Stabex support to SCIP II, found that,

> "to some extent it has enabled the sector to survive. However, institutional problems in the coffee sector resulting from liberalisation and other factors have caused a number of problems resulting in reduced production and in poorer quality coffee. There is an urgent need to recast the project…"

The overall conclusion of PWC (2001:4) is that SCIP II, upon which Stabex builds, has failed to obtain its objectives[13] of improving the quality of coffee and the incomes of farmers; and there seems to be little hope for the near future:

> "funds lent now through a flawed system would have little effect as quality will not increase in the short run and prices will not increase."

The most appropriate strategy at this juncture would be a selective one:

> "Release CAPS and FILS only to societies and estates that have been performing well in terms of deliveries, quality and efficiency." (PWC 2001:4)

However, this does not solve **the fundamental problem of grossly inadequate returns,**[14] to which many farmers have responded with neglect of coffee farms and some with uprooting of coffee, and the threatening **collapse of the program**:

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[13] This is not the wording of PWC, which conceals its verdict behind contradictory statements: "SCIP II has had a positive impact on the Societies" is juxtaposed to: "the positive impact has been watered down by a number of factors… Production has however declined significantly… farmer frustration in addition to difficulties in loan repayment… amounts given to the farmers are considered to be inadequate forcing them to obtain additional loans from other financiers… inputs being dumped at Societies…"

[14] This is why some farmers were found to sell fertilizers and chemicals obtained through SCIP or diverted inputs for use on other crops. This is sound from the viewpoint of household viability.

> "Repayment of CAPS, FILS and working capital loans leaves the farmer with very little or nothing for his needs…. The dilemma of the farmer is that he still has to obtain even further credit…, lack of which would result in even lower quality and volume of coffee production. This would lead to extreme loan recoverability risks culminating in a possible collapse of the programme." (PWC 2001:21)

Distorting rural financial markets: In view of the repayment problems of cooperatives, the preferential interest rate of 15% is being lowered in the next phase of SCIP II to a yet more preferential rate of 5% p.a. This finds the approval of PWC (2001:34), despite the reported deleterious effects:

> "The reduction is a good gesture to the farmers and will reduce the loan repayment burden, which is already too heavy on the farmer…. The existence of dual and discriminatory rates for the same facility is likely to exacerbate resistance to repay the existing loans."

Such isolated emergency measures will only make things worse. The distortion of rural financial markets, which sets a precedent for future government and donor interventions in financial markets and troubled institutions, will not prevent the collapse of the program, but might lead to the **collapse of rural financial institutions**.

(b) Views from the field:

The Murata SACCO:

- Until 1999, the Murata SACCO gave cherry picking advances. Because of its monitoring system (farm size, production, financial track record), repayment was 100%.
- Then Coop Bank came in with Stabex funds and provided CAPS loans on the basis of exaggerated figures reported by the farmers to their society; this is now creating repayment problems.
- Societies fail to do their job of controlling.
- External supervision is required; supervision by the Cooperative Department does not work.

The Nyeri SACCO:

- "Low-interest Stabex funds benefit but a few."
- New loans are used to pay back old debts instead of financing inputs.
- "Funds are insufficient. Advances are given on the basis of last year's production, which was low. This leads to poor quality of coffee. Advances should be given on the basis of a field report."
- "Inadequate loans do more harm than good. Eg, a farmer needs Ksh 6,000 for fertilizer and gets Ksh 1,200. Another farmer needs Ksh 2m for a tractor and gets Ksh 500,000. Can he buy a quarter of a tractor?"
- "Every politician wants to get a piece of the cake".
- "The Stabex funds are coming too late. The feasibility study was done 10 years ago; changes are not taken into account."
- "The process of getting the Stabex money to the farmer is very wrong. The Coffee Board pays the Coop Bank as a commission agent, which has no problem of getting its money. But the SACCO is closer to the farmer; disbursement through the SACCO would be more efficient.

Following PCW's (2001:33) advice of monitoring members suspected of diverting inputs (which Coop Bank now seems to be doing through its Society Field Committees) would make matters only worse.

D. Notes on organizations in the coffee sector

The organizations in the coffee sector have been affected – and damaged - by two major forces: the World Bank-funded smallholder coffee improvement schemes since 1979; and unregulated liberalization since 1992. With the Coffee Act of 2002 (passed 31/12/2001; effective 25/3/2002) [15], improvident deregulation is now being replaced by prudential regulation, which will hopefully generate a new order of competitive and efficient organizations. SCIP is being replaced by the EU's Stabex funds, with the challenging task of strengthening the emerging order, possibly in coordination with CFC.

Collapse is imminent: It is estimated that 45% of the Ksh 7.3bn loans outstanding to the coffee sector are in arrears. Cooperative unions and societies are in crisis; many have been liquidated or are dormant. Their financiers are in jeopardy too, with half their outstanding portfolio non-performing, despite their access to deductions of payment at source. Many farmers and their cooperative societies are deeply indebted. The problems of the cooperative unions have affected their Union Banking Services (UBS). To salvage them, they were converted into SACCOs. When unions were liquidated, the SACCOs took over their loan portfolio, including their bad debts. This has undermined the financial health of the SACCOs from their onset. No study of the performance of rural SACCOs was available; but it is safe to say that they too have been affected by the coffee wars and the coffee crisis. No increase in international coffee prices is being predicted that might reverse the situation and allow all debtors and creditors to settle their accounts. It is difficult to avoid the conclusion that collapse is threatening.

With the policy environment in the process of being stabilized and the Coffee Board relegated to the role of regulator, the core farmers' organizations have to re-establish their cooperation in a competitive market economy. The biggest unresolved issue here is the debt burden carried over from SCIP I and II. There is thus no easy fresh start for donors and organizations in the coffee sector. The challenge to CFC is to assist KPCU and the core farmers' organizations on pilot basis to set up a sustainable system of services and bring both the smallholders and their institutions back on the road to viability.

There are three intertwined farmers' organizations: (i) KCPU, the preferred miller and warehousing agency, which also provides extension and financial services; (ii) cooperative unions which are now splitting up into primary societies, which operate wet-processing factories; (iii) Savings and Credit Associations (SACCOs), which are the coffee farmers preferred local financial institutions. Cooperatives and SACCOs are owned and managed by smallholders; their shareholding membership is to a large extent identical. KPCU is a managed limited liability company predominantly owned by smallholders through their cooperatives. The vast majority of smallholders in the coffee sector are members of cooperatives and SACCOs. To these, (iv) Equity Building Society has to be added, which is owned by a broad spectrum of farmers, microentrepreneurs and others and has perhaps the greatest potential on a local scale of providing sustainable financial services to farmers and helping to reform the SACCOs. (v) Coop Bank has been the channeling agent, under government direction, for the SCIP funds and now of the Stabex funds, with half its portfolio non-performing. It would be audacious to exclude the risk of its collapse, as have suffered so many similar institutions in Africa. (vi) Kenya Commercial Bank, the small estate farmers preferred bank, has suffered a similar fate as Coop Bank, with half its portfolio non-performing. (vii) Last not least, self-help groups including informal financial institutions need to be mentioned, with an as yet unexplored potential, which are ubiquitous among the farmers and among the deposit account holders of SACCOs.

[15] Election rules have been enacted; trading rules are pending.

1. Kenya Planters' Co-operative Union Ltd. (KPCU)

Organization and governance

KPCU is an organization of coffee farmers founded in 1937 and incorporated in 1945. It operates under two acts: the Companies Ordinance and the Co-operative Societies Ordinance. Smallholders, cooperatives and estate farmers are its shareholders. In the words of one of our discussants: *"KPCU is the farmers' own thing."* Reflecting the relative importance of cooperatives and smallholders in the coffee sector, cooperatives (owned by smallholders) are majority shareholders. There are 9 representatives of cooperatives and 6 representatives of estate farmers on the board. Management powers are vested in its directors, who are nominated by the members in designated electoral districts at the grassroots level. Policymaking lies with the Board of Directors.

The number of permanent staff is 660. There are ten branches with warehouses (including Nairobi). Four branches (including Nairobi) are equipped with mills with a maximum capacity of 240,00 tons of coffee per year and a break-even capacity of 100,000 tons.

Two subsidiaries have been established (as *sleeping companies*), but are not yet operational:

(a) Kahawa Credit International (KCI*)* as an off-shore company registered in Mauritius and domiciled in Kenya, with the dual purpose of (a) linking with the international coffee roasters and dealing with coffee abroad and (b) handling KPCU's bad debt portfolio (see below)
(b) KPCU Marketing Services Ltd., which is expected to be one of four marketing companies to be licensed in 2002.[16]

Once operational (which remains to be awaited), they will be separate economic units with their own balance sheet and profit & loss operations.

Purpose and objectives

> *As a cooperative, it is KCPU's purpose to provide services and inputs to coffee farmers for the improvements of yields and incomes. As a company, its purpose is to do so in a cost-effective and profitable way.*

Its original purpose was bulk purchasing of inputs and reselling them cheaply to cooperatives, mostly on a credit basis. Until 1992, KPCU practically had a monopoly in coffee for milling, extension services and agro-inputs including credit in kind and cash: a smoothly running closed system. With the licensing of other millers in 1994, farmers could obtain payment through bodies other than KPCU, disrupting the tie between coffee delivery, payment and repayment.

Business activities

The main areas of activities include:

(a) Milling and storing: KPCU's core business is milling (including hulling, polishing, cleaning, grading, sorting and liquoring) and storing, processing 60-70% of the national coffee production. It owns four mills and nine warehouses. Their capacity is 240,000 tons per year; actual capacity utilization is around 100,000 tons, at which it roughly breaks even.
(b) Field services: These encompass extension services, coupled with the supply of inputs such as seedlings produced in its own nurseries[17], fertilizer and chemicals, and

[16] Coffee traders have indicated an interest in acquiring equity in KPCU.

credit. Credit is provided in cash or kind and is considered as an input. When prices are good, demand for inputs is high, and field services are profitable. At low activity levels – as now – they are loss-making.

(c) *Payment services and credit:* Onlending credit (approved at the head office) in cash or kind, provided by a consortium of banks; channeling payments of auction proceeds to cooperatives and smallholders

(d) *Agency services:* Advocacy through representation of members in national, regional and international coffee forums; dissemination of information; and training of members.

