AGRICULTURAL FINANCE 3(3-0)

Meaning:

Agricultural finance generally means studying, examining and analyzing the financial aspects pertaining to farm business, which is the core sector of Pakistan. The financial aspects include money matters relating to production of agricultural products and their disposal.

Definition of Agricultural finance:

Murray (1953) defined agricultural. Finance as "an economic study of borrowing funds by farmers, the organization and operation of farm lending agencies and of society's interest in credit for agriculture."

Tandon and Dhondyal (1962) defined agricultural. Finance "as a branch of agricultural economics, which deals with and financial resources related to individual farm units."

Nature and Scope:

Agricultural finance can be dealt at both micro level and macro level. Macro-finance deals with different sources of raising funds for agriculture as a whole in the economy. It is also concerned with the lending procedure, rules, regulations, monitoring and controlling of different agricultural credit institutions. Hence macro-finance is related to financing of agriculture at aggregate level.

Micro-finance refers to financial management of the individual farm business units. And it is concerned with the study as to how the individual farmer considers various sources of credit, quantum of credit to be borrowed from each source and how he allocates the same among the alternative uses with in the farm. It is also concerned with the future use of funds. Therefore, macro-finance deals with the aspects relating to total credit needs of the agricultural sector, the terms and conditions under which the credit is available and the method of use of total credit for the development of agriculture, while micro-finance refers to the financial management of individual farm business.

Significance of Agricultural Finance:

1) Agriculture finance assumes vital and significant importance in the agro–socio-economic development of the country both at macro and micro level.
2) It is playing a catalytic role in strengthening the farm business and augmenting the productivity of scarce resources. When newly developed potential seeds are combined with purchased inputs like fertilizers & plant protection chemicals in appropriate / requisite proportions will result in higher productivity.
3) Use of new technological inputs purchased through farm finance helps to increase the agricultural productivity.
4) Accretion to in farm assets and farm supporting infrastructure provided by large scale financial investment activities results in increased farm income levels leading to increased standard of living of rural masses.
5) Farm finance can also reduce the regional economic imbalances and is equally good at reducing the inter–farm asset and wealth variations.
6) Farm finance is like a lever with both forward and backward linkages to the economic development at micro and macro level.
7) As agriculture is still traditional and subsistence in nature, agricultural finance is needed to create the supporting infrastructure for adoption of new technology.
8) Massive investment is needed to carry out major and minor irrigation projects, rural electrification, installation of fertilizer and pesticide plants, execution of agricultural promotional programmes and poverty alleviation programmes in the country.

Capital Budgeting

Meaning of Capital Budgeting:

Capital expenditure budget or capital budgeting is a process of making decisions regarding investments in fixed assets which are not meant for sale such as land, building, machinery or furniture.

The word investment refers to the expenditure which is required to be made in connection with the acquisition and the development of long-term facilities including fixed assets. It refers to process by which management selects those investment proposals which are worthwhile for investing available funds. For this purpose, management is to decide whether or not to acquire, or add to or replace fixed assets in the light of overall objectives of the firm.

What is capital expenditure, is a very difficult question to answer. The terms capital expenditure are associated with accounting. Normally capital expenditure is one which is intended to benefit future period i.e., in more than one year as opposed to revenue expenditure, the benefit of which is supposed to be exhausted within the year concerned.

Nature of Capital Budgeting:

Nature of capital budgeting can be explained in brief as under

- Capital expenditure plans involve a huge investment in fixed assets.
- Capital expenditure once approved represents long-term investment that cannot be reserved or withdrawn without sustaining a loss.
- Preparation of coital budget plans involve forecasting of several years profits in advance in order to judge the profitability of projects.

It may be asserted here that decision regarding capital investment should be taken very carefully so that the future plans of the company are not affected adversely.

Procedure of Capital Budgeting:

Capital investment decision of the firm have a pervasive influence on the entire spectrum of entrepreneurial activities so the careful consideration should be regarded to all aspects of financial management. In capital budgeting process, main points to be borne in mind how much money will be needed of implementing immediate plans, how much money is available for its completion and how are the available funds going to be assigned tote various capital projects under consideration. The financial policy and risk policy of the management should be clear in mind before proceeding to the capital budgeting process. The following procedure may be adopted in preparing capital budget :-

(1) Organization of Investment Proposal.

The first step in capital budgeting process is the conception of a profit making idea. The proposals may come from rank and file worker of any department or from any line officer. The department head collects all the investment proposals and reviews them in the light of financial and risk policies of the organization in order to send them to the capital expenditure planning committee for consideration.

