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Natasha DANILOSKA*)

COSTS AND RISKS SPECIFIC TO AGRICULTURAL LENDING

Abstract

The question of how to best develop an effective rural financial system in developing countries has been much debated over the past decades. During this period, developing countries are facing rather drastic changes of the agricultural sector, accompanied with decline in agricultural credit supply for borrowers. Lack of access to formal credit and to full financial intermediation services impedes agricultural development. In addition, most banks have neither the rural branches nor the agricultural lending expertise to serve small farmer clients. As a result, many rural people still rely heavily on unformal financial arrangements. These sources may be beneficial in some respects but cannot be a substitute for effective banking services.

Issues of high risks and costs are the main attributes of the rural finance markets within the developing countries. Within the framework of rural financial markets, this paper concentrates on the specific issues of lending to agricultural producers. Namely, agricultural lenders face distinct challenges that are related to the specific nature of farm production and are associated with the granting of rural and agricultural credit. The problems of high risks and costs are specific issues for agricultural finance and they are elaborated in this paper. Major attention is given to an assessment of the specific cost and risk barriers that formal lenders face in agricultural lending. In the conclusion remarks, particular attention is given to those aspects that facilitate a better cost and risk management in agricultural lending.

Keywords: agricultural lending, agricultural lenders, rural finance markets, cost reduction, risk management

*) Ph.D, Institute of Economics- Skopje E-mail:natasha.daniloska@ek-inst.ukim.edu.mk

Introduction

Agricultural lenders who serve small farmers face high financial transaction costs when granting small loans. High lending risks are suggested by the frequent inability of small farmer-borrowers to provide acceptable forms of loan collateral. The unique features of agricultural lending are summarized in the table below.

Table 1

UNIQUE FEATURE OF AGRICULTURAL LENDING

1.	**Lending activities in a politically sensitive environment**
	• Agriculture is a politically sensitive sector
	• State interventions often occur in rural financial markets.
2.	**Risks associated with agricultural lending**
	• Similar economic activities of borrowers generate covariant risks due to market and price fluctuations, yield uncertainties, changes in domestic and international policies.
	• State interventions.
	• Low loan repayment discipline in externally-funded credit schemes
3.	**High financial transaction costs for lenders and borrowers**
	• Long distances to serve a dispersed rural clientele.
	• Poorly developed transportation and communication infrastructure.
	• Little knowledge about heterogeneous farm households.
	• Expensive management and supervision of rural bank branch networks.
	• High additional costs for borrowers: opportunity costs (e.g. lost working time), transport costs, bribes, fees.
4.	**Specific credit demand**
	• The provision of long-term credit can lead to matching problems between assets (loans) and liabilities (funding sources).
	• Reduced turnover of agricultural loan portfolio over the yea
	• Seasonality in agricultural credit demand
5.	**Lack of required loan collateral**
	• Small farmers have few physical assets (e.g. land).
	• Farmers and especially poor rural women have difficulties in clearly demonstrating their legal ownership of assets.
	• Legal contract enforcement problems arise even when collateral is available.
6.	**Farm households are integrated production and consumption units**
	• Demand for loans depends on the self-financing potential, access to savings deposit facilities and risk management ability of borrowers.
	• Due to the fungibility of money borrowed funds can be used in the farm household for consumption, education, social insurance, production and investment purposes.

1. COSTS OF AGRICULTURAL LENDING

In this part special attention is given to the challenges that agricultural lenders face in managing their financial transaction costs and risks.They are as fallow:

Dispersed clients: Low population density together with dispersed location of rural clients make the provision of formal financial services costly. From the lender's perspective, the long distances between communities and the inadequate rural transportation facilities in many developing countries increase the costs of loan appraisal, loan monitoring and enforcement of loan repayments.[1)] The use of mobile loan officers and/or branch offices can be effective in lowering transaction costs. But mobile facilities may be subject to security risks if bank staff are required to transport money. The establishment of a rural branch network reduces the security risks, but branches are costly to maintain and to supervise. Financial transaction costs of institutional credit can also be high for rural borrowers. This results from the high opportunity costs of lost working time. A borrower may have to pay several visits to the bank branch office to conclude cumbersome loan application procedures which require a long time for processing. Clients often have to spend much time and money to obtain the required documents and to find loan guarantors. For very small loans, these costs can significantly increase the effective lending interest rate. While the decentralization of field operations has been effective in reducing the transaction costs in some countries their success depends on the local environment, infrastructure conditions and the management skills of the financial institution.