The intact system, with KPCU in the middle

- Before 1992, KPCU was the monopoly miller; it bought the coffee from cooperative societies and small estate farmers; it gave advances; it provided transportation and storage facilities; it took the coffee to auction; and it received the pay from the Coffee Board. It also offered extension services.
- To finance its advances, KPCU cooperated with a consortium of banks (syndicated by Barclay's Bank), borrowing the funds for on-lending to farmers.
- KPCU consulted with the unions/societies, which kept the accounts of the farmers at UBS, which are now SACCOs.
- KPCU received payment from the Coffee Board, made deductions and paid the unions/societies.
- These in turn made their deductions and paid the farmers.
- Commission agents (among them KPCU) were required by the Coffee Board to issue a letter of no objection that there are no outstanding loans before a farmer can change his agent.
- Before 1992, there was a system of near-perfect information on production and credit between KPCU and the unions.

Crisis and restructuring KPCU in the era of liberalization

The close tie between the farmer and KPCU was disrupted in the early 1990s (starting 1992/93) by the following:

- The World Bank started channeling SCIP II funds, to which KPCU had no access, through Coop Bank, bypassing KPCU.
- Four other milling companies (in addition to KPCU) were licensed "overnight" in 1994, creating unregulated competition.
- With SCIP funds and under political influence, the Coffee Board abandoned the rule that commission agents had to issue a no-objection letter before a farmer could change his agent.
- The farmers were now able to deliver their coffee to other millers and get their credit from the Cooperative Bank credit line, which was assured of repayment at source.
- This opened the way for double hypothecation, and many stopped their payments to KPCU.

This threw KPCU into a crisis and led to the overall coffee crisis. In the process, everybody lost: the farmers, the cooperatives and KPCU as well as Coop Bank. KPCU had its income halved and ran into losses of Ushs 500m ($10m) in1994/95. KPCU then started provisioning for bad debts, which previously had been deemed unnecessary.

Cooperation refused

KPCU reportedly attempted to maintain the stability of the system by cooperating with Coop Bank as the channeling agency for SCIP funds, offering information on the farmer, his farm and his track record; a pre-service on extension; appraisal of applications; follow-up on the

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[17] This includes the Ruiri 11 variety developed in Kenya, which is high-yielding and disease-resistant, requiring substantially less chemical inputs.

application of funds; hypothecation and supervision – but this offer was rejected. It appears that this has permanently strained relations between Coop Bank and KPCU.

KPCU: a financial institution?

KPCU has been functioning like a specialized financial institution, but is not registered and supervised as such. Under conditions of prudential regulation, it is unlikely that it can continue operating as a financial institution without being regulated as such. PricewaterhouseCoopers has expressed skepticism:

> "KPCU has little experience lending to small-scale farmers. It also does not have a strong financial base and will be competing with private millers. As a result, it cannot be an independent administrator of loans." (PWC 2001:12)

KPCU will therefore have to decide:

a) whether *to establish* a financial institution within Kenya, eg, under the legal form of a SACCO;
b) or to *work through* local financial institutions such as SACCOs and other MFIs.

KPCU's new vision

Under the influence of liberalization and the resulting coffee crisis, KPCU is shedding its administrative approach in favor of a competitive commercial approach, spelled out in its *new vision and mission* (KPCU 4/2000:8-9). Its new vision is that of a "one-stop shop of the farmers":

> *to be the leading commercial enterprise in the provision of integrated services to the coffee industry ensuring high and sustainable returns to its investors, who are farmers.*

In the future, its operations will be profit-driven rather than budget-driven; and its business units will be converted into profit centers. Retaining a core emphasis on coffee services, KPCU adds to its objectives diversification into other agribusiness activities; coffee marketing; leveraging the use of its assets and maximizing returns; modernizing its technologies and operational procedures; R&D for the enhancement of the coffee supply chain; and socially responsible and gender-sensitive strategies.

KPCU is responding to liberalization and the ensuing competition with restructuring, which affects staffing, milling, IT and public relations:

- 220 staff members out of 570, or 39%, were laid off in 2001.
- Its various operations are being reorganized in separate cost centers (*profit centers*).
- The mills are being modernized.
- Preparations have been made for marketing through a subsidiary.
- A new computer-based information system is being introduced.
- Public relations and lobbying is evolving as a new activity.

KPCU also considers joint ventures with roasters as equity participants, particularly from Europe – adding value to the benefit of the farmers, KPCU and the roasters.

The unfinished task: cleaning the portfolio

The debt portfolio is considered by KPCU its biggest problem. KPCU is now making provision for bad debts. But this does not suffice to clean its bad debt portfolio which built up over the past decade. The problem has been confounded by dwindling production and by competition with other millers (and, in the future, marketers) for a reduced crop.

To clean its portfolio, KPCU has established a special purpose vehicle (SPV), *Kahawa Credit International (KCI)*, registered in Mauritius and domiciled in Kenya. To guarantee its independence from political interference, KCI is legally and financially separated from KPCU. KCI is to purchase the bad and doubtful debts presently in the balance sheet, amounting to

Kshs 1bn ($ 13.3m) as of Dec. 1999, and pursue their collection undeterred, including loans made to “influential figures”. Donor support is being sought. (KPCU 4/2000:35, 38-42).

2. Farmers’ cooperatives

Many problems of the cooperatives are rooted in their **history as top-down organizations**, initiated and controlled by government, with compulsory membership of coffee smallholders. The exclusive focus on coffee has undermined the diversification of the farmer households and the rural economy. At times of falling coffee proceeds, this has negatively affected the cooperatives, the farmers and the community.

In hindsight the **core problem** of cooperatives has been their lack of autonomy and their dependence on government, coupled with ineffective supervision of cooperative operations. Cooperatives are supposed to be self-help organizations controlled by their members and not by any outside agency.

A related problem has been the lack of institutional independence of their Union Banking Services and the lack of effective supervision over the financial operations of the UBS. This problem has been partially solved by transforming UBSs into SACCOs. But as the Central Bank refuses to supervise SACCOs as financial institutions and there is no other effective supervisory service (eg, bu KUSCCO), the problem of lack of supervision persists at another level. Cooperatives were given more power in 1996, but this was at a time of turmoil and has not led to a new strength. The Co-operative Act was reviewed in 2001 and is in the process of being amended, introducing a system of checks and balances.

Smallholders, in addition to statutory deductions, have to cover society costs from their payments. Smallholders have no control over deductions. Because of poor management and incidents of misuse, revenues for smallholders have been as low as 50-60% of the revenues received by the cooperatives from CBK. The result:

- Estates are more efficient than smallholder coffee farms, despite the latter’s lower production costs and higher production of high quality coffee among some smallholders (coupled with low quality production among other smallholders – leaving ample room for improvement).
- Many farmers are losing confidence in coffee, and use inputs for other crops.

Decline in cooperative membership[18] further aggravates repayment problems, as the remaining members (down by 10%, 14%, 23% and 26% in four societies studied by PWC 2001:24) have to stand in for their society’s obligations.

Unviable societies: In many cooperative unions, financial problems became unsurmountable. Therefore, unions split into societies, which took over the factories. Eg, the Tetu Coffee Growers Co-operative Society, run by a committee of nine, with 18 factories was dissolved in December 1999; 18 individual societies were created in January 2000, each with one factory – and each run by a committee of nine and administrative costs of its own. 4 out of these 18 societies and factories are doing reasonably well; of the remaining 14, some have collapsed, others are in the process of merging. One of these societies is the Thiriku Coffee Growers Co-operative Society, which inherited Ksh 13m in debts (mainly for factories, some for farm inputs and irrigation), borrowed an additional Ksh 7m and now ows Coop Bank Ksh 20m.

[18] “Some of the defaulters may be… dead or are no longer farmers.” (PWC 2001:24)

Decline in cooperative production: As a result, the percentage of coffee produced by smallholders in 2001 has dropped from 60% to 40%, while the share of estates has conversely increased from 40% to 60%.

3. SACCOs

3.1 SACCOs as self-reliant local financial intermediaries with a savings bias

Since the 1960s, cooperative finance has grown impressively in Kenya, comprising:the Cooperative Bank of Kenya; the Union Banking Sections (UBSs) of the cooperative unions, which are being converted into autonomous SACCOs; and the Savings and Credit Cooperatives (SACCOs).

Kenya its renowned in Africa for the strength of its savings and credit cooperatives (SACCOs). There are close to 2500 SACCOs with 1.2m members: 2300 urban SACCOs, mostly company-based[19], with 1m members (average: 430) and 130 rural SACCOs with 200,000 members (average: 1540). SACCOs originated in Kenya as savings and credit cooperatives of wage and salary earners, following the American credit union model. Rural SACCOs of producers are closer to the German Raiffeisen model. On principle, the rural SACCOs in Kenya are savings-based self-reliant local financial institutions owned by their farmer-shareholders. Given the (imputed) availability of credit for coffee, rural SACCOs were first established as savings catchers so that the farmer could self-finance school fees, health and other domestic requirements and use coffee loans for coffee. With the onset of the crisis of cooperative unions, the union-owned Union Banking Services (UBSs) have been transformed into member-owned SACCOs.

With a minimum balance of Ksh 200[20], access barriers are low, they are the most accessible network of financial institutions in Kenya. Discussants agreed that the propensity to save is generally high in rural Kenya, generating the resource base for self-financed SACCOs. Coffee-based UBSs, which are now being transformed into SACCOs, and rural SACCOs provide savings and credit services to 610,000 farmers. There are about 10 coffee farmer-based SACCOs. There are two types of members: cooperative societies and individual members of cooperative societies. Others may open deposit accounts, but cannot become members with borrowing privileges. Only individuals have voting rights. For clearing house functions, SACCOs cooperate with corresponding banks. SACCOs are not supervised by the Central Bank. There are several **notable features** (PW 1997:66-68):

(1) Size: SACCOs are potentially large, self-reliant local financial institutions. Eg, the Murata Farmers SACCO Society Ltd., with total assets of Kshs 1.14bn, has about 50 delivery units, 60,000 smallholder-members and 132,000 depositors (*see below*).

(2) Low percentage of borrowers: As membership has been practically compulsory, their actual financial service is limited: between 2% and 21% (average: 13.1%) of members of nine SACCOs/UBSs in coffee-growing areas listed by PW (1997:67) have loans outstanding (June 1996):

Number of farmers in cooperatives	610,000
% of farmers with loans	13.1%
Total credit	Ksh 591m

(2) Slow growth of loans outstanding due to SCIP competition : From 1993 to1996, total credit has increased by only 23%, from Ksh 482m to 591m. The demand for production loans

[19] There is also a staff credit union in KPCU.
[20] In contrast to Ksh 3,000 at KCB and Ksh 10,000 at Barclay's.

has been greatly reduced by the availability of SCIP II financing through the primary cooperative societies.

(3) Rapid increase in savings: Between 1993 and 1996, savings balances have increased by 150%, from Kshs 939m to Ksh 2,345m. PW (1997:67) noted:

> "The level of savings is a clear indication that savings are extremely popular in the rural areas and much appreciated by smallholder coffee farmers… (They are) an important contribution to improved household financial management… (and) are largely voluntary."

