



## **Building partnerships between fair trade and rural micro-finance**

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**Improving access to financial services for  
producer organisations and family farms  
associated with fair trade**

*Concept Note*

**AGROFINE, CERISE**

**November 2007**



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## Building partnerships between fair trade and rural micro-finance

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### Improving access to financial services for producer organisations and family farms associated with fair trade

#### AGROFINE-CERISE

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The global liberalization of recent years has left many family farmers struggling to make a living from what they produce. Fair trade developed in response to this situation, as a means of giving farmers in Southern countries an opening into the market and guaranteeing them “fair”, stable prices that will allow them to increase their incomes. Yet family farmers are still hampered by their lack of access to funding. To date, micro-finance has proved to be of limited use in meeting their needs, and producer organisations are increasingly concerned with finding ways of overcoming these financial constraints. This is a key issue for them, and is of particular importance given current initiatives to build pre-financing into the marketing of fairly traded products.

One way of tackling this problem is to build stronger partnerships between fair trade and micro-finance to improve funding for family farming and rural economies.

#### **1. The context: limited funding for agriculture**

##### ***1.1 The funding requirements of producer organisations is not entirely fulfilled by the fair trade***

Fair trade is an alternative that enables family farmers in the South to get better value from their produce. It is no exaggeration to say that it has had a major impact on incomes in rural economies, and that these rapidly expanding niche commodity chains are a way of securing higher and more stable incomes for small producers.

But producers still need credit, and their lack of access to sustainable financial services and widespread dependence on expensive and limited informal sources of credit are undermining the potential of these commodity chains and limiting the ability of producer organisations to contribute to local economic development.

Fair trade commodity chains are addressing this issue by providing producer organisations with temporary financial assistance, particularly in the form of pre-financing. However, the needs of producers in these supply chains exceed current levels of pre-financing from the fair trade sector. Furthermore, lack of information and poor timing prevent many producer organisations from making full use of the limited funding available, while some importers are reluctant to pursue this option due to risks involved – potential problems with liquidity, insufficient forms of guarantee, concerns about the management of producer organisations, etc.

We need to identify more sustainable solutions that can be adapted to different contexts in order to break the vicious circle of producers’ reliance on informal sources of funding, and to strengthen alternative fair trade commodity chains and increase their investment potential.

## **1.2 *Micro-finance is not developing in step with the needs of the agricultural sector***

Micro-finance is designed to be a tool for financial inclusion, offering services to the “non-credit worthy” – those who cannot provide guarantees or who live in remote areas where there are no financial services. Its ambition is to combat poverty by bringing the marginalized into the workings of the economy and restoring their dignity to them. In order to respond to this desire for inclusion, micro-finance institutions (MFIs) operate on the basis of social links and work closely with beneficiaries.

Despite significant levels of activity in rural areas, micro-finance is rarely used to fund investments in agriculture, particularly through producer organisations. Most micro-finance in these areas is directed into rural micro-enterprises, commerce and food processing rather than agricultural activities, which carry higher risks and require the kind of medium- and long-term investment that micro-finance cannot always provide, given the short-term nature of most of its resources. Furthermore, producer organisations are often seen as unreliable entities with poor credit background and questionable internal management.

## **1.3 *Producer organisations adopting diverse strategies to improve their access to funding***

The difficulties faced by producer organisations seeking funding for agriculture are catalogued in various studies undertaken in West Africa, Madagascar, South East Asia and Central and Latin America since the late 1990s.

Many of these organisations are ill-equipped to secure funding, as they have no information on financial institutions, lack the capacity to formalise their funding needs, find it difficult to make contact with financial institutions and prepare funding applications, have poor management capacity and governance skills, and face a lack of equity or assets to offer banks as warranties.

Producer organisations have put a lot of effort into the rural financial services sector, developing three main strategies to gain access to funding: 1) by providing financial services for their members; 2) by creating their own financial institutions; 3) by developing partnerships with rural micro-finance institutions. These strategies have had mixed results, highlighting the complexity of the financial services supply and the problems associated with partnerships (see Appendix 1).

