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AFGHANISTAN

AGRICULTURAL CREDIT ENHANCEMENT PROGRAM

CREDIT MANAGEMENT UNITS

TECHNICAL REPORT

NOVEMBER 2012



CREDIT MANAGEMENT UNITS TECHNICAL REPORT

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The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.





Punjab Seed Company

Crop: Wheat
Variety: Herat-25
Lot No: PHSC-25
Net Weight: 50 KG
Position: 25
Not eat or feed to

Punjab Seed Company

Certified Seed
Wheat
Herat-25
Lot No: PHSC-25
Net Weight: 50 KG
Position: 25
Not eat or feed to Animals

CREDIT MANAGEMENT UNITS

TECHNICAL REPORT

NOVEMBER 2012

Program Title:	Agricultural Credit Enhancement Program
Contract Number:	EDH-00-05-00004
Contractor	Development Alternatives Inc.
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Contracts Officer Technical Representative:	Ali Ahmad
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ABBREVIATIONS AND ACRONYMS

ACE	Agricultural Credit Enhancement
ADF	Agricultural Development Fund
CMU	Credit Management Units
DAI	Development Alternatives Inc.
GIRoA	Government of the Islamic Republic of Afghanistan
MAIL	Ministry of Agriculture Irrigation and Livestock
USAID	United States Agency for International Development



EXECUTIVE SUMMARY

The Agricultural Development Fund (ADF) is the result of the collaboration between the Government of the Islamic Republic of Afghanistan, represented by the Ministry of Agriculture, Irrigation and Livestock (MAIL) and the Ministry of Finance (MOF), and the United States Agency for International Development (USAID). This collaboration was made official through a bilateral agreement signed by the 3 parties on July 21, 2010.

The support from the United States Government consists of a grant of US\$100 Million to provide credit to small commercial farmers through Afghanistan, with the use of financial and non financial institutions and channels, understanding that the ADF is a wholesale lender.

The Agricultural Credit Enhancement Program is a USAID contract awarded to Development Alternatives, Inc. (DAI) to establish the infrastructure for the operation of the ADF, build the capacity of its staff and ensure the operation, sustainability and the integrity of the fund following the transition to the government of the Islamic Republic of Afghanistan.

The ADF was designed to lend most of its capital through financial intermediaries, while making a small number of loans to large agribusinesses, as a way support the growth of Afghan agriculture by increasing production and enhancing processing capacity.

The reluctance of financial institutions to engage in the provision of agricultural credit prompted a strategic shift in the implementation of the ACE program. The Credit Management Units (CMUs) arose from the need to provide credit to farmers without the participation of financial intermediaries, a challenging proposition in a context characterized by costly contract enforcement, weak institutions and a volatile security situation.

In essence, the CMUs are small branches of the ADF located within non-financial intermediaries, such as cooperatives and farmer associations. Their fundamental purpose is to process, disburse and recover loans provided to individual farmers. The costs of the CMUs are covered with contributions from the 'host organizations' and small grants from the ADF, and have proven to be an effective and efficient mechanism to build the competence of non-financial intermediaries in the area of credit management. CMUs have allowed the ACE program to support over 9,000 farmers in the last 2 years.

Thanks to this and other innovations, the ACE program has disbursed loans in excess of US\$23 million to over 15,000 rural households in 30 provinces of Afghanistan, maintaining a default rate of 1.32 percent, substantially below the norm in more stable environments.

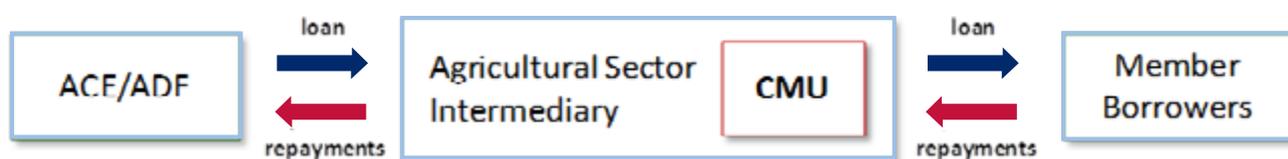
OVERVIEW

This technical report presents a framework upon which the Agricultural Credit Enhancement (ACE) program and the Agricultural Development Fund (ADF) are cooperating with agricultural sector intermediaries to deliver financing to member borrowers via the establishment and operation of Credit Management Units (CMUs).