However, the fact that proceeds from coffee sales were directed to members' savings accounts, originally in the UBSs, now in the SACCOs, greatly contributed to the appreciation and growth of savings, from which loan repayments were deducted at source.

(4) Rapid increase in excess liquidity: Excess liquidity (savings balances over loans outstanding) has increased during this period from Ksh 457m to Ksh 1,754m.

(5) Adequacy of internal resources: During the period 1993 to 1996, savings balances of SACCOs/UBSs consistently exceeded SCIP II loan balances; and in 1995 and 1996, their excess liquidity exceeded the SCIP allocations for CAPS/FILS. This calls the necessity of external resources into question:

Table 10: Savings and credit in rural SACCOs/UBSs, (June) 1993-1996 (in million Ksh)

	1993	1994	1995	1996
Total savings	939	1312	1880	2345
Total credit	482	396	509	591
In % of savings:	51%	30%	27%	25%
Excess liquidity	457	916	1371	1754
SCIP II loans disbursed:				
CAPS	288	256	826	211
FILS	363	426	860	639
SCIP allocation for CAPS+FILS			1122	1430
In % of excess liquidity			82%	82%

(6) Conclusion - a strong self-financing potential of SACCOs/UBSs:

PW (1997: 69, 67) notes

> "a potential for increased self-financing from the smallholder coffee sector and the capacity of UBSs/rural SACCOs to participate more actively in credit to small scale coffee farmers, both financially and operationally."
> "The impressive savings mobilisation among small scale coffee farmers forms an adequate base for self-financing." (PW 1997:67)

The main obstacle seen in 1997, the lack of autonomy of UBSs, has been removed to the extent that they are being transformed into autonomous SACCOs.

(7) Historical weaknesses of the UBSs:
As strong as the SACCOs may appear today, their strength has been greatly diminished by the flaws of the UBSs from which they originated (PW 1997:70):

- Funds from members' deposits were liable to attachment by union creditors
- Misuse of members' deposits.

- Use of members' funds for risky other union activities beyond the member's control and financial interest
- Lack of professional banking discipline and control
- Loss-making investments
- Inadequate loan management.

Several UBSs collapsed, including those in Machakos and Bongoma with more than 100,000 coffee growers.

(8) From unsustainable UBSs to sustainable SACCOs: a delayed process
The flaws and failures of the UBS system led to the launching of the rural SACCO concept by the Commissioner for Cooperatives in 1991. SACCOs are autonomous rural financial institutions which are to provide a range of sustainable (!) financial services to their members. This was meant to take the SACCO management out of the hands of the Union officials and turn the SACCOs into viable institutions. This however was resented by many Union officials, who saw a major source of revenue and power as well as unsupervised personal income eliminated. In 1997, PW noted that the coffee based UBSs in Meru, Nyeri, Kirinyaga, Muranga and Kiambu still operated unchanged under the union framework. Only those in Meru South, Kisii and Embu had been converted into single purpose savings and credit cooperatives, while the SACCO in Meru North was established by three coffee societies in 1990. Professionalization of SACCO management remains a continual challenge.

Farmers, cooperatives and the SACCO have all suffered severely from the breakdown of order in the coffee sector, worsened by the decline in prices.

3.2 Murata Farmers SACCO Society Ltd.

The SACCO of Murata, legally registered in 1997, has resulted from the transformation of the informal banking section of the Muranga District Farmers Cooperative Union, formed in 1960. It seems to have the potential of growing into a model SACCO.

The transformation was reportedly carried out because of mismanagement of funds in the UBS – after several years of resistance against the transformation order of the Registrar of Cooperatives . There are about 50 delivery units, comprising nine branches and mobile services at over 40 paying centers, covering three districts (with a population of about one million). It is owned by:

- 67,000 individual shareholders, who are at the same time members of cooperative societies,
- 48 primary cooperative societies and
- the Mugama Farmers Cooperative Union as their umbrella organization.

Minimum shareholdings are 30 shares of Ksh 100 for individuals and 1,000 shares for cooperatives. The SACCO is a shareholder of the Co-operative Bank (Kshs 15.8m), the rural SACCO network Kerussu (Kshs 10,000), K.N.F.C (Kshs 10,000) and Co-op. Insurance Services (Kshs 1m).

As a financial cooperative, the SACCO is authorized to take deposits from non-members, but can lend only to its shareholders. As of December 2001, it had:

- total assets of Kshs 1.14bn,
- 132,000 depositors,
- total deposits of 845m (down from 978m in the preceding year),
- loans outstanding of 635m (up from 527m), ie 75% of the deposit volume,

- a surplus of 8m (audit pending),
- 20-25% of deposits as a liquidity reserve.

Interest rates on passbook savings are 2%, 4% and 6%, depending on the savings balance; fixed deposits of 6-12 months are 1% higher. The interest rate on loans, with maturities ranging from 12 months to 5 years, is 16%. Loans are granted for capital development, school fees, medical expenses, and housing.

Adopting and modifying CPCS rules during the 70s: Around 1970, the UBS adopted the rules of the Scandinavian-aided CPCS, but continued using its own funds instead of borrowing from CPCS. Input loans were given 80% in kind and 20% in cash. This was found inappropriate, as cash-strapped farmers were found to produce fake invoices or sell the inputs provided in kind, particularly fertilizer, at a lower prices, thus increasing his transaction costs. The UBS therefore changed this practice and provided loans in cash combined with training, insisting (and monitoring) that borrowers showed an increase in production. According to the Chairman, "you must educate your members." Loans were guaranteed by two guarantors who had to be active members. Loan size depended on production. Loans were officially given for production only, but could actually be used for other purposes; the UBS did not mind, respecting the various credit needs of the members, as long as loans were repaid. With this new system, the arrears ratio was 6%, recovery was 100%.

The impact of SCIP I: This smoothly functioning system was interrupted by SCIP I. In the words of the chairman:

> *"This is the project that made us poor; we have not recovered from that."*

In its report for 2000, it is stated that, due to poor coffee payments, many individual members and primary marketing societies were unable to honor their obligations; and that some cooperatives diverted their members' payments to other financial institutions. This brought the SACCO into serious problems and made her dependent on additional resource mobilization through deposits from non-members and tea growers who received their payments monthly (Annual Report, p. 8). The decline in repayment performance continued into 2001.

SACCOs are in a double bind: on the one hand, they act – or should act - in the financial interest of their individual members, who are majority shareholders with 96.5% ownership; on the other hand, they act on behalf of the cooperative societies and collect debts on their behalf from their members.

Request for fresh capital: The SACCO would like to diversify its portfolio, but requires additional capital. A proposal for a microenterprise lending program for farmers and microentrepreneurs has been submitted to the European Investment Bank on 29 August 2001;[21] but no reply has been received.

3.3 Nyeri Farmers SACCO Society Ltd.

Nyeri is a coffee-growing district. Main cash crops are coffee, tea, pyrethreum, dairy and horticultural crops. 70% of the coffee comes from cooperatively organized smallholders, 30% from estate farmers. The main sources of credit reportedly are the SACCO, Coop Bank and Stabex funds.

The cooperative movement in Nyeri districts comprised 175 primary cooperatives, of which 115 are active (dealing with coffee, dairy and pyrethreum) and 60 are dormant (dealing with

[21] Submitted to David White, European Investment Bank, Luxemburg; Tel. 00352-43-791353

dairfy and pyrethreum). These are all members of the cooperative union. In addition, there are 12 SACCOs of tea farmers, who are not organized in primary cooperatives. As elsewhere, the economic situation in the district is precarious. From 1999/2000 to 2000/01, there has been an enormous drop in coffee production. Coffee cherry intake declined by a 58%; payments to farmers dropped even more.

In January 1998, the Union Banking Section (UBS) of the Nyeri Districtiion Co-operative Union Ltd. was transformed into an independent SACCO, which took over all its obligations. It has branches which cover all administrative divisions of the district, two paypoints and mobile banking services at various market centers.

In 2001, the SACCO paid its shareholders a dividend of 7%. The SACCO's financial health and performance would require further study.

There are 46,00 shareholders – 65% of them coffee farmers - with a paid-up share capital of Ksh 70m. The SACCO has 105,000 depositors, with a total deposit balance (passbook savings and fixed deposits) of Kshs 446m. It is estimated that 20% of depositors hold 80% of the deposits; the majority are too poor to save – impoverished by the decline of coffee. Deposits are the SACCO's source of loanable funds. Loans outstanding amount to Kshs 274m, or 61% of deposits. Only 25% of its income is derived from interest on loans, the remainder from various types of investments. The SACCO gives production loans and so-called welfare loans for health, education and consumption.

The SACCO faces two types of *demand for additional credit:* one from members to diversify their income-generating activities; the other one from non-member depositors. In response to its members's demand for additional credit, the Nyeri SACCO has accepted 59,000 depositors who are not members of a cooperative society and therefore, according to its bye-laws, not members of the SACCO with borrowing privileges. This has allowed the SACCO to expand its lending to members, but not fully. Until 1999, coffee and dairy were the only two agricultural purposes the SACCO lent for; since 2000, it has started to diversify its agricultural portfolio and permit members to borrow for a wide range of agricultural purposes (instead of diverting loans). Additional capital is reportedly needed to respond to the members' request for loans for various income-generating activities.

At the same time, there is a demand from non-member depositors – among them numerous self-help groups of women and men – for credit, but they are not eligible. If the SACCO is to become a healthy local financial institution with a diversified portfolio, it needs to change its bye-laws to accept members who not members of a farmers' primary cooperative society. This issue requires further study.

3.4 Associations of SACCOs

There are two associations of SACCOs:

- Kenya Union of Savings & Credit Co-operatives Ltd. (KUSCCO)
- Kenya Rural SACCO Society Union (KERUSSU)

Historically, KUSCCO has been the only apex organization of SACCOs in Kenya. By December 2000, there were 1,466 SACCO-members (out of a total of 2430 SACCOs), 39% of them in Nairobi and 61% in the provinces. KUSCCO is owned by its members, with a share capital of Ksh 42.0m. Total assets are Ksh 880.0m. Loans to member-SACCOs amount to a modest Ksh 645.7m – approximately the same business volume as for example the Murata SACCO. The loan period is 24 months, repayment is monthly. The arrears ratio is 7%. KUSCCO lends to SACCOs at interest rates of 11-15%; SACCOs lend to members at 12-18%.