## **1.4 *Finding synergies between fair trade and micro-finance***

One good way of opening up new avenues of funding for producer organisations and their members is by strengthening the links between micro-finance and fair trade. Both have proved their worth as development tools and share the same operating principles – wanting to be effective in targeting poor households and those excluded from classic banking or commercial systems; putting in place sustainable structures (financially sustainable MFIs); seeking stable and profitable outlets and optimising fair trade marketing and distribution channels, etc. Both are committed to scaling up their efforts through vigilance and constant endeavours to reinforce the social impact on beneficiary households (fair trade and labelling standards, thought on social performance assessment in microfinance sector).

Fair trade is a means of:

- Decreasing the risks to agricultural production by guaranteeing prices and providing stable (and increasing) outlets to meet growing demand in Northern countries; and ensuring quality in the production.
- Reducing doubts about the reliability and management of producer organisations through FLO standards requiring transparent governance, fair trade premiums that can be invested in capacity building and, indirectly, by making export supply chains more structured and competitive.
- Finally, by offering a source of funding that operates according to fair trade standards and which will be able to offer substantial, secure and stable resources by establishing a guarantee fund.

Another advantage of the micro-finance sector is its thirty-year track record of innovative initiatives to secure finance for individuals and micro-enterprises. It now has a considerable body of experience in financing producer organisations, and has established good relations in many countries through its support for MFIs and POs.

Recourse to the micro-finance sector has the dual advantage of reassuring importers that the organisations they work with will be well managed, while diversifying sources of funding for producer organisations and their members. This could mean that MFIs will be interested in investing in fair trade commodity chains in return for guarantees and tailored sources of funding.

These observations suggest that linking micro-finance with fair trade will facilitate the development of innovations that will remove the constraints identified above and make funding the agricultural sector a much more attractive prospect.

## **2. Synergies between micro-finance and fair trade: an innovative project to secure funding for agriculture**

CERISE and AGROFINE are now joining forces to build on the respective achievements of fair trade, micro-finance and their own interventions, and develop innovative mechanisms to fund agriculture within the framework of fair trade commodity chains and their associated producer organisations.

### **2.1 The project's aims and objectives**

To determine the extent to which the funding tools used by fair trade (particularly pre-finance) can be used as leverage for micro-finance for fair trade producers.

This approach is based on two hypotheses:

(1) fair trade funding will become more effective (more transparent, secure, professionally managed and responsive to needs) if it passes through professional funding structures (whether these are MFIs that are subsidiaries of POs, independent MFIs or even local banks).

(2) if they can manage funding from fair trade initiatives, MFIs and other professional financial structures will be strengthened and encouraged to expand and diversify the services they offer to producer organisations and their members.

Specific project objective

The Cerise-Agrofine programme aims to build a funding mechanism for agriculture within the framework of fair trade commodity chains, based on tripartite partnerships between POs, MFIs and

funding agencies (usually an importer offering pre-finance) and secured by a guarantee fund dedicated to fair trade.

By participating in the fair trade supply chain producer organisations will benefit from the advantages cited above. Financial institutions will receive funding, mainly from importers, while the funding agencies' position will be secured by a specially created guarantee fund (see point 2.3 below). Where there is already a financial institution (FI) operating in the PO's intervention zone, the PO and FI can develop a partnership (see point 2.4 below); if there are no reliable FIs, the PO can create one (see point 2.5 below). POs will define their own financial service needs and those of their members with the MFI, and may receive technical support.

The project will work on the conditions for negotiating and implementing this partnership to ensure that it is effective and sustainable, and can meet the financial needs of fair trade producer organisations and their members. This will entail defining new practices, identifying forms of guarantee and new forms of contract between the different intervening agencies, as well as working on norms and decision-making tools to support these new partnerships.