While the ADF was originally conceived with the idea that the majority of its funding would be deployed through the Afghan financial system (including banks, non-bank financial institutions and microfinance institutions), institutional weaknesses and the unwillingness of the financial sector to take on risks associated with the agricultural sector made this approach unviable.

As an alternative, ACE/ADF has devised the CMUs as a critical mechanism to enable beneficial collaboration with agricultural sector intermediaries (e.g. cooperatives) in order to prudently administer financial resources to their members. Since most of these organizations have not previously managed lending programs, they have not yet established the institutional capacity to manage such activities. Therefore, by establishing appropriate credit administration structures and processes, the purpose of the CMUs is to enable ACE/ADF to provide financing to non-financial institutions in the agricultural sector and to ensure orderly repayment of present and future loans, while simultaneously strengthening the institutional capacity of agricultural sector intermediaries to manage credit activities.

ADF/ACE CMU INITIATIVE



Using this innovative mechanism in 2012, ACE/ADF approved 43 loans to agricultural sector intermediaries valued at \$30.8 million, and in parallel supported the establishment of CMUs at each organization. This collaboration has enabled the provision of financing to almost 9,203 member borrowers.

CURRENT CMU ACTIVITY

Intermediary	Location	Activity	Loan Amount	Grant Amount	Member Borrowers	Projected CMU Staff
ANSOR	Kabul	Seed Program	\$4,950,000	\$168,200	60	12
EFGA	Jalalabad	Fruit	\$500,000	\$96,200	1,620	7
AAIDO	Kabul	Almonds	\$800,000	\$49,090	300	7
Total			\$5,533,000	\$313,490	1,980	14

ACE/ADF will continue replicating this approach in order to achieve the objectives of the project. It is projected that ACE/ADF will eventually initiate long-term collaboration with 10 to 15 agricultural sector intermediaries to establish corresponding number of CMUs. It is expected that two tiers of intermediaries/CMUs will be developed, outlined as follows:

1. Tactical Intermediaries: Opportunity to support well placed intermediaries to reach targeted agricultural subsectors.
 - Smaller, less sophisticated CMU 'hosts'.
 - Smaller loans, fewer member borrowers, smaller CMUs.
 - Lower probability of becoming clients of commercial lenders.
 - CMU may discontinue credit operations at the conclusion of the ACE/ADF loan program.
 - Minimize credit risks through installation of clear and simple credit controls and restricted loan terms.
2. Strategic Intermediaries: Opportunity to increase long-term sustainability, characterized by the following.

- Larger institutions, which are likely to take repeat loans.
- Multiplier potential of member borrowers to reach greater number of beneficiaries
- Mature organizations with established technical capacities.
- Greater likelihood of covering costs of credit activities through generated income (spread between interest/fee expense and interest/fee income).
- Potential to continue diversified borrowing from other lenders.
- More flexible loan terms to support reflows of loan funds.

This segmentation provides opportunities to customize development approaches to the specific needs of each type of intermediary including loan structuring, grant design and technical assistance provision. Understanding that grant funds are limited, the long-term sustainability of Strategic Intermediaries is supported by the development of institutional capacity over the course of collaboration with ACE/ADF program. Alternatively, over the long-term, ADF may decide to continue the establishment and operation of CMUs at Tactical Intermediaries in order to support service delivery to agricultural sector beneficiaries funded by interest/fee income generated by ADF lending activities.