KUSCCO has a staff of 380. Its main activities are liquidity exchange among its members, risk management, training, and R&D. Business development, marketing and auditing services using PEARLS (in cooperation with the US-based Credit Union League) have recently been added. KUSCCO has been supported by many donors, among them the Konrad Adenauer Foundation. KUSCCO deserves a more thorough study; so far neither the Annual Report 2000 nor the discussions held at the headoffice revealed a potential for cooperation in the context of the proposed project. It is clear that Coop Bank is not the apex bank of SACCOs. But it does not appear that KUSCCO has really filled the void; in terms of liquidity exchange and access to sources of refinance, both urban and rural SACCOs seem pretty much left at their own. It appears that a tradition of below-market interest rates has hampered the growth of the network and of the apex. KUSCCO has also failed to intervene in the delivery of the World Bank and EU credit programs through Coop Bank.

KERUSU has been established around 1997 as an apex organization for rural SACCOs, housed by Coop Bank. It is still little-known; and no evidence was found in the field of its activities.

4. Equity Building Society Ltd. (EBS): a sustainable commercial banking MFI of farmers and microentrepreneurs

EBS is remarkable in at least two respects:

- It is a self-reformed microfinance institution. In contrast to donor-supported MFIs (like KWFT[22]) which rarely become self-reliant, it mobilizes its own resources without external financial assistance, has experienced spectacular growth, and finances its growth from its profits.
- It is a financial institution which found agricultural lending more profitable than housing finance.

EBS is living proof that sustainable and profitable rural and agricultural finance is feasible. With EBS around as a model, there is no excuse for any SACCO procrastinating. What is EBS doing right that others did wrong?

A successfully reformed bank: EBS was established in 1984 as a building society for long-term housing loans. At the end of the first decade of its existence, December 1993, it was declared technically insolvent by the central bank, with non-performing loans of 54% and capital fully eroded by accumulated losses. It is this shock which brought about the impetus to self-reform. In 1994, with support from EU, UNDP, DFID, Swiss Contact and others, reform started from within over a five-year period and enabled EBS to transact business as a commercial bank, regulated by the central bank.[23] It is now one of the most vibrant financial institutions and probably the strongest microfinance provider with a rural and agricultural emphasis in Kenya. The secret of EBS reform lies in the competence and enthusiasm of its

[22] **Kenya Women Finance Trust (**KWFT), founded in 1981, received donor grants of $9.8m over the last ten years and attained a remarkable degree of outreach and, compared to the industry average, an excellent level of repayment performance. By September 2001, it had 50 delivery units, over 40,000 members and 26,700 active borrowers, mostly poor women, with Kshs 350m loans outstanding. The repayment rate is 96%. Its portfolio of outstanding loans amounts to $4.7, though it received double the amount in grants. With an operational self-sufficiency ratio of 91% (up from 48% in 1996), it still does not cover its operational costs – despite the fact that it does not incur financial costs, as all its loanable funds are grant money. Its core problem is the lack of a legal status which would allow for deposit mobilization. Without this authorization, KWFT has been unable to adequately respond to its clients' demands for deposit facilities.

[23] Since financial liberalization, prudential requirements for Building Societies are the same as for licensed banks.

chairman and its CEO.[24] It is owned by 2,367 shareholders, most of them farmers and microentrepreneurs.

Through 13 branches (as profit centers) in the Central and Nairobi provinces and 18 mobile banking units in remote areas, EBS provides a wide range of carefully crafted demand-oriented savings and credit products as well as other financial services including cheque clearing. Loans are disbursed and recovered through monthly instalments deducted from the client's savings account ("a built-in repayment catcher") and thus easily monitored. Computerization took place in 2000. The system allows for timely identification of payments due and for information on aging of arrears.

Banking with low-income people: Its market segment is the "missing middle", comprising "micro, small and medium enterprises, salaried persons, and small-scale farmers that are marginalized by the mainstream financial services providers" (Strategic Plan 2002-2006:14). About half its clients are women, who account for 47% of active borrowers (May 2001). The main emphasis is on low-income people, not the poorest of the poor. Between 6/2000 and 5/2001, 50% of its loans disbursed were under Ksh 10,000; but EBS is very flexible in its lending, providing loans as small as Ksh 500 and as big as Ksh 3m. The lending methodology is individual.

Financing agriculture: EBS is strongly involved in the financing of agriculture, including tea, coffee, rice and horticulture (reportedly 65% of its portfolio is agriculture-based). Input credit accounts for 18% of its portfolio. Agricultural loans comprise crop advances, farm input loans based on household income (rather than pegged to other indicators), and medium-term development loans (eg, for tree crops, fencing).

Interest rates are comparatively low, varying from 15% to 24%; the initial interest rate on agricultural loans is 21%. The interest rate on each consecutive loan is lowered by 1% if repayment is satisfactory. It is notable that the lowest interest rate of 15% , which customers may achieve after several satisfactory loans, is equivalent to the preferential rate under SCIP II. What is preferential to SCIP and Coop Bank (and loss-making) is commercial to EBS (and profit-making).

Timely repayment is incentives-driven by: (i) an assessment of the ability of a household to repay and its track record of savings and repeat loans, rather than collateral; (ii) decentralized lending ("knowing the customer"); (iii) repeat loans without red-tape (granted within one day); (iv) decreasing interest rates in consecutive repeat loans; and (v) lending for an array of purposes – in the words of the CEO:

> "A farmer who can pay for education and health can also afford to invest in coffee (not the other way round!)"

Spectacular growth: From 1995 to 2001, EBS underwent a process of rapid growth which is still ongoing:

- ✓ Total assets grew from Ksh 213m to 1.9bn
- ✓ the number of depositors grew from 28,000 to 105, 000
- ✓ Deposit balances grew from Ksh 123m to 1.6bn
- ✓ The number of borrowers grew from 347 to 20,000
- ✓ Loans outstanding grew from 35m to 762m
- ✓ Profits grew from 7m to 54m (before tax)
- ✓ Shareholder funds (including reserves) grew from 9m to 227m.

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[24] P. K. Munga and J. K. Mwangi, who were inspired by a visit to Raiffeisen banks in Switzerland. *Consultant*: Mirie Mwangi, Dept. of Accountion, University of Nairobi. T 249290; macly@wananchi.com.

Performance rating: As at 31/12/2000, EBS received a satisfactory rating from the central bank, with non-performing assets down to 11.4% (compared with an industry average of 42%).[25] On the basis of an appraisal by Planet Finance in June 2001, it received a rating of G4, with a positive future trend; this is said to be the best rating ever granted anywhere under the Girafe methodology. EBS's operating self-sufficiency ratio was 124% and its financial self-sufficiency ratio 119%; its return on assets was 3.4% and its return on equity 13.5% (December 2000).

Growth has continued since the evaluation by Planet Finance. Between 2000 and 2001, total assets grew by 49%, customer deposits by 65%, loans outstanding by 71%, shareholder funds by 17% and profits by 61%. Loan provisions went down from 2.3% in 2000 to 1.6% in 2001, reflecting an improving quality of the portfolio.

EBS plans to continue expanding its outreach to rural areas and deepening its services. International investors are invited to support its growth and thereby the development of its clients.

5. Co-operative Bank

Coop Bank has been the main supplier of credit to cooperative societies, the agricultural smallholder sector (mainly through cooperatives) and to small-scale coffee farmers in particular (PW 97:63), serving as a channel for government and donor funds. It has been the sole channeling institution for SCIP and Stabex funds. It claims to be "the single successful surviving cooperative Bank in Africa." In contrast, advances given by the Coffee Board were mainly financed through other commercial banks (Stabic as the main lender, KCB, City Bank).

In 1994, it was transformed into a commercial bank, inviting individual shareholders (now at 40%) in addition to cooperatives and, more recently, SACCOs, and started acquiring new customers. It is reported to have 61,000 shareholders, including 4,000 cooperatives and 57,000 individual members of cooperatives. Coop Bank is now placed under the supervision of the central bank. At the same time, the financial sector was being liberalized, one implication being that SACCOs are not tied by law to Coop Bank.

Through most of its history, there seems to be a discrepancy between donor assessment of Coop Bank and its actual performance. Repeatedly, optimism concerning its future role has been expressed, to which the Bank has not lived up.

Under SCIP II, both donor-supported factory loans and smallholder credit were channelled to, or through, cooperative societies as the Bank's debtors, under a framework of controlled terms and conditions, appraisal, disbursement and administration. In addition, the Bank used own funds at 22-25% interest p.a. in 1996 (compared to 15% for donor-funded credit) for working capital and investment loans to cooperatives, based on security in fixed assets and crop hypothecation. (PW 1997:66)

"Since 1990, the bank has implemented a comprehensive capital investment program, involving the establishment of 12-13 new branches and a major rehabilitation of the Nairobi head office… it is therefore important that the bank's new business approach combines desire for business volume with requirement for profitability and consolidation." (PW 1997:63)

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[25] With a portfolio at risk (PAR) of 15.5% as at May 2001, portfolio quality is good by Kenyan Standards, though poor by international standards. The high PAR is a result of long term mortgage loans granted before the reform of EBS. The PAR for its six other loan products is 11.5% (for both De. 2000 and May 2001).

“The bank has an already well established system and linkage to Co-operative Societies which works well. The interviews carried out… indicated that both farmers and officials are comfortable working with the Bank’s management.” (PWC 2001:11)

Performance: According to its annual report for 2000 audited by Ernst & Young, total assets amounted to Ksh 23.6bn, less than one-third the size of KCB; total capital amounted to Ksh 1.5bn. Loans outstanding were Ksh 13.4bn (down 8%). Customer deposits were Ksh 17.6bn (up 18%), exceeding loans outstanding by 31%, or Ksh 4.2bn. Borrowings amounted to Ksh 1.9bn (including Ksh 1.6bn from SCIP 1 and 2); grants amounted to Ksh 1.25bn. The total amount of borrowings and grants is less than its excess liquidity – calling into question the need for external resources.

Coop Bank reportedly did well until the advent of SCIP II, when societies and farmers began borrowing from different sources and funds were diverted. According to its annual reports, the bank has shown profits of an increasing magnitude until 1997; and losses of an increasing magnitude in 1997.[26]

Performance in 2000 was dismal. Losses amounted to Ksh 1.6bn. Non-performing loans (on which interest is no longer accrued) amounted to Ksh 7.2bn, which amounts to 55% of the outstanding loan portfolio (Note 15e, page 26); no information was available on the composition of the non-performing loan portfolio and on the aging of arrears. Interest on non-performing loans amounting to Ksh 1.2bn was held in suspense and not credited to the profit & loss account. Provisions for bad debts amounted to Ksh 1.9bn (no provisions made on government and donor funds). As one discussant put it: “Coop Bank sunk into debts, they are never recoverable, because it was lent badly.” According to one source, the Stabex funds saved Coop Bank from collapsing.

One reaction to the dismal performance was a change in management. In the words of a discussant, “there is now a completely new bank with a young management team.”