Seasonality and loan term structure: The seasonal nature of agricultural production and the relative long periods before crops can be harvested and sold have direct implications for the financial transaction costs of the lender. Agricultural loans are normally larger and are required for longer periods. Matching assets and liabilities is more difficult than for non-farm activities. Agricultural credit is also often repaid in unbalanced installments. These are one or two loan repayments rather than regular weekly or monthly installments common in microcredit. This irregular pattern implies more difficult monitoring of repayment capacity and willingness. Moreover, an uneven distribution of the agricultural lending operations over the year increases the fixed costs of personnel. The earnings from lending may not be sufficient to cover these costs. Liquidity requirements in periods of high seasonal loan demand also increase the price of loanable funds. In times of low demand, excess liquidity needs to be invested in low or non-earning assets. This will increase the opportunity costs of these funds. In summary, lenders face high agricultural lending costs.

Heterogeneity of farming: The diversity in farm and non-farm income-generating activities of rural households requires better knowledge of the farm household

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1) Gurgand M: "Rural finance institutions-their outreach and sustanability"; Savings and Development, 20,2, 2006, p.129-166

financial situation. Loan officers have more information than may be needed in the case of urban lending. This can extend the bank staff time (and expenses) needed for loan appraisal. It may also require the setting of individual loan repayment terms. It is likely to increase the costs of training agricultural loan officers.

2. RISKS ASSOCIATED WITH AGRICULTURAL LENDING

Generally speaking, financial institutions face four major risks:

1. Credit or loan default risk-refers borrowers who are unable or unwilling to repay the loan principal and to service the interest rate charges
2. Liquidity risk-occurs when a bank is not able to meet its cash requirements. Mismatching the term of loan assets and liabilities (sources of loanable funds) exposes banks to high liquidity risks.
3. Interest rate risk-risk that a loan will decline in value as interest rates change.
4. Foreign exchange risk-defines exposure to changes in exchange rates which affect international borrowings denominated in foreign currency.

Regarding agricultural lending, in this paper, the focus is mainly on agricultural credit or loan default risks. Active management can reduce these risks. Risks and uncertainty are pervasive in agricultural production and are perceived to be more serious than in most non-farm activities. Production losses are also impossible to predict. They can have serious consequences for income-generation and for the loan repayment capacity of the borrowing farmer. The type and the severity of risks which farmers meet, vary with the type of farming system, the physical and economic conditions, the prevailing policies, etc.

Agricultural lending implies high liquidity risks due to the seasonality of farm household income. Surpluses supply increased savings capacity and reduced demand for loans after harvest and deficits reduce savings capacity and increase demand for loans before planting a crop. Also, agricultural lenders face particular challenges when many or all of their borrowers are affected by external factors at the same time. This condition is referred to as covariant risk which can seriously undermine the quality of the agricultural loan portfolio. As a result, the provision of viable, sustainable financial services and the development of a strong rural financial system is contingent on the ability of financial institutions to assess, quantify and appropriately manage various types of risk.[2)] Credit risks in agricultural lending are summarized below.

Production and yield risks-yield uncertainty due to natural hazards refers to the unpredictable impact of weather, pests and diseases and calamities on farm produc-

[2)] World Bank series: "Sustainable Banking with the Poor"; World Bank, Washington D.C., 2000.

tion. Risks severely impact younger, less well-established, but more ambitious farmers. Especially affected are those who embark on farming activities that may generate a high potential income at the price of concentrated risks, for example in the case of high input monoculture of maize. Subsequent loan defaults may adversely affect the creditworthiness of farmer borrowers and their ability to secure future loans.

Market and price risks-Price uncertainty due to market fluctuations is particularly severe where information is lacking and where markets are imperfect, features that are prevalent in the agricultural sector in many developing countries.[3)] The relatively long time period between the decision to plant a crop or to start a livestock enterprise and the realization of farm output means that market prices are unknown at the moment when a loan is granted. This problem is even more acute for perennial plants because of the gap of several years between planting and the first harvest.

Risk of loan collateral limitations-Problems associated with inadequate loan collateral pose specific problems to rural lenders. Land is the most widely accepted asset for use as collateral, because it is fixed and not easily destroyed. It is also often prized by owners above its market value and it has a high scarcity value in densely populated areas. Smallholder farmers with land that has limited value, are less likely to have access to bank loans. Moveable assets, such as livestock and equipment, are regarded by lenders as higher risk forms of security. The owner must provide proof of purchase and have insurance coverage on these items. This is rarely the case for low-income farm households.