The project will be systematically and professionally implemented to ensure that it delivers a credible and effective system of pre-financing that is designed in accordance with fair trade standards and capable of achieving the desired impact.

## **2.2 Project achievements to date**

Agrofine and CERISE have undertaken two complementary activities through their members:

- Diagnostic analysis of fair trade organisations wishing to engage in actions to strengthen funding mechanisms for their members. This study was undertaken in three countries in 2006-2007: Peru, Bolivia and the Dominican Republic, under the auspices of the Institut des Régions Chaudes<sup>1</sup> partnered by Agrofine (Bernard & Kessari, 2006; Garino, 2006; Geiger, 2006).
- Building on experiences supporting producer organisations engaged in creating financial organisations in the state of Oaxaca, Mexico, led by IRAM through the PATMIR programme of technical assistance for rural micro-finance. This programme supported three large fair trade organisations serving tens of thousands of agricultural producers: CEPCO, Comunidades Campesinas en Camino and Esperanza Indígena Zapoteca.

After the first syntheses of these works were presented and discussed by AGROFINE and CERISE in 2007, joint reflection on the nature of this innovative tripartite partnership resulted in plans for a combined intervention to create a guarantee fund and identify an appropriate support mechanism.

## **2.3 The place for a guarantee fund**

Because producers are under-capitalised, a system of pre-financing was introduced for imported produce. Within this framework, it is standard practice for European or French importers to give producers in partner Southern countries an advance on the purchase price of their merchandise, payable when the order is placed. This is often paid in the first stages of harvesting or processing agricultural produce. To address the significant risks associated with this system of advances, it was decided to set up a guarantee fund to cover the risks taken by fair trade importers.

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<sup>1</sup> ex CNEARC, the Centre National d'Etudes Agronomiques des Régions Chaudes.

As currently envisaged by Agrofine, the objective of this fund is to cover the pre-financing of such purchases.

#### **Guarantee funds as a means of securing pre-financing for fair trade**

It was proposed that a guarantee fund should be created to cover the risks taken by fair trade importers (see Appendix 2).

The objective of this fund is to cover the pre-financing of purchases with an estimated value of around 15 million euros.

A pilot phase for the guarantee fund will start in 2007, with French importers/enterprises participating in fair trade and the coffee and cocoa commodity chains.

The estimated initial capital requirement is 750,000 euros, which is expected to increase to 2.5 million euros between 2008 and 2009.

Under the proposed arrangement, 50 producer organisations in over 20 Southern countries will benefit from this guarantee for fair trade pre-financing, which is coupled with technical support for beneficiary producer organisations.

#### **2.4 The mechanism for existing MFIs**

The benefits of fair trade in alliances between producer organisations and MFIs may be a determining factor in facilitating strategic rapprochements and encouraging micro-finance institutions to look favourably on funding for agriculture.

Fair trade not only helps reduce the level of risk associated with funding agriculture, but also provides an opportunity to gain access to resources that are tailored to agricultural needs in terms of volume, kind, cost and duration, etc.

Therefore, defining innovative mechanisms is a matter of identifying the products, forms of guarantee and level of costs (especially interest rates) that meet the needs of producer organisations and their members and respond to the constraints facing MFIs.

Beyond the technical definition of products, it also involves building support to foster partnerships between producer organisations and MFIs (or more generally, financial institutions, or FIs). These partnerships will not develop spontaneously, despite the fact that MFIs are starting to move closer to fair trade producer organisations with proposals for various types of contract.

#### **Support in building partnerships between producer organisations and FIs**

The training-action procedure (see Appendix 3) has been tested with producer organisations experiencing funding problems, and with financial institutions working in the areas covered by producer organisations. The aim is for stakeholders (POs and FIs) to acquire the basic knowledge required to understand the rural financial sector by resolving a concrete financial problem.

The training activity has a three-fold objective:

- To give POs basic knowledge of rural finance through training on the analysis of financial problems;
- To raise awareness of the benefits of working with POs among FIs in the intervention zones covered by producer organisations, and give them the basic knowledge needed to understand and evaluate producer organisations;

- To assist POs in preparing a funding application for submission to one or more FIs in the area.