Despite this bleak picture and the fact that “the weight of non-performing loans increased”, the Annual Report 2000 (pp. 6-7) radiates **unfounded optimism,** which is extended to the expected impact of fresh donor funds**:**

- “the Bank’s balance sheet is still strong”
- the Bank is “poised for a turnaround in 2001.”
- Stabex funds will jump-start the coffee sector.

A new task for Coop Bank? Coop Bank has not performed well as a retailer. Its new banking function may be that of a wholesale institution; and its developmental function that of a builder of an infrastructure of sustainable local financial institutions, investing into SACCOs as local financial intermediaries and retailers. Taking on such a new function would require the prior cleaning of its portfolio.

[26] Losses appeared in the books as audited by Ernst & Young since 1998 and increased at an alarming rate: Ksh -13m in 1998; -69m in 1999; -1.6bn in 2000. During the period 1990-97, on which we received annual reports, the books show profits of increasing magnitude: Ksh 10m in 1990; 11m in 1991; 20m in 1992; 34m in 1993; 66m in 1994; 123m in 1995; 174m in 1996; and 279m in 1997. It is not clear to what extent the losses since 1998 are due to SCIP II and to the bombing attack on the American Embassy in Nairobi in 1998, which destroyed part of the head office of Coop Bank (rebuilding will be completed during 2002). Particularly the jump in losses in 2000 is hardly due to the bombing attack; nor can the volume of non-performing loans be explained in that way.

6. Kenya Commercial Bank Ltd. (KCB)

KCB was originally a government bank and is now 65% privately owned. It has 87 branches and 20 agencies; 20 branches are involved in tea financing, 17 in coffee. According to its annual report for 2000 audited by Ernst & Young, total assets were Ksh 74.1bn, total capital Ksh 8.4bn. Its outstanding loan portfolio amounted to Kshs 39.1bn (down 13%); the non-performing portfolio amounted to Kshs 19.4bn, ie 50% of loans outstanding. Deposits amounted to Ksh 48.6bn, exceeding the volume of the loan portfolio by 24%. Operating costs were 15% of loans outstanding. Losses were Ksh 765m.

KCB reportedly is the preferred bank of small estate farmers. KCB has several small-scale loan schemes of minor importance, among them a small-scale tea and coffee farmers loan scheme. Loans are given for the new development of tea or coffee farms from two to five acres. Most loans are between Ksh 100,000 and 200,000; the limit is 500,000. The loan period is up to 5.5 years; the grace period is 2.5 years; the concessionary interest rate is currently 14.5% p.a. (0.5% above the bank's base rate). Interest is paid monthly or quarterly from various sources of income. The land title is used as collateral (to be approved by the Land Board). Repayment of tea loans is satisfactory; no satisfactory recovery mechanism has been found for coffee. (Tea takes a month to get paid, coffee up to a year.) A new system of non-negotiable warehouse receipts is under preparation.

7. ROSCAs and other self-help groups (SHGs)

Self-help groups including rotating savings and credit groups (ROSCAs) are widespread in Kenya. Many function as informal financial intermediaries, collecting savings in the form of regular contributions or membership fees and providing loans to members. Almost every member of the Nyeri SACCO belongs to one or several SHGs and makes regular payments. Among the SHGs are ROSCAs, church organizations, women's groups, extended family groups, community development groups. It is estimated that more than 50% of the members of the Nyeri SACCO are also members of a ROSCA, with weekly or monthly, sometimes daily, contributions. In the non-rotating SHGs, the contributions are typically collected by a treasurer who deposits them in the SACCO.

Rotating savings and credit associations deserve special attention as informal financial institutions of indigenous origin based on self-help. In Kenya as elsewhere, they are a modernized version of a more ancient institution, the rotating work group, *gitati*, which may work in turn on each member's farm but is now mostly used in housebuilding. RoSCAs are widespread in Kenya, predominantly among women, though not as ubiquitous as in some West African countries where they are widely practiced by both sexes and have produced many financial innovations (eg, nonrotating credit associations, private deposit collection). The most commonly used term in Kenya is merry-go-round. Due to peer pressure, default is minimal.

Little information is available on mainstreaming and upgrading RoSCAs to higher institutional levels[27] or how RoSCAs link up with banks and other formal or semiformal institutions in Kenya. AFRACA (with its head office in Nairobi), assisted by GTZ, has supported linkages between banks and self-help groups (SHGs) in various African countries[28] and might be

[27] See Hans Dieter Seibel, Rural Finance: Mainstreaming Informal Financial Institutions. Journal of Developmental Entrepreneurship 61 (April 2001): 83-95

[28] H.D. Seibel, Transforming Rural Finance in Africa: The Role of AFRACA in Linkage Banking and Financial Systems Development. Internationales Afrikaforum vol. 32 no. 3, 1996: 185-190 ; H. D. Seibel, Linking Banks and Self-Help Groups: A Training Manual for Self-Help Groups, Banks and NGOs. VfE Verlag Saarbruecken, 1992.

instrumental in developing a special approach for rural households including coffee farmers, among whom SHGs were found to be widespread. IFAD, with its concern for rural poverty alleviation and women, has been a supporter of AFRACA and might cooperate in an approach which benefits SHGs and ROSCAs of rural women.

8. Credit registries

Since the onset of liberalization, there has been no credit registry and no exchange of information on borrowers between financial institutions. This has been one of the main reasons for heavy indebtedness and non-performing loans in the rural sector. An approach is urgently needed among financial institutions in a given area geared to information exchange on borrowers. This issue requires in-depth study in Kenya.

The World Bank has looked favorably at the development of credit registries:

- "Credit registries that collect information on payment histories can improve information flows on small borrowers and allow potential borrowers to use their good reputation to secure finance." (WB 2002:96)
- "Many credit registries are run by credit-reporting agencies (CRAs), private third-party proverds that make information available not just to members of an exclusive industry group but to any creditor willing to pay their subscription fee." (p.94)

9. Financial services: some issues

Seasonal input credit vs. self-financing from savings
Depending on the area in Kenya, there are one or two flowerings of coffee stems per year. Inputs are thus required on a regular basis: once or twice a year. Such recurring expenses should be financed from savings rather than credit. Credit has a role to play either in a start-up phase, for the modernization or expansion of coffee production, or for delayed sales beyond harvest-time price dips. Regular expenses should be self-financed by the farmers from the proceeds of coffee sales or other income. This requires local financial institutions where the farmer can deposit his savings. These exist, as every coffee farmer is a member of a SACCO, a Savings and Credit Association. No new structures are required, only an incentives-driven revamping of financial practices, combined with farmer education.

Smoothing the effects of price fluctuations through savings and credit
Farmer income is influenced by short-term and long-term price fluctuations. Following liberalization, farmers are no longer paid an average price for their coffee calculated on an annual basis, but the market price at the time of sales. They now have to manage short-term price fluctuations over the course of the year themselves. In addition, there are long-term price fluctuations over several years. The effects of these fluctuations on the farmers' income can be smoothed by financial services, encompassing savings and credit.

Loan diversion: good or bad?
80-90% of all agricultural lending of the Coop Bank is based on crop hypothecation, based in the case of coffee on an irrevocable instruction of a cooperative to deduct payments from Coffee Board receipts. This makes coffee-based borrowing a main source of credit, which is frequently used for general farm and household activities. In the case of credit-in-kind, eg, fertilizer, the goods supplied may be sold to raise cash for other purposes, approved by PW (1997:66) in their assessment: "This is a natural and inevitable feature of small farmer credit and should not be resisted."

E. Notes on coffee and coffee producers: *Only quality pays*

On the day that we visited the auction,
prices per 50kg bag varied from a low of $10 to a high of $284.
(April 2002)

1. Coffee producers

Coffee has been grown in Kenya for about 100 years. For the first fifty years, coffee was grown by white Kenyans on estates; it remained of negligible importance until independence (1963). It is only since the 1950s that **smallholders** were allowed to grow coffee; it quickly become one of the most important crops. Since independence (1963), the coffee growing area has nearly doubled: from 81,700 ha to 160,000, of which 38,000 ha are estates and 122,000 ha smallholdings. PW (1997:20) estimate that in 1996 coffee was grown by over 500,000 smallholders with an average size of little more than 0.2 ha, who are members of 220 cooperative societies, and on 380 large estates (average size 87 ha) and 1,291 small and medium estates (average size 4.6 ha). It is estimated that there are now (2002) some 160,000 smallholders, 1,500 small estates and 500 large estates.

The average smallholder has a few hundred coffee trees (mostly between 200 and 300), producing less than 700kg of cherries, equivalent to 100kg of clean coffee per year (losses due to pulping, fermentation and drying). Coffee, the main cash crop for many years, has now become an increasingly incidental source of cash (ib.). According to KPCU's experience, a family with its own labor can handle 250 coffee trees. Above this, additional labor has to be hired, which usually leads to drop in quality. 250 well-kept coffee trees produce a higher profit than 1000 poorly maintained trees, claims KPCU.

Both the very best and the very poorest coffee are produced by smallholders. There are thus wide opportunities for improving smallholder coffee quality.

Gender: The whole family is involved in coffee production, with the women and children playing the major role:

- Men do land preparation, planting, spraying, pruning and pulping
- Women do the fertilizing and manuring, weeding, picking, marketing, drying and bagging
- Children do weeding and picking.
-

Many households in the main coffee growing areas are headed by women. (PW 1997:39) No attention seems to have been paid to women as co-producers of coffee and as agricultural and non-agricultural producers of their own standing. This issue requires further study.

Small estate farmers: There is an increasing number of small estates, as smallholders leave the cooperative system to escape the delays and costs of cooperative processing and marketing; many continue to be listed as inactive members. It is estimated that there are now some 1,500 small estates. There is no established credit system for small estate farmers. KPCU states that there are about 700 small estate farmers among its borrowers (out of a total of 2,700 societies and individuals who delivered to KPCU). Small estate farmers may group together to set up a pulping factory (jointly or individually financed and managed) and jointly deliver their coffee.

Potential target groups: For a smallholder-oriented project, there are thus two potential target groups:

- smallholders organized in cooperative societies
- very small estate farmers non organized in cooperatives, but possibly forming informal groups.

2. Quantity vs. quality of coffee

2.1 Quantity

Until 1988 coffee was Kenya's most important agricultural export product, accounting for over 40% of total exports in 1975 and 1986. After 1986, the international price for coffee fell sharply; and in 1992 coffee accounted for less than 9% of total export value and climbed to 15% in 1995. The volume exported increased from 80,000 tons in 1982 to a peak of 217,000 tons in 1994. Since then, it has declined. 66% of the coffee is produced in the Mt. Kenya area.
Total coffee production has been oscillating widely. It increased from 42,800t in 1963 to a peak of 130,000t in 1983 and 1987, fell to 73,000t in 1993 and rose to 91,000t in 1995. In 1998 it dropped to 68,000t, reached a new peak of 101,000t in 2000 and slumped to 57,000t in 2001.

