

## **Summary from Round Table 1**

### ***“Instruments for agricultural financing and risk management in the EastAgri region”***

The discussions came to the following conclusions:

Expanding agricultural finance remains a key challenge in the Eastern Europe and Central Asia (ECA) region.

As an introduction into the subject, Sandra Broka (World Bank) provided an overview on a series of studies recently conducted by FAO and the World Bank on different agricultural finance and risk management instruments such as index-based insurance (IBI), commodity exchanges and price risk management instruments, structured finance, and guarantee funds. The studies assessed the current use of these instruments in ECA, relevant experiences in other regions and the potential for introducing/upscaling their use in the region. In addition, a rapid assessment of the agricultural and financial sectors in 30 ECA countries has been conducted. Some of these studies (on index-based insurance and commodity exchanges) were presented during the subsequent sessions.

The first session discussed the potential for introducing IBI as a production risk management instrument in ECA countries. In contrast to traditional crop insurance, IBI does not require individual on-farm loss assessments since indemnity payments are triggered by an indicator which can be objectively measured, e.g. at a weather station. It can therefore be administered at low transaction costs and avoids typical problems of damage-based crop insurance such as moral hazard and adverse selection. IBI can be used to insure against a number of weather-related risks including rainfall, temperature or wind speed but can also be applied to area yields and livestock mortality rates. Due to higher degrees of standardisation and transparency of insurance contracts, IBI can be shifted more easily to international reinsurance markets. The main bottleneck relates to basis risk resulting from an imperfect correlation between farm yields and the index which triggers indemnity payments. Experiences with IBI in agriculture have so far been limited and only in a few cases index insurance products are being sold at a commercial scale. There are almost no experiences with IBI in ECA

Prof Martin Odening from Humboldt University in Berlin presented the results of a preliminary screening of the potential for introducing IBI in 20 ECA countries. The study assessed key factors determining the demand and supply of IBI based on secondary data. A number of countries were identified where potential for introducing IBI is likely to be high: Moldova, Kazakhstan, Russia and Uzbekistan. Further potential candidates include Romania, Ukraine and Turkey. In these countries, in-depth feasibility assessments and stakeholder consultations could be considered as next steps. In addition, a rigorous ex-post assessment of existing experiences with IBI in a number of countries is recommended to strengthen its credibility as production risk management instrument and more efficient alternative to highly subsidized traditional crop insurance.

Roman Shynkarenko, Insurance Expert from Ukraine, presented the results of a pre-feasibility assessment of IBI in 3 ECA countries: Ukraine, Russia and Moldova. Overall, the highest potential seems to exist in Moldova which presents a high density of weather stations and strong interest from the government and the insurance industry in this product. However, given the small size of the country, access to reinsurance markets would be crucial. Ukraine presents a huge potential market for IBI but important challenges need to be addressed for successful introduction and upscaling: Given the lower density of weather stations and the abundance of microclimates, basis risks may be an issue. Moreover, IBI would have to compete against highly subsidised traditional crop insurance programmes. The immediate potential would be niche markets not covered sufficiently by traditional crop insurance, such as high value crops and small farms. The comparative advantage of IBI might increase to the extent by which problems of traditional subsidised crop insurance become more apparent and farmers, insurance companies and the government more interested in alternative solutions. There are indications that such situation is emerging in Russia where the deficiencies of

traditional crop insurance programmes have already surfaced and industry stakeholders have started looking for alternative solutions. Russia has a huge potential market and a strong human resource base although specific training on IBI would be needed.

Bernard Belk from Swiss Re provided some examples on alternative uses for IBI as risk transfer instruments to corporate agribusiness clients. These include insurance against production shortfalls due to fluctuations of prices and volumes measured against certain triggers, as well as weather index-based insurance. Swiss Re offers such products directly to large agribusiness clients engaged in agricultural value chains, in addition to the traditional reinsurance business.

Two key issues emerged from the RT discussions: First, the interest of farmers and other possible customers in IBI needs to be further assessed. Experiences from other parts of the world suggest that farmers' interest in IBI tends to be higher if IBI is not sold as a stand-alone product but bundled with access to loans, possibly at more attractive lending conditions. Second, government policies regarding risk management and disaster relief need to be more consistent: Free disaster relief discourages farmers from buying crop insurance and large subsidy volumes to conventional crop insurance undermine the market for IBI.

The second session was centred on structured financing techniques that allow moving beyond conventional balance sheet lending. In structured finance, the main emphasis is placed on the commodity transaction and on minimising related risks and transaction costs rather than an assessment of the borrower's creditworthiness. Structured finance includes a variety of instruments ranging from financing against stocks of commodities (warehouse receipts) and future cash flows (receivables, forwards, and futures) to securitisation techniques.

Marc van Strydonck (EBRD) provided an overview on EBRD's experiences with the use of structured finance instruments in agricultural commodity finance. So far, the main approach has been to extend working capital finance against commodities stored in reputable warehouses. Where possible, EBRD has used warehouse receipts to secure its lending and the Bank has supported the introduction of warehouse receipt financing in several ECA countries including Bulgaria, Czech Republic, Hungary, Kazakhstan, Lithuania, Poland, Romania and Slovakia. Currently, such initiative is being undertaken in Tajikistan. In Russia, where no warehouse receipt system is in place, EBRD has used repurchase agreements (repos). The main constraints faced by EBRD are related to taxation issues (in case of repos) and recovery rules. Moreover, due to the lack of well functioning and liquid commodity exchanges proper valuation of stocks and price risk management is a challenge. The presenter outlined ways how collateralized commodity lending could be enhanced by linking it to commodity exchanges which offer price risk management instrument.

The latter aspect was expanded by Lamon Rutten (ACE) who illustrated various ways to enhance structured finance arrangements through well functioning commodity exchanges. In case of collateralized commodity lending, the existence of commodity exchanges make valuation and liquidation of the commodities easier and enable banks to hedge price risk. The latter aspect becomes even more critical in case of supply chain finance based on future receivables. However, despite their impressive number, the majority of commodity exchanges in ECA are underdeveloped and only a few have achieved high trading volumes and started offering futures contracts. Hedging on quality exchanges outside the region is fought by high costs and basis risk. Several opportunities were highlighted on how commodity exchanges in various ECA countries could be enhanced. A second aspect, illustrated by the presenter, was related to the possibilities for banks to outsource risk management along the value chain to specialized collateral management companies.

Cristophe Cordonnier (EBRD Consultant) gave a practical example on value chain finance in Tajikistan. The EBRD-funded Tajik Agricultural Finance Facility (TAFF) has been introducing new financing approaches in the cotton sub-sector based on tripartite arrangements between banks, farmers/cooperatives and processors, enhanced by open procurement arrangements and guarantees.

The approach contributes to reforming traditional cotton financing based on in kind transactions which has led to the built up of a huge cotton debt.

Overall, the RT showed that considerable potential exists for expanding the use of different structured finance instruments for expanding agricultural finance in ECA. Even in difficult environments with weak legal and institutional framework, financing instruments can be adjusted to specific circumstances of selected commodity chains if market size and profitability are attractive enough.