The procedure is based on 5 stages of training and action:

1. Analysis of the POs' funding needs and constraints
2. Analysis of existing funding opportunities
3. Raising awareness among FIs of the problems associated with funding for agriculture; PO assessment
4. Analysis of available funding in relation to the POs' funding requirements
5. Preparing a funding proposal in conjunction with the PO.

If the procedure is completed, it should lead to a funding dossier being prepared and submitted to a financial institution in the area, and to the PO progressively assuming responsibility for negotiations with the financial institution.

This procedure for building partnerships can be refined and adapted by producer organisations working in fair trade commodity chains. This will not only allow them to capitalize on the advantages of the supply chain when building partnerships, but could also open the way for POs and FIs to discuss the types of service offered by innovative FIs in relation to their standard services – taking account of the specific needs of the PO and its members and secured by pre-financing and the fair trade guarantee fund, which should help release the necessary resources to finance the partnership.

In addition to periodic training, the procedure will be standardized in a guide to PO-MFI partnerships within the framework of fair trade.

## **2.5 Creating subsidiary financial organisations**

One major – and often insurmountable – constraint to this option is the cost and duration of implementation. These financial organisations may be unsustainable in the medium or long term, on account of their restricted client base, agricultural specialisation, dispersed membership and intrinsic operating costs (technical assistance, infrastructure, competent staff, providing sufficiently diversified services, information and management systems, etc.). Despite this, many POs do go for this option.

Under favourable conditions, the tripartite relationship could be based on a financial institution created by the PO.

### **Financial institution created by a farmer organisation**

This model for a micro-finance institution (MFI) created by a producer organisation (PO) is based on three experiences in rural regions in the state of Oaxaca in southern Mexico (see Appendix 4).

Before embarking upon the long, risky and expensive process of creating a financial institution, it is important to ensure that the environment is favourable to such an undertaking. Key factors in the success of this type of project are:

- A producer organisation that has the capacity to carry this type of project and is highly motivated to create an MFI;
- A favourable environment (buoyant market, clear juridical-legal context, etc.);
- Opportunities to access financial resources to cover investments, initial costs, credit, etc.;
- Technical assistance to support the structure from the outset.

Subsequent stages involve:

1. Defining the MFI project: strategic and financial planning procedures developed on the basis of situational analysis;
2. Establishing the network and implementing the activity: legal structure, setting up the network, recruiting and training staff, setting up an information system, determining the place for savings and external refinancing, etc.;
3. Geographic development / diversifying products in order to broaden the MFI's target public.

Budget estimates in the Mexican case

The average investment budget can be broken down as follows:

- Year 1: 20,000€ for the central bureau and each branch, to cover the cost of computer equipment, furniture and fittings, licensing the information system, promotional materials, vehicle for central office, etc.
- Year 2: 10,000€ to cover the purchase of motorbikes for the offices, promotional materials, contract for technical assistance with the information system, etc.

In terms of operating costs, the annual budget for an agency with two paid employees is around 25,000€ to 30,000€, based on Mexican pay levels and the legal requirement for supervision by a federation, which is very expensive during the MFI's start-up phase. In addition to these direct agency operating costs, there are the 'office costs', which are estimated at between 50,000€ to 60,000€ per annum, taking account of the same requirements for supervision and the cost of centralised management.

In the programme in Mexico, investments were fully subsidised and 50% of the operating costs covered, diminishing to 30% over 3 years.

Technical assistance and training.

The programme was mainly based on technical assistance and training for all actors in the MFI – from the elected directors and managers to the administrative and operational staff. Moreover, a permanent "advisor" from the project's regional staff was assigned to each MFI to support the process of creating and developing the structures. Specialist technical assistants were also brought in to deal with specific problems, such as computer technology, marketing, accounts and management.