Yield: Yields are low, at less than 600 kg/ha. To improve production it is necessary to give incentives to the grower and to maximize his share of the fob value. (PW 97:7) Crop husbandry is the main determinant of yield, which varies widely. Between 1963 and 1995, the coffee yield of large estates averages 1,000 kg/ha of clean coffee, small and medium estates 840 kg/ha and smallholders 560 kg/ha. The better small estates achieve 2,000 kg/ha. (PW 97:22)

The input-related cycle of high and low yields: With the system of coffee husbandry and input supply in disarray, high yields in one year are almost invariably followed by low yields in the next. High yields are demanding on the coffee tree, requiring additional inputs to feed the tree. In the absence of such inputs, soils deteriorate in the following year, with negative impact on plant health.

Coffee varieties include high and low input traditional varieties and the **Ruiru 11** hybrid cultivar, which is disease-resistant and cuts input costs by 30% (but requires steady husbandry including regular fertilization to feed the high-yielding trees) (PW 97:35-36). PW (1997:28) calculated the gross margin per day of Ruiru 11 at 528 Ksh/ha in Muranga, compared to Ksh 298 for traditional high-input coffee and Ksh 181 for low-input coffee. Ruiru 11 might solve the problem that disease control by fungicide sprays at the recommended level of 50 kg/ha/year "is technically and financially beyond the means of the majority of smallholders who account for 65% of production." (PW 97:35)

Cost and price: Producer costs differ for smallholders and estates. Smallholders, who employ domestic labor and tend to a kind of organic production using fewer fungicides, incur costs of Ksh 65,000/t; while estates - with hired labor and higher inputs - incur production costs of Ksh 115,000/ on non-irrigated and Ksh 130,000/t on irrigated land. When prices in 1999/2000 dropped to Ksh 100,000/t, many estates sold coffee below cost.

The relative cost of cash inputs is according to the findings of Price Waterhouse (1997:31) not the dominant cause of the apparent neglect of coffee husbandry and declining yield trends. However, KPCU stated that over the past 10 years, the cost the costs of production have doubled and caused many farmers to abandon coffee.
This declining trend has continued. For example, The Thiriku Coffee Growers Co-operative Society in Nyeri (visited on 5 April 2002), with a total of 2,400 members (1,800 of them active members), reported the following production figures:

Table 11: Coffee production reported by Thiriku Coffee Growers Co-operative Society, Nyeri

Year	Production (in kg)	Gross sales (in million Ksh)	Payment to members (in million Ksh)
1999/2000	1,691,776	25.7	17.4
2000/2001	1,009,819	21.2	15.3
2001/2002	873,000		

Relative profitability:
Coffee is being neglected because of a popular belief that tea prices have become more attractive than coffee prices, which is unfounded according to PW findings (1997:32), which concludes:

> "The popularity of tea has increased despite relatively poor price performance….The decline in coffee yields cannot be fully explained by conventional analysis of the relative incentives of different crops, since coffee should be generating attractive returns, if farmers were prepared to devote resource to achieving past yield levels…. Coffee would produce much higher margins than tea, at current prices (1997)." (p. 33)

2.2 Quality

Kenya produces some of the mostly highly valued coffee in the world, albeit in small quantities accounting for about 2% of global production. Its reputation as a high quality blending arabica generates a price premium above other arabica coffees. Quality is of crucial importance as a determinant of price and farmer income. At an auction attended in Nairobi during April 2002, prices per 50kg bag varied from $12 to $280. At the lower end of this range, prices to do not cover the costs of production; they produce losses, which result in the inability of farmers to maintain their standard of living and to repay their loans. The loss of revenue to the coffee sector due to lower than necessary quality has been estimated at $17m per anum (1996 prices, PW 1997:16). The marketing system is set up in such a way that price incentives are passed down to the level of the cooperative factory by maintaining as much information as possible about the source of coffee supplied to the auction.

Determinants of quality: Coffee quality refers mainly to cup quality with its aroma, flavor and mild acidity. It is affected by soil and climate and by crop husbandry and processing. Crop husbandry, ie, the method of cultivation, affects yield, disease losses and flavor. Husbandry activities which determine profitability include fertilizer or manure application, fungicide and pesticide use (affecting level od disease damage), irrigation (increasing yield but reducing quality), pruning practices (affecting bush health and productive cycle), and variety of coffee.

Flavor is influenced by fertilizer input and the selectivity of picking:

- Low use of fertilizer tends to produce cleaner tasting berries;
- hand-picking the ripest cherries ensures good cup quality.

However, the impact of fertilizer input is contradictory, as stated by PW 1997:14:

- The very highest quality Kenyan coffee tends to come from low input smallholders who hand-pick cherries.
- However, the use of fertiliser improves the yield of berries and reduces disease loss, and higher input farms tend to obtain better average quality.

In 1994/95, high input smallholders received 18% higher cherry prices than low input growers. Because of the higher yields, their returns per man-day were almost double. But due to the complexities of crop husbandry, these observations cannot easily be generalized.

Less than 20% of smallholders use high inputs. This may be due to limited working capital; but given the large savings in UBSs and rural SACCOs, there may also be other factors, such as risk management strategies of diversification and more attractive returns from using inputs in other crops.

2.3 How to increase husbandry, quality and income

2.3.1 The tragedy of the commons

Smallholders supply cherry in small amounts – without identification of origin - to pulping factories, where pulping and drying is carried out in bulk. Using density tests, the factories separate the product of this process, parchment, into three or four categories and deliver the different types of parchment as separate outturns to the mills. These are then milled, separated into seven size and density grades, and supplied to the auction in numbered lots. The cup-quality of each grade in each out-turn is liquored by the mill; and additional samples are drawn from each lot to enable CBK and the dealers to test the cup quality before the auction. On the basis of its own liquoring, CBK has allocated a class to each lot as an indicator of quality, ranging from a high of one to a low of ten, to be used in the pool payment system

The weak part of the incentive chain is at the end, where individual farmers are paid by their society **regardless of the quality of the coffee delivered**. To date, the system only ensures the identification of the source pulping factory for each lot; the pulping factory itself is the figurative commons, where different qualities delivered are processed and remunerated in bulk, without incentives tied to individual performance. Extending price premiums for quality to the individual farmer requires innovations discussed below. In the words of the Acting Managing Director of the Coffee Board: "Do not mix up poor and good quality. Take your rubbish back!"

Two field approaches designed to increase of quality and husbandry are presently being experimented with:

- Classifying farmers into A and B categories according to quality of husbandry
- Separating cherries manually at factory level.

2.3.2 A and B farmers - an incentives-driven approach to good husbandry

KPCU has been involved in an incentives-driven approach to break through the *tragedy of the commons*, an ongoing experiment. Farmers of a particular cooperative society are classified into A (good husbandry) and B (poor husbandry), depending on the health of their coffee trees and the quality of their cherries as indicators. They have their coffee processed on different days of the week and differentially remunerated in separate lots. This is expected to serve as a powerful incentive for farmers to apply good husbandry and produce good quality coffee.

To be replicable, it must be combined with a system of effective extension services, which may be provided on a fee basis by extension agents of cooperative societies.

KPCU may play a triple role:

- Establishing and supervising the system of classifying farmers according to levels of husbandry
- Training and supervision of the extention agents at society level
- Establishing and supervising the system of differentially processing and marketing of the coffee delivered to the factories; and providing training to factory managers.

Both services at farm level may be provided either by the proposed field agents of the co-operative societies; or separately by two different agents. Their pay may be composed of a basic monthly stipend by the society and additional incentive payments by farmers who request their services in groups of neighbours. Alternatively, one may also consider a deduction from the coffee proceeds due to the farmer; but given the multitude of deductions already in force, this is less to find favor with the farmers.

2.3.3 Separating cherries according to quality at factory level

Primary processing, comprising pulping fresh cherry, fermenting, washing, soaking, sun-drying in thin layers and eliminating stinkers, is also critical to coffee quality. Wet processing, in contrast to dry processing, produces coffee with a finer aroma, flavor and acidity. Poor control over this complicated process can lead to tainted, sour or unclean flavours with low prices.

At producer level, a heavy, fully ripe cherry translates into the best quality with a high proportion of large heavy beans. This can be tested at the pulping factory through low-technology density methods. Rigorous sorting is essential to coffee quality. This used to be done by society members, but without separation into different categories. Sorting has been largely replaced by wage labor, resulting in a decline of quality.

Organized by EAFCA under its Vice-chairman Simeon Onchere (also Acting Managing Director of the Coffee Board), five cooperative societies in Embu have recently started manually separating cherries delivered at factory level into three categories according to quality. Old men and women are being employed: as a locally available human resource and holder of indigenous knowledge. This has led to substantial improvements in overall quality of processed cherries and financial returns. It is not clear yet whether, and how, there is an impact on the quality of cherries delivered to the factory.

Where the two systems can be combined, and replicated, remains to be seen.

2.4 Extension services

Extension services are essential for the quality of coffee at two levels: the farm and the factory. Both can be organized by KPCU in collaboration with the Coffee Research Foundation.

It has been noted that extension services have largely broken down:

- There are too few extension officers in MOALD&M
- The extension services which used to be provided by a field officer of the cooperative unions are no longer available since they split up in individual societies
- Linkages between research and extension are inadequate
- There is a lack of knowledge among the few remaining extension agents ("They are often less knowledgeable than the farmers" – PW 97:37)
- Farmers "have received very little training in crops husbandry… during the past three years". (PWC 2001:33)
- Farmer field days are not sufficient!

For effective extension services at farm level, societies should designate a farmer acting has a field officer. He may be trained and supervised by KPCU. He may receive a base payment from the society and additional incentive payments from farmers who ask for his services as a group of neighbors. This can be combined with the *incentives-driven approach to good husbandry* (discussed above under 2.3.2). At factory level, extension services can be combined with *separating cherries according to quality at factory level* (suggested above under 2.3.3).

3. Household diversification

Coffee growing is one of several IGA for most smallholders, with both cash crops (coffee, tea, horticulture) and food crops (maize, beans, vegetables) competing for limited

smallholder land. Adequate diversification of subsistence and cash production are essential; otherwise the farmer will be cash-strapped and cannot afford to invest in his coffee trees.

Depending on the area, PW (1997:28) found that tomatoes, groundnuts, French beans, potatoes and dairy had attractive margins (in addition to tea, with by far the highest margins in Kisii). In particular, they found that low-input coffee does not compare favorably with other cash crops, leading to high levels of intercropping. Potatoes and horticulture are attractive alternatives but require high inputs. Fruit and vegetables are the third most important agricultural export product (after tea and coffee), accounting for 10% of total exports in 1995.