1 For the purposes of this document, references to 'financing', 'credit' and 'loans' are used interchangeably to discuss financial transactions between parties including advances, receivables, and Islamic financial products as applicable.



PROJECTED CMU ACTIVITY 2012 TO 2013

indicative estimates

Tier	Quantity	Average Loan	Total Loans	Average Grant	Total Grant	Total Borrowers	Total Beneficiaries
Strategic	5	\$5m	\$25m	\$200k	\$1m	500	25,000
Tactical	10	\$500k	\$5m	\$50k	\$500k	10,000	10,000
Total	15		\$30m		\$1.5m		35,000

This document outlines the basis upon which CMUs are to be established and operated, including discussion of purpose, structure, functions and processes. It is intended to lay the foundation for continued development of internal structures and processes within ACE/ADF to support the CMU initiative.

ESTABLISHMENT OF CMUs

The formal basis upon which the relationship between ACE/ADF and agricultural intermediaries are established include a loan agreement for the provision of financial resources, and a grant agreement to support the establishment and operation of the CMU. In order to avoid misunderstanding and establish clear boundaries for the scope of the CMU activity, it is critical that the terms and limits of the collaboration between ACE/ADF and agricultural sector intermediaries is clearly stated and understood.

1. **Loan Agreement:** The loan agreement outlines the terms of the financial transaction between ACE/ADF and the agricultural intermediary (Master Loan Agreement) to provide funding in a specified amount, for a specified period, for a specific purpose, as well as indicating schedule for repayment of the loan or terms of revolving credit line. Loan proceeds are intended to be used to support activities that benefit the members of intermediaries, and eligibility criteria for loans to member borrowers should be clearly defined therein. However, it is understood that the intermediary is fully responsible for the full repayment of loans granted by ACE/ADF, regardless of repayment performance of loans extended to member borrowers.

The loan agreement also clearly outlines requirements for establishment of a dedicated CMU to support prudent management of loan funds as discussed below.

2. **Grant Agreement:** To support the establishment of the CMU, ACE/ADF awards a grant to the agricultural intermediary to cover setup costs, salaries of CMU staff, office rent, and transportation expenses.
3. **Technical Assistance:** ACE/ADF also organizes technical support to establish appropriate credit management, credit administration, as well as the provision of training of CMU staff and management of intermediaries.

Over time, it is expected that the larger Strategic Intermediaries will develop capacities to sustainably continue the provision of credit services without the need for grant funding. This will include credit administration capacity housed within the CMU and strategic development capabilities of the leadership of the intermediary gained through experience. Interest and/or fee income generated by lending activities should eventually cover expenses associated with operating the CMU function. The smaller Tactical Intermediaries may be less sustainable and the CMU structures within may be more transient.