During their first three years these MFIs benefited from a very favourable environment for the launch of their activities. This enabled them to successfully deal with two problems:

- Developing appropriate and accessible financial services for people that had never had access to such services, beyond simply responding to the needs of promoter producer organisations;
- Creating MFIs in accordance with a very cumbersome and restrictive new legal framework for small-scale rural institutions, and achieving financial and operational balance within a short 2-3 year timeframe.

While the pre-financing made available through links with fair trade can facilitate the creation of MFIs, it will not cover their subsequent costs or technical support needs. MFIs that remain too closely linked to a PO will be over-dependent on a restricted client base that essentially revolves around agriculture – in which case, the tripartite arrangement will not necessarily bring much added value to

the enterprise, contrary to what might be envisaged when building a partnership with an existing financial institution.

## **2.6 Internalising financial services**

Producer organisations are sometimes tempted to internalise financial services, seeing this as an opportunity to offer their members new services, develop a desirable source of income and capitalize on pre-financing, etc. They frequently under-estimate the costs and difficulties of providing these services, thinking that they will be able to offer their members a cheaper and more appropriate service than those available from MFIs. However, numerous studies and experiences have highlighted the constraints associated with this option: the lack of professional skills and tools needed for healthy credit management; the difficulty of managing several different economic activities within a single structure; conflicts of interest (because they are supposed to represent and support their members, producer organisations find it very difficult to exert the pressure needed to get these members to repay their loans); and lack of savings services that creates long-term dependence on external sources of credit. Given the risks and severe limitations of this option, it should only be seen as an interim alternative to be used before the PO can implement a long-term solution. It cannot be directly supported, and producer organisations should be advised to move away from this model and build a tripartite relationship linked to an external financial institution.

## **3. Operational set-up of the Agrofine-Cerise project**

On the basis of these observations, the project partners plan to:

1. Present the hypotheses of this assessment and explore them in greater depth with the various actors involved in fair trade and pre-financing for fair trade initiatives: producer organisations, importers, technical and financial partners.
2. Conduct a preliminary study on the technical mechanism and how it links in with the guarantee fund, to support the standardisation of fair trade pre-financing and raise awareness of these issues among actors in fair trade commodity chains.
3. Over a 3 to 5 year period, pilot implementation of this mechanism, which will help fair trade producer organisations implement their strategy to improve small producers' access to financial services, either by creating specialist financial institutions or by building partnerships with existing institutions. This mechanism will:
  - a. respond to the demands of organisations that have decided to become involved in the process;
  - b. respect the management practices followed by the financial services and international risk management practices, in order to optimize conditions for mobilizing guarantee funds;
  - c. ensure that operations to pre-finance the production and marketing of produce conform to the principles of fair trade.

Standardized procedures will be used to mobilize recognised national and sub-regional expertise in the rural micro-finance sector. If this is not possible, start-up finance will be managed within the regulatory framework to ensure that the financial services developed in this way are sustainable.

IRAM has been mandated by AGROFINE-CERISE to run the operational arrangements for this project.

Systematic and professional implementation of this set-up will ensure that it is credible and effective, and that the pre-financing system designed according to fair trade standards has the desired final impact.

Under this framework, the links between fair trade and micro-finance will help create a stronger micro-finance sector (diversified and expanded services that take account of the needs of populations that are still marginalized or excluded), and reinforce the commercial and social aspects of fair trade supply chains (supporting supply-side development and responding to the growing demand in Northern countries, responding to the needs of producer organisations and target producers).

### **Expected results of the preliminary study**

- Confirmation that importers are interested in improving the efficiency of their pre-financing tools by adapting to producers' needs, working on customer loyalty and obtaining more secure funding (work meetings, studies).
- Progress on the feasibility study on the tripartite arrangement between POs/importers/local financial institutions (economic and legal analysis, strategic thinking, case studies).
- Identification of POs and MFIs that are ready to work on this type of arrangement, and more detailed consideration of their specific needs.
- The basis for a more operational mechanism to support partnership arrangements.