One farmer visited in Karangia (Nyeri), who was at the same time a committee member in the Njoroge Karuiru Co-operative Society, listed the following activities on his 1.5 acre farm: 300 coffee trees, 7 beehives, 3 goats, one cow and calf, chicken, fruit trees, banana trees, leak, sugar cane, yams and maize. His main source of income is coffee, augmented by the sale of honey, milk and bananas. There is a dug well on his sloped land; but as the pump is broken, he has to pull water by hand.

Given the fungibility of money, credit cannot be restricted to coffee input. Instead, both savings and credit have to be available to finance a diversified household production.

F. Summary and conclusions

A. From unsustainable input credit to sustainable rural finance

1. The issue: lack of input credit!?

In a workshop in Nairobi in April 2001 organized by CFC and KPCU, it was found that past donor-supported credit schemes in Kenya and other countries have failed to establish a sustainable system of credit for smallholders; some have done more harm than good. Taking Kenya as a model case, the question is now being posed what has gone wrong with input credit in the coffee sector and how can CFC contribute to the establishment of a self-reliant system which is no longer dependent on international assistance.

2. Sustainable rural finance: an infrastructure for sustainable input credit

2.1. A hypothetical framework

In the proposal to the Fund, a hypothetical framework has been presented, placing input credit into the wider framework of a sustainable rural financial infrastructure, which is in turn intricately related to the development of a diversified rural economy, comprising coffee and a range of food and cash crops as well as other income-generating activities.

2.2. Price Waterhouse: the crucial role of sustainable financial institutions

This view has been confirmed by Price Waterhouse (1997), an impartial arbiter, which has presented the most thorough available analysis of the coffee sector in Kenya: commercial banks have been deterred by the influx of cheap money for directed credit; as these schemes failed, there is a need for new approaches; finance belongs into the hands of sustainable financial institutions which are savings- and demand-driven and charge adequate interest rates.

B. Basic data on previously implemented credit schemes

Basic information on the terms and conditions of loans to the coffee sector are presented with a triple qualifier: of inadequate sources of information, incoherent project implementation, and inconsistent World Bank policies on beverage crop projects.

In the light of the finding that the savings of coffee farmers in their SACCOs and other local financial institutions are far higher than their borrowings, there is a basic paradox of coffee finance in Kenya, resulting from the distorting effects of preferential credit: the substitution of external loans for existing cooperative savings.

C. Assessment of previous experience with input credit schemes in Kenya

1. The first Smallholder Coffee Improvement Project (SCIP I) (1979-1987): Did the World Bank learn from the experience?

The project was designed and imposed from above, without local participation. Most of the credit (74%) went into the construction, rather than rehabilitation of wet-processing coffee factories; 14 new factories had been planned for, 183 were built; 280 were rehabilitated (instead of 400 as planned). This led to huge excess capacities, as production failed to increase in subsequent years.

Implementation, ie, the selection of proposals and the allocation of funds, was highly politicised. Standardized blueprints were imposed by government, local technologies ignored. Prices reportedly shot up from Ksh 300,000 to Ksh 3m per factory in a first phase and continued to skyrocket up to Ksh 5-13m. Bereft of effective supervision, this benefited many of those who controlled the flow of funds. Cooperative societies were made to believe that these were relief grants, or they were coaxed into the loans by special incentives or other means. This led to huge debts in the cooperatives far beyond their repayment capacity augmented by interest accruals month after month. In the absence of rising coffee revenues and subsequent downturns, it had a crippling effect on many cooperatives until today and was one of the factors leading to the break-up of the cooperative unions in the 1990s.

The most deleterious impact was on the coffee farmers who are the owners of the cooperatives and are ultimately liable for the repayment. The concomitant reduction of revenues received from coffee reduced their savings capacity and initiated a process of declining input use and coffee maintenance.

The farm input credit component, which was supposed to rehabilitate neglected farms, failed almost completely; only $2m out of the projected $13.4m were spent. Coop Bank was chosen to channel the funds according to imposed administrative criteria, expecting to be assured of repayment through deductions from coffee proceeds at source, ignoring sound banking practices. All decisions were centralized and remote from the coffee-growing smallholders and their cooperatives. There was no effective banking supervision; and no prudential rules were applied.

Government and World Bank failed to first convert the Union Banking Services (UBS) of the cooperatives into self-reliant savings and credit cooperatives (SACCOs) as local financial institutions of the farmers; and to enable them through capacity building to allocate the SCIP resources in an effective way driven by local participation and demand. It is quite unlikely that SACCOs would have accepted ruinous blown-up loans.

A hidden factor of the failure of SCIP I lies in the tradition in the coffee sector to provide finance for annually and semi-annually recurring input requirements, which should be financed from savings. Preceding credit schemes (eg, CPCS) had already allocated credit regardless of the existence of local savings in the UBSs. This is in turn related to the failure of taking finance out of the hands of cooperative unions, which are not financial institutions, and building up autonomous rural SACCOs right from the beginning of the movement in the 1960s.

There is consensus that SCIP I completely failed to attain its objectives of improving the quality of smallholder coffee and rehabilitate neglected farms. Only 58% of the estimated project costs of $62.2m were spent. In a view from the field: “That is the project that made us poor… it impoverished the region and caused the present defaulting.”

2. The Second Coffee Improvement Project (SCIP II) (1990-1997): *Did it have an impact on production, income and sustainable access to credit?*

SCIP II learned from the experience with factory construction in SCIP I by substantially reducing this component and rehabilitating, rather than building, factories. The main emphasis was shifted to a Farm Input Loan Scheme (FILS) and a Cherry Advance Payment System (CAPS). It also included the establishment of an Improved Payment System, which is now generally accepted.

Some of the major flaws of SCIP I were carried into SCIP II: the channelling of funds without local participation and without regard for sound banking criteria; the bypassing of local financial institutions; and the disregard for the wider financial needs of a diversified rural

economy of which coffee is an integral part. Cost of factory construction and renovation continued to rise, and so did overcapacities. In a number of cases, electrification remained incomplete. The debt burden of cooperatives continued to rise.

This led to the fundamental problem of SCIP II: its inability to function satisfactorily under adverse conditions, which included poor rains, fluctuating and falling international coffee prices, and the deregulation of the coffee sector without concomitant prudential regulation. KPCU's loss of its monopoly position in milling undermined the interlocked system of input supply, credit and credit information, coffee delivery, and repayment at source, opening the way for double hypothecation on the same crop. This went unchecked, as there is no credit registry.

Input credit and cherry advances were disbursed generously, without adequate local control – "yours for the asking" in the eyes of many farmers. At the same time, the wider financial needs of the farmers were disregarded, leading to widespread diversion of funds and the sale of fertilizer received as credit-in-kind at a loss. This resulted in declining production, lower incomes and further repayment problems.

As new debts were heaped on old ones carried over from SCIP I and uncontrolled multiple borrowing spread, a spiral of indebtedness set in. Interest payments on overdue loans soared from 15% to 32% and above. With non-performing loans increasing in Coop Bank and other involved institutions to levels of 50% and higher, access to new loans became increasingly difficult, farmers could no longer finance the inputs and neglected their coffee.

In its evaluation of SCIP II, FAO concluded that a rise in income of smallholder coffee producers through increased production was not realized; and the sustainability of the credit component is an unresolved issue. In plain language: many financially involved organizations are threatened by collapse. One of our discussants concluded: "The World Bank project has impoverished the farmers."

3. Stabex: Will it distort or strengthen rural and agricultural finance?

Disbursement of resources available under the 1990/91 transfers began only in 1997, in continuation of SCIP II through Coop Bank. To date, there is no evidence that any of the flaws are being remedied. The recent decrease of the lending rate from 15% to 5% further distorts rural financial markets, making credit even less sustainable. This is now creating an inverted interest rate structure as in the former socialist societies, with fixed deposit rates higher then the lending rate. It is now feasible to borrow Stabex funds from Coop Bank and deposit them in a SACCO at a profit.

PricewaterhouseCoopers (2001: 4, 21) urgently recommends a recasting of the program:

> *"Funds lent now through a flawed system would have little effect as quality will not increase in the short run and prices will not increase."*
> *"This would lead to extreme loan recoverability risks culminating in a possible collapse of the programme."*
> *"There is an urgent need to recast the project."*

The EU in Nairobi is aware of this need and sees the potential of cooperating with CFC in the process. As our discussants pointed out, this is all the more necessary as the program was designed around 1990. As discussants pointed out by our discussants in the field, local financial institutions such as the SACCOs should occupy a central position in a recasted program.

D. Organizations in the coffee sector

The organizations in the coffee sector have been affected, and damaged to the verge of collapse, by two major forces: the World Bank-funded smallholder coffee improvement schemes since 1979; and unregulated liberalization since 1992. With the Coffee Act of 2002, improvident deregulation is now being replaced by prudential regulation, which will hopefully generate a new order of competitive and efficient organizations. SCIP is being replaced by the EU's Stabex funds, with the challenging task of strengthening the emerging order, possibly in coordination with CFC.

The challenge to CFC is to assist KPCU and the core farmers' organizations on pilot basis to set up a sustainable system of services and bring both the smallholders and their institutions back on the road to viability. There are four organizations which may play crucial roles in a pilot project:

1. KCPU is a managed limited liability company predominantly owned by smallholders through their cooperatives. As the preferred miller and warehousing agency, (presumably) future marketer, and provider of extension and financial services, it may occupy a key position as organizer of a pilot project and provider of key inputs and innovations. Like all other organizations in the coffee sector, it has been severely damaged by the turmoil in the coffee sector, but is taking steps to adjust to the new competitive order. Among these are staff retrenchment, management reform, a profit center approach, the establishment of an offshore financial subsidiary for international trade and the cleaning of its portfolio, and the establishment of a marketing subsidiary (both not yet operational). No other organization is as well placed as KPCU to organize extension service at farm level through cooperatives and factory level geared to high-quality coffee.

2. Farmers cooperatives have been compulsory organizations for smallholders in the coffee sector, historically initiated and controlled by government. Political interference, mismanagement and the coffee wars of recent years have led to the break-up of cooperative unions into societies with one or few factories, struggling for viability, and to the loss of members to the small estate sector; their UBSs have been reorganized into autonomous SACCOs. Major challenges are their transformation into genuine professionally managed self-help organizations, the diversification of their membership, and the coping with their debt burden under conditions of diminishing production and membership.