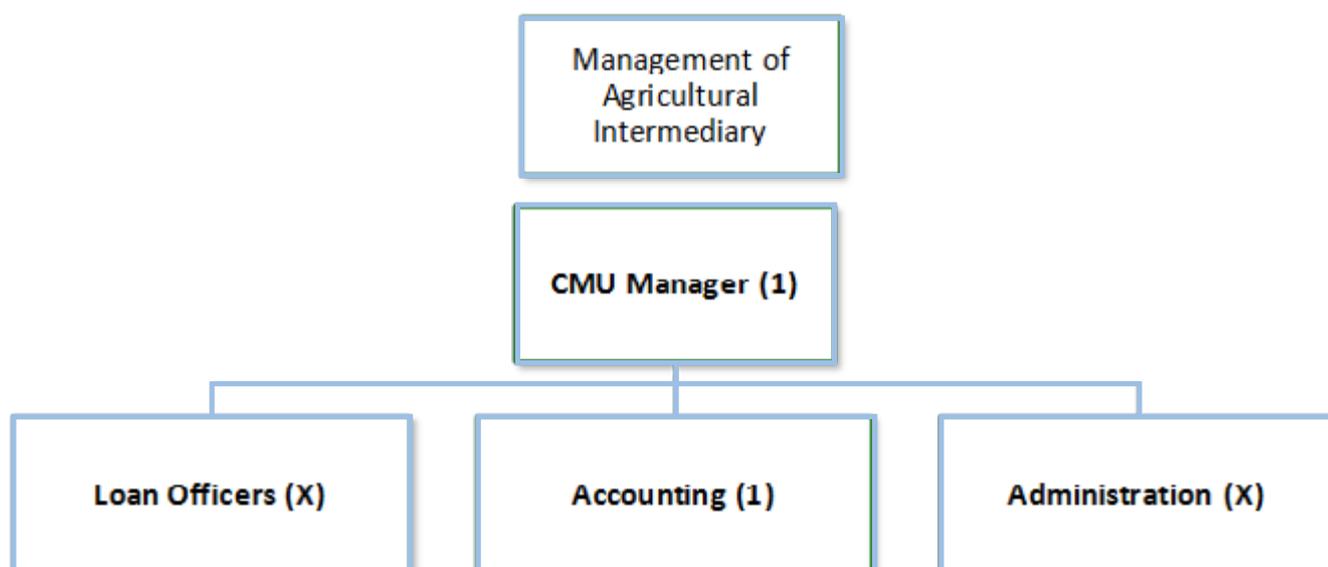
STRUCTURE OF CMUs

In order to support credit operations associated with ACE/ADF lending activities, the institutional structure and context of CMUs include the following elements:

(ii) relationship management (loan officers),
(iii) accounting, and
(iv) administrative support functions.

1. **Authority:** The CMU will formally report to the management of the agricultural intermediary.
2. **Functions:** In addition to (i) management, CMUs will include staff to perform
3. **Scale:** The size of the CMU depends on the scale of operations undertaken at respective agricultural intermediaries, specifically the quantity and volume of loans processed. The number of staff members of currently operating CMUs range from between 3 and 10 persons.

ORGANIZATIONAL AND GOVERNANCE STRUCTURE OF CMU



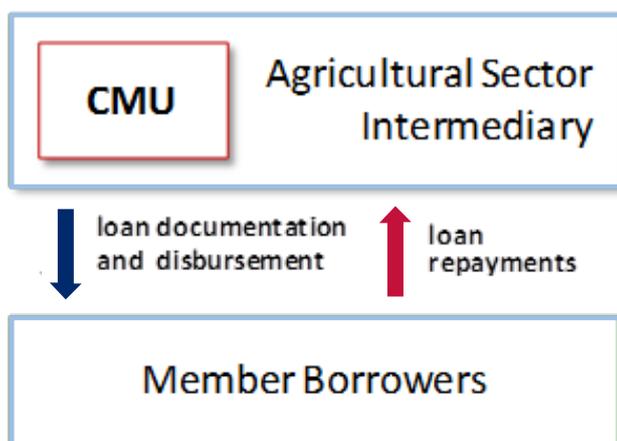
The establishment of CMUs will be supported by technical assistance to be provided by ACE/ADF.

FUNCTIONS OF CMUs

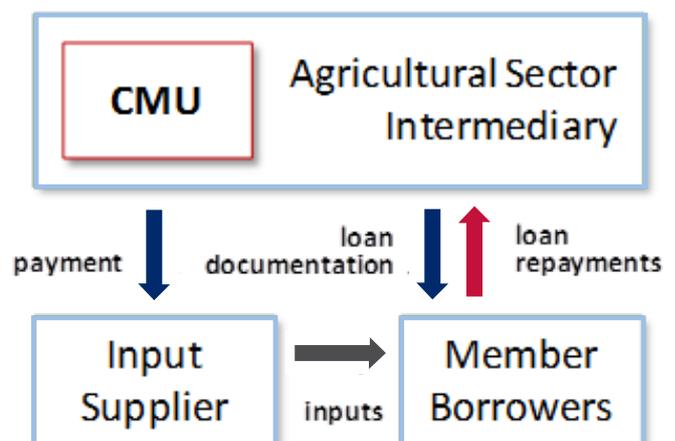
The primary function of the CMU is to ensure proper administration and integrity of lending activities through the host agricultural intermediary, as well as full repayment of ACE/ADF loans. These objectives are accomplished through the following activities:

1. **Process Applications:** Perform simple due diligence to process member borrower loan applications to ensure compliance with eligibility requirements in accordance with terms outlined in the Master Loan Agreement.
2. **Credit Approval:** Submission of loan proposals (lists of proposed member borrowers) to leadership of agricultural sector intermediary to obtain formal approval.
3. **Credit Administration:** Facilitate extension of financing to member borrowers in accordance with the terms outlined in Master Loan Agreement. Loans may be provided as direct transfers of funds to member borrowers, or through provision of agricultural inputs, illustrated as follows:

Direct Disbursement



Input Disbursement



- **Loan Documentation:** Regardless of method of disbursement, and before the actual receipt of disbursement of funds or inputs by the member borrower, all loans must be properly documented in accordance with the requirements of the Master Loan Agreement. This will include a loan agreement which specifies terms including loan amount, repayment dates and other relevant details. Collateral agreements must also be prepared. All loan documentation must be appropriately endorsed by the member borrower and authorized representative of the agricultural sector intermediary.
- **Loan Disbursement:** Once loan documentation has been accomplished, the CMU will execute disbursement either through the transfer of funds or delivery of inputs. In either case, receipt of loan proceeds should be formally confirmed and documented.
- **Followup:** It is expected that in the period between the disbursement and collection of payments, the leadership of the CMU and relationship managers will engage in an intensive awareness campaign to convey the importance of timely payments.
- **Loan Repayments:** The CMU must ensure collection of loan repayments from member borrowers in accordance with the payment schedule agreed to in the member borrower loan agreement. This should be actively facilitated through the provision of payment reminders to member borrowers, and prompt and aggressive actions to collect past due payments. Payments should be confirmed by official payment documents
- **Accounting:** In order to adequately manage lending activities, the CMU must establish and maintain appropriate accounting systems to provide accurate, reliable and timely financial information regarding the agricultural sector intermediary's lending activities. Such systems must be able to manage account balances, disbursements, and repayments, as well as the recording of interest income from member borrowers and interest expense paid to ACE/ADF. Ideally, accounting systems will be supported by the utilization of specialized management information systems. Lending activities must be segregated from all other activities of the intermediary, and separate bank accounts should be maintained for receipt and repayment of loans from ACE/ADF, as well as disbursement and collection of loan repayments from member borrowers.
- **Credit Files:** Credit files must be maintained for each member borrower loan containing all documentation including loan application and proposal, loan approval, loan and collateral agreements, confirmation of receipt of loan proceeds, confirmation of loans repayments, etc.
- **Portfolio Management:** The CMU will install and maintain systems to support ongoing management of intermediary loan portfolios, with special attention to the monitoring of individual member borrower loans and the resolution of problem loans.



- **Loan Monitoring:** The CMU must establish and carry out monitoring regime and corresponding action to ensure overall health of the loan portfolio, including periodic onsite inspections of member borrowers to ensure repayment of loan obligations.
- **Problem Loan Management:** The CMU must actively work to resolve instances of late payment and loan default.
- I. **Reporting Requirements:** The CMU must satisfy all reporting requirements as specified in the Master Loan Agreement. Ideally, this will be supported by specialized portfolio management systems. Reports should include the following:
 - **Portfolio Status:** Monthly report regarding loan disbursements during period, loan repayments during period, and outstanding balances for each loan and overall portfolio.
 - **Portfolio Quality:** Monthly reports regarding the quality of the portfolio, presenting portfolio at risk with breakdowns by number of days past due.
 - **Account Balances:** Daily account balances and corresponding activity reports.
 - **Accounting Reports:** As outlined above.