Moreover, there are a number of loan contract enforcement problems, even when borrowers are able to meet the loan collateral requirements. Restrictions on the transfer of land received through land reform programmes limits its value as collateral-even where sound entitlement exists.

Moral hazard risks in distorted credit cultures-Potentially serious risk problems have risen from the effects of failed directed credit programmes. The impact on the loan repayment discipline is pervasive. Borrowers who have witnessed the emergence and demise of lending institutions, have been discouraged from repaying their loans.

Under these circumstances, the incidence of moral hazard is high. The local "credit culture" is distorted among farmers and lenders. Borrowers lack the discipline to meet their loan repayment obligations, because loan repayment commitments were not enforced in the past. Lenders, on the other hand, lack the systems, experience and incentives to enforce loan repayment. There is also an urgent need to change bank staff attitudes and the poor public image of financial institutions in rural areas.

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3) Von Pische, John D., Dale Adams and Dordon Downald: "Rural Financial Marketis in developing Countries: Their Use and Abuse"; Johns Hopkins University press, Baltimore, 2004, p. 255-261.

Risks from changes in domestic and international Policies-Policy changes and state interventions can have a damaging impact on both borrowers and lenders. For the latter they can contribute significantly to covariant risks. Many low-income economies under structural adjustment programmes have slashed their farming subsidies. This has had, for instance, a serious effect on the costs and the demand for fertilizer. Reducing government expenditures as an essential part of structural adjustment programmes may also affect employment opportunities in the public sector. Costs may even reduce agricultural production levels, if extension services are suddenly discontinued.

Concluding remarks

One of the biggest challenges that agricultural lenders face, is the problem of high costs that are associated with the granting of small loans. In fact, loan administration costs do not vary by loan amount. By definition small loans are less profitable for a lender, and in the same time, financial transaction costs are high for borrowers. However, below are listed some recommended ways to reduce the high costs of providing small loans. They are:

- Standardization of loan products and lending procedures-offering only a few highly standardized loan products and in the same time, additionally establishing collaboration with partner agencies for the provision of non-financial support services.
- ***Increasing productivity of loan officers-***loan officers are expected to serve a large number of clients. In order to achieve this, staff performance bonuses are widely used.
- ***Group lending-***there are two modalities of group lending. A microlender may lend to a collective entity such as a co-operative or a village bank, which in turn on-lends the funds to its members. Second type is joint liability or solidarity group lending, whereby the lender provides loans to individual borrowers who are organized in groups. In both cases, group members are collectively responsible for the full and timely repayment of the loans.
- ***Individual lending-***the idea is to examine the enterprise household cash flow and check the credit history of the loan applicant to get a complete picture of his/her loan repayment capacity and creditworthiness.

Regarding the risk management, an assessment of the specific risks that are associated with different agricultural production activities is essential in determining the potential risk exposure of lenders. Other recommendations are:

- Loan appraisal should include a thorough assessment of the borrower loan repayment capacity and his creditworthiness. Also, external risk factors of farm production should be taken into account.

- Collaboration with organizations which know farmers well, reduces client information costs and risks of lenders.
- Agricultural lending should start in production zones that present low risks. Operations can then gradually be expanded to more risky areas.
- Managing of external risks through loan rescheduling, agricultural insurance and emergency assistance can assist both the farmer-borrower and the agricultural lender.
- Staff incentives systems motivate staff and effectively increase their lending productivity.
- Close monitoring of markets and exposure to lending risks is essential for agricultural lenders.
- Clear information should be given to borrowers on the financial conditions of loans and loan repayment obligations.
- Close contacts between the lender and the borrower are conducive for an atmosphere of mutual trust that improves credit discipline.
- Agricultural lending institutions should be free of political interference in their daily management.
- Agricultural lenders as part of their risk management strategy need to monitor policy and market changes that affect their agricultural clientele.
- Collateral substitutes replace more conventional types of loan guarantees and can provide important loan repayment incentives.

Concerning the agricultural lending, despite the above listed recommendations, it is firmly believed that there are really not “best“ practices that can be applied to all circumstances. Instead, the development of better rural and agricultural lending technologies is seen as a dynamic and ongoing process that guides the lending institution towards meeting the specific demands of the rural clientele.

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