3. Savings and Credit Associations (SACCOs) are the coffee farmers' preferred local financial institutions. Like farmers' cooperatives, the SACCOs are owned by smallholders; their shareholding membership is to a large extent identical. They are savings-based financial intermediaries, with a strong self-financing potential and low access barriers. The outreach of the two SACCOs visited is impressive: 67,000 shareholders and 132,000 depositors in Murata; and 46,000 shareholders and 105,000 depositors in Nyeri. Some of them have only recently been transformed from UBS into SACCOs and had therefore not presented an alternative to Coop Bank for SCIP I and II. This is now different. They are facing to new demands: from members to diversify their IGA; and from non-member depositors for credit, among them many women, self-help groups and ROSCAs. There are two additional major two challenges: the cleaning of their portfolio; and the transition to professionally managed fast-growing financial institutions with adequate financial services to their members. In the pilot project area, CFC may contribute to that transition. The role of the SACCO associations KUSCCO and KERUSSU in this context needs to be further explored.

4. Equity Building Society, which is owned by a broad spectrum of farmers, microentre-preneurs and others, has perhaps the greatest potential on a local scale of providing

sustainable financial services to farmers and helping to reform the SACCOs. Technically bankrupt by 1993, it has been thorough reformed into a highly profitable institution with a full range of commercial banking services to low-income people including tea and coffee farmers, no repayment problem, and spectacular growth. Its lowest commercial interest rates are at the same level as the preferential rates of Coop Bank. Through cooperation with CFC and KPCU, it might substantially expand its services to coffee farmers.; and at the same time transfer its sound banking expertise to the SACCOs.

5. Cooperative Bank has been the channeling agent, under government direction, for the SCIP funds and now of the Stabex funds; but half its portfolio is non-performing. It is now under new management; but it would be audacious to exclude the risk of its collapse, as have suffered so many similar institutions in Africa. If transformed into a wholesale agency with full operational autonomy and sound banking practices applied to all schemes including those financed by government and donors, it might help building a sustainable rural financial infrastructure by investing into SACCOs as its preferred local financial intermediaries. The EU might contribute to this transformation.

6. Kenya Commercial Bank, the small estate farmers preferred bank, has suffered a similar fate as Coop Bank, with half its portfolio non-performing. It has several small-scale loan schemes of minor importance, among them a tea and coffee farmers scheme.

7. Self-help groups including informal financial institutions (ROSCAs) are ubiquitous among the farmers and among the deposit account holders of SACCOs and other financial institutions. Their outreach and linkage potential in the pilot project needs to be further explored.

8. A credit registry or credit information system is urgently needed by the institutions in the pilot project area. This needs further study.

9. Savings and credit services offered by local financial intermediaries need to be balanced without undue bias. Savings have to be built up for the financing of recurring seasonal input credit and for the smoothing of the effects of price fluctuations. Credit is of importance for the modernization or expansion of coffee production. Through tied savings-cum-credit products, savings and credit can be built up as complementary, combining the relative strengths of self-financing with external financing in a dynamic way.

E. Coffee and coffee producers: *Only quality pays*

1. Coffee producers

Smallholders produce the very best and the very poorest quality of coffee. They comprise two categories: smallholders organized in cooperatives; and small estate farmers, who have left the cooperatives. Among smallholders, the whole family is involved, with women and children playing the major role. More attention needs to be paid to women as co-producers of coffee and as agricultural and non-agricultural producers of their own standing.

2. Quantity vs. quality of coffee

With a price range per 50kg bag of coffee at auction from $10 to $300 and beyond, production must be oriented towards quality, not quantity. With family labor, a smallholder can handle 250 coffee trees, which may yield a substantial profit, while 500 or 1000 poorly maintained trees may yield substantial losses.

The tragedy of the commons has affected the quality of coffee, as pulping and drying is normally carried out without identification of smallholder origin. Quality of coffee and smallholder income may be substantially improved through one of the following techniques:

(i) classifying farmers into A and B according to the quality of their husbandry and processing their deliveries on different days of the week as separate lots
(ii) separating cherries according to quality at factory level.

Extension services at farm level and factory level are of utmost importance to the quality of coffee. Good husbandry is a very complex process, in which local and expert knowledge must be carefully balanced. KPCU may play a crucial role:

- Training and supervision of extension agents at society level to provide farm-level extension services
- Establishing and supervising the system of classifying farmers according to levels of husbandry
- Establishing and supervising the system of differentially processing and marketing of the coffee delivered to the factories
- Providing training to factory managers and technicians.

F. Conclusions

1. Constraints and weaknesses:

- Donor-driven and government-controlled credit schemes in the coffee sector during the 1980s and 90s have largely failed.
- Easy money has undermined the self-reliance of farmers and financial institutions.
- Imprudent liberalization without concomitant prudential regulation has further aggravated the problem,.
- The ill-designed and poorly implemented credit schemes together with haphazard liberalization have jointly led to the breakdown of the interlocking system of coffee finance and caused the so-called coffee wars during the second half of the 1990s.
- As a result, most coffee farmer households and supporting institutions are heavily indebted; this in turn has further restricted their debt capacity.
- Many farmers have abandoned or neglected coffee, leading to a decline in quantity and quality of coffee production.
- Farm-level extension services have all but broken down, leading to inadequate husbandry and input use (e,g, fertilizer instead of lime).
- The use of local knowledge has declined (eg, intercropping is improperly done; credit-financed fertilizer has replaced compost and manure).[29]
- Husbandry including input use has suffered; incomes have gone down
- Declining coffee revenues in connection with overindebtedness and improperly balanced agricultural and non-agricultural income-generating activities have made many farmers poorer.
- A number of farmer cooperatives have dissolved.
- Many financial institutions directly or indirectly involved in the financing of coffee from donor funds – among them Coop Bank – are burdened with a large non-performing portfolio and therefore technically at the verge of collapse.
- Subsidized targeted credit has distorted rural financial markets, undermined financial institutions and prevented scarce financial resources from flowing into a diverse and risk-balanced range of investments, including investments with the highest rates of return.
- It is widely claimed that over the past twenty years, donor-supported credit schemes have had a negative effect on the farmers, their cooperatives, their financial institutions and the country and have made them poorer, not richer.

[29] S. Onchere,Acting Managing Director of the Coffee Board, that there has been a tendency of ignoring knowledge and practices of the colonial past of Kenya and that there has been a gradual loss in professionalism;adding: “Knowledge has no color.”

2. Strengths and opportunities:

- All new development results from crisis. The experience of failed donor credit schemes and of the coffee crisis provides a positive basis for a fresh start.
- Imprudent deregulation is currently being replaced by prudential regulation of the coffee sector, opening up new avenues for a competitve order in the coffee sector.
- A number of smallholders produce high-quality of coffee; many more – but certainly not all - have the potential of doing so.
- A number of smallholders have left their overindebted cooperative societies and are taking a fresh start as small estate farmers.
- With increasing diversification of the rural economy, farmers are facing new opportunities of diversifying their household income through a wide range of agricultural and non-agricultural IGA.
- There are new opportunities of risk management for coffee farmers, improving their subsistence and food security through additional combined food & cash crops
- From the dissolution of mismanaged cooperative unions, smaller-size farmers' cooperative societies have emerged some of which are undergoing a process of restructuring and consolidation.
- A number of cooperative and non-cooperative local financial institutions have evolved which vigorously mobilize deposits and provide sustainable financial services to the local population.
- SACCOs are facing a new market: lending to depositors who are at present still barred from membership because they do not belong to primary cooperatives; and diversifying their portfolio by responding to the demand of old and new members for loans for a wide range of purposes, including agricultural and nonagricultural IGA
- KPCU, while having lost its monopoly position in milling, appears to have retained much of its strength and is in the process of building a new strength in a competive environment.

3. Building an integrated sustainable system of coffee finance on a pilot basis

The problems of the coffee sector in Kenya will not easily be resolved . But it might one might demonstrate on a pilot basis how donor resources can contribute to the development of a sustainable system of finance for the coffee sector as an integral part of a diversified rural economy with healthy institutions and self-reliant rural households. The following elements would be required:

- The strength and growth of coffee in a given area are related to the strength and growth of the rural and agricultural economy in that area: a diversified rural economy requires and supports a sustainable system of financial, institutional and human resources as inputs for the coffee sector available over time regardless of sectoral ups and downs; conversely, a strong coffee sector can be a dynamic force supporting the diversification of the rural economy (both with its profits at good times and its need for inputs at bad times) and leading to the emergence or transformation of strong rural financial institutions
- The viability and growth of rural households and rural financial institutions are intricately related: Farmers need to deposit and accumulate savings for future consumption and investments; these savings are in turn needed by local financial institutions as loanable funds.
- Savings are of particular importance in financing investments with low returns, such as subsistence crops and, at times, coffee.
- Farmers need access to loans on appropriate terms for diverse investments with high rates of return; these loans – repaid on time - are in turn the basis of the local financial institutions' profitability.

- Farmers require financial and extension services for coffee, food & cash crops, and other IGA – not at the expense of each other but mutually reinforcing.
- Extension services must be (re-) oriented towards quality rather than quantity of production. This includes an orientation towards quality-oriented decisions (such as applying a limited quantiy of fertilizer to 100 trees rather than 300, perhaps cutting back the remaining 200 for production in a later season when more fertilizer might be available).
- Local financial institutions require capital and capacity building to grow into healthy financial intermediaries, mobilizing their loanable funds through deposits from all segments of the rural population and lending for all purposes according to demand.

4. Improving coffee husbandry and the quality of coffee: *Do less, but do it well*

Individual farmers and their cooperative societies must both learn to realize that only quality pays. At the individual farmer level, income from 250 well-maintained trees may be far higher than income from 500 neglected trees; in fact, the former may be highly profitable, the latter loss-making. Similarly, societies may profit far more from members who produce high quality than from those who produce low quality; in fact, the latter may cause losses for the society and be advised to stop growing coffee (or improve quality), or the society may refuse to accept their low-quality coffee.

This requires a system of identification and direct reward for individual performance in terms of crop husbandry and quality of product delivered.
Two measures are required:

- Farm-level extension services, to improve coffee husbandry.
- A classification of farmers into A (good husbandry) and B (poor husbandry), who have their coffee processed on different days of the week and differentially remunerated in separate lots. This will serve as a powerful incentive for farmers to apply good husbandry and produce good quality coffee.

The role of societies and KPCU: Both services may be provided by field agents of the co-operative societies. Their pay may be composed of a basic monthly stipend by the society and additional incentive payments by farmers who request their services in groups of neighbours. It may be the role of KPCU to instal and monitor the system and to train and supervise the field agents of the societies.

Another approach, either alternative or complementary, involves manually separating cherries according to quality at factory level.

Both systems are still in their experimental stage. The feasibility of extending these system on a broader scale, including perhaps groups of smallholders who have left their cooperative societies and become small estate farmers, needs to be further examined.

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