MANAGEMENT OF CMUs

In order to ensure the viability of the proposed business model, ACE/ADF will play an active role in the ongoing development of the CMUs to preserve portfolio quality, and ensure repayment of loans by both member borrowers and agricultural sector intermediaries, while helping to build the capacity of intermediaries to manage lending programs. The success of the CMU initiative will require significant investment and involvement of ACE/ADF management. While the ACE/ADF lending, grant administration and credit administration departments each play critical roles in the management of CMUs, the work of each function will be supported by the CMU Supervisor/Unit which serves as the primary contact between ACE/ADF, agricultural sector intermediaries and respective CMUs.²

- **Relationship Management:** The ACE/ADF Lending Department leads business development and lending activities, including those to agricultural sector intermediaries, developing loan proposals with customized structures to fit their specific needs. In the case of intermediaries this includes careful consideration of the scope and scale of activities to be financed, as well as the quantity,

character and activities of member borrowers. In order to manage the specific risks associated with lending to such intermediaries and to ensure prudent administration of loan proceeds, the establishment of CMUs becomes an integral component of the loan proposal, and the Lending Department correspondingly designs appropriate (grant) proposals to support such activities.

A member of the Lending Department, the CMU Technical Advisor plays a lead role in the preparation (in coordination with respective loan advisors) of CMU Technical reports to support the establishment of CMUs, which clearly define eligibility requirements of member borrowers, structure loan terms to correspond with specific agricultural activities, and propose appropriate organizational structure of the CMU in response to the scope and scale of the activity. While approaches must be customized to the specific characteristics of each relationship, opportunities to standardize processes must be identified to manage increasing numbers of CMUs

² Initially the CMU Supervisor/Unit will report directly to the Head of the Lending Department (as illustrated in the diagram below). However over time, and as capacity is built in Credit Administration, responsibility of the management of CMU activities will migrate out of the Lending Department. This will allow the Lending Department to place more attention on relationship management and business development activities.



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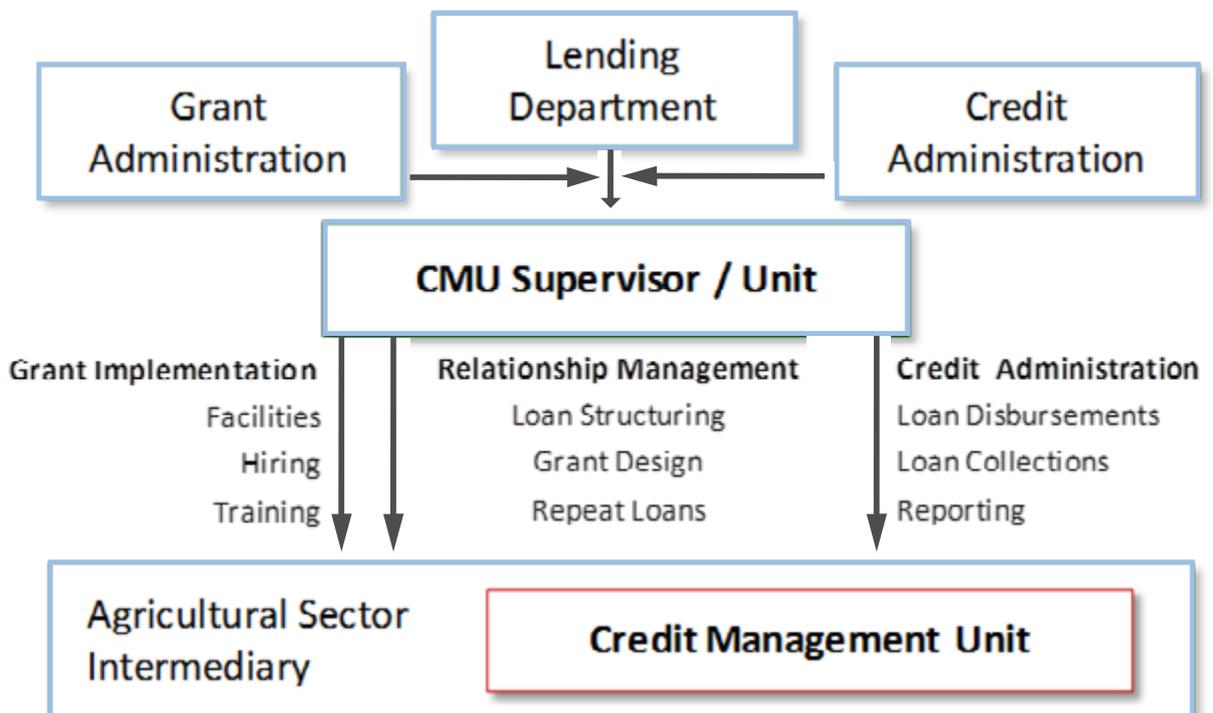
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1. **Grant Management:** To support the establishment of CMUs, grants are provided by ACE/ADF to agricultural sector intermediaries to equip CMU offices, and employ and train CMU staff. Taking into account the specific capacities of each respective intermediary, the Lending Department (CMU Policy Advisor) designs the general framework for grant proposals and upon the approval of loan applications passes them on to the ACE/ADF Grants Department to secure funding by obtaining approvals from both USAID and MAIL. The terms and requirements of the grant are formally outlined in a grant agreement.
2. **Credit Administration:** The following are required to be accomplished as conditions of disbursement:
 - Establishment of CMU (as detailed in the establishment and structure sections above, and as formally confirmed by the CMU Supervisor/Unit
 - Formal approval of member borrower loan proposals

Once accomplished, ACE/ADF Credit Administration executes transfer of funds to the agricultural sector intermediary.

ADF/ACE CMU MANAGEMENT FRAMEWORK



I. Role of CMU Coordination Unit: The CMU Coordination Unit is responsible for various activities to support the establishment and ongoing operation of CMUs as follows:

- Relationship Management: As lead implementer, the CMU Supervisor provides support the Lending Department and CMU Technical Advisor to structure loan proposals and design grants to support the establishment of CMUs. Experience gained over the course of ongoing relationship management activities will inform the processing of repeat loans and continued business development.
- Grant Management: The implementation of the grant to establish CMUs is directed by the CMU Coordination Unit who works closely with the intermediary leadership. In addition to providing ongoing mentoring to the management of intermediaries and on-the-job training to the CMU staff, the CMU Coordination Unit also organizes training and ensures the installation of appropriate accounting practices and software systems.
- Credit Administration: The CMU Coordination Unit will ensure that the terms of loan agreements are complied with, and that all reporting requirements are satisfied. Additionally, the CMU Coordination Unit will support Credit Administration to ensure that required monitoring procedures are accomplished.

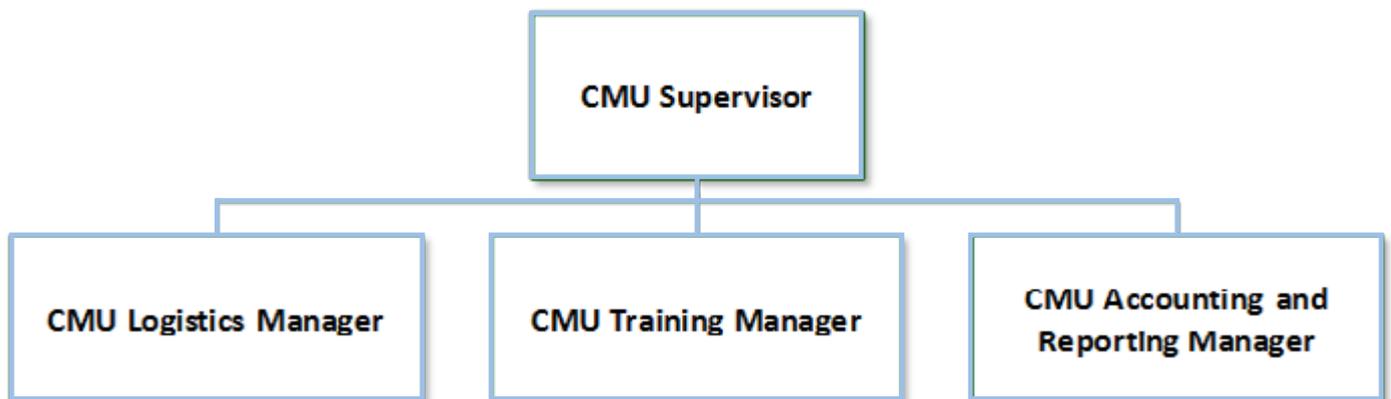
Credit administration will from time to time organize the conduct of audits of agricultural sector intermediaries to ensure proper use of and accounting for loan funds provided.

2. Structure of the CMU Coordination Unit: With a view to establishing a considerable number of CMUs over the 2012 to 2013 period, it is important that ACE/ADF install strong team dedicated to this activity.

- CMU Supervisor: Directs efforts of CMU Coordination Unit, and leads relationship management with and mentoring of leadership of agricultural sector intermediaries to support CMU establishment and ongoing management.
- CMU Logistics Manager: Supports establishment of CMUs including setup of facilities, purchase of equipment and hiring of CMU staff, and related logistics issues.
- CMU Training Manager: Organizes and delivers training and mentoring to CMU staff and leadership of intermediaries.
- CMU Accounting and Reporting Manager: Coordinates all accounting and reporting issues associated with management of CMUs.



STRUCTURE OF CMU UNIT





Agricultural Development Fund **ADF**



MINISTRY of AGRICULTURE,
IRRIGATION and LIVESTOCK.

NEWS BRIEF

AUGUST 2011

MANAGING CREDIT RISK IN AGRICULTURE



"Through these ADF financial services, we are able to provide credit to 1,850 members in Nangarhar, Kunar, and Laghman provinces and build credit management unit within our Association."

*Mr. Abdul Jan
Member, Eastern Region Fruit
Growers Association*

According to its original design, the ADF was expected to work through commercial banks and other financial institutions, providing them with lending capital and compensating them for the risks inherent to agricultural lending. Despite numerous efforts by the ADF, banks were in general unwilling to provide financial services to the agriculture sector, hence the ADF had to explore the option of non-financial institutions, such as farmer associations and cooperatives, and agribusinesses to use them as conduits to make credit available to farmers. While this option had the potential to reduce transaction costs, there were risks of relevance, especially related to the lack of capacity of non-financial intermediaries to administer credit. Hence giving rise to a series of innovations to build their capacity, develop their management activities in order to ensure the repayments of the loans.

One of such innovations are the Credit Management Units (CMUs) a concept developed and introduced by the ADF, which are small functional units operating within non-financial intermediaries, including farmer associations, cooperatives and agribusinesses. The program covers part of the operating costs of the CMUs, which have three fundamental objectives: a) processing individual loan applications, b) disbursing loans, and c) ensuring timely collection. The typical CMU includes 3-4 employees from the same communities in which the intermediary institution operates, thereby banking on social capital and local knowledge.

During the first 8 months since the concept was introduced, over 4,000 farmers have accessed credit through 4 CMUs operating within 2 farmer associations, a group of cooperatives and an agribusiness association. These organizations have been able to disburse, manage and collect loans achieving and maintaining a "zero" default rate. The CMUs, which now constitute standard operating practice when lending to non-financial institutions, are generally funded through combination of challenge grants and the interest markup of the financial intermediary.

By providing financial services to non-financial institutions, the Agricultural Development Fund will not only strengthen the capacity of credit management within the organizations but also reach out to larger number of farmers.





AGRICULTURAL CREDIT ENHANCEMENT (ACE) PROGRAM
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