(2) Screening the Proposals.

In large organisations, a capital expenditure planning committee is established for the screening of various proposals received by it from the heads of various departments and the line officers of the company. The committee screens the various proposals within the long-range policy-frame work of the organization. It is to be ascertained by the committee whether the proposals are within the selection criterion of the firm, or they do no lead to department imbalances or they are profitable.

(3) Evaluation of Projects.

The next step in capital budgeting process is to evaluate the different proposals in term of the cost of capital, the expected returns from alternative investment opportunities and the life of the assets with any of the following evaluation techniques:-

- Degree of Urgency Method (Accounting Rate of return Method)
- Pay-back Method
- Return on investment Method
- Discounted Cash Flow Method.

(4) Establishing Priorities.

After proper screening of the proposals, uneconomic or unprofitable proposals are dropped. The profitable projects or in other words accepted projects are then put in priority. It facilitates their acquisition or construction according to the sources available and avoids unnecessary and costly delays and serious cot-overruns. Generally, priority is fixed in the following order.

- Current and incomplete projects are given first priority.
- Safety projects ad projects necessary to carry on the legislative requirements.
- Projects of maintaining the present efficiency of the firm.
- Projects for supplementing the income
- Projects for the expansion of new product.

(5) Final Approval.

Proposals finally recommended by the committee are sent to the top management along with the detailed report, both o the capital expenditure and of sources of funds to meet them. The management affirms its final seal to proposals taking in view the urgency, profitability of the projects and the available financial resources. Projects are then sent to the budget committee for incorporating them in the capital budget.

(6) Evaluation.

Last but not the least important step in the capital budgeting process is an evaluation of the programme after it has been fully implemented. Budget proposals and the net investment in the projects are compared periodically and on the basis of such evaluation, the budget figures may be reviewer and presented in a more realistic way.

Significance of Capital Budgeting:

The key function of the financial management is the selection of the most profitable assortment of capital investment and it is the most important area of decision-making of the financial manger because any action taken by the manger in this area affects the working and the profitability of the firm for many years to come.

The need of capital budgeting can be emphasised taking into consideration the very nature of the capital expenditure such as heavy investment in capital projects, long-term implications for the firm, irreversible decisions and complicates of the decision making. Its importance can be illustrated well on the following other grounds:-

(1) Indirect Forecast of Sales.

The investment in fixed assets is related to future sales of the firm during the life time of the assets purchased. It shows the possibility of expanding the production facilities to cover additional sales shown in the sales budget. Any failure to make the sales forecast accurately would result in over investment or under investment in fixed assets and any erroneous forecast of asset needs may lead the firm to serious economic results.

(2) Comparative Study of Alternative Projects:

Capital budgeting makes a comparative study of the alternative projects for the replacement of assets which are wearing out or are in danger of becoming obsolete so as to make the best possible investment in the replacement of assets. For this purpose, the profitability of each projects is estimated.

(3) Timing of Assets-Acquisition.

Proper capital budgeting leads to proper timing of assets-acquisition and improvement in quality of assets purchased. It is due to ht nature of demand and supply of capital goods. The demand of capital goods does not arise until sales impinge on productive capacity and such situation occur only intermittently. On the other hand, supply of capital goods with their availability is one of the functions of capital budgeting.

(4) Cash Forecast.

Capital investment requires substantial funds which can only be arranged by making determined efforts to ensure their availability at the right time. Thus it facilitates cash forecast.

(5) Worth-Maximization of Shareholders.

The impact of long-term capital investment decisions is far reaching. It protects the interests of the shareholders and of the enterprise because it avoids over-investment and under-investment in fixed assets. By selecting the most profitable projects, the management facilitates the wealth maximization of equity share-holders.

(6) Other Factors.

The following other factors can also be considered for its significance:-

- It assists in formulating a sound depreciation and assets replacement policy.
- It may be useful n considering methods of coast reduction. A reduction campaign may necessitate the consideration of purchasing most up-to-date and modern equipment.
- The feasibility of replacing manual work by machinery may be seen from the capital forecast be comparing the manual cost an the capital cost.
- The capital cost of improving working conditions or safety can be obtained through capital expenditure forecasting.
- It facilitates the management in making of the long-term plans an assists in the formulation of general policy.
- It studies the impact of capital investment on the revenue expenditure of the firm such as depreciation, insure and there fixed assets.

Credit Worthiness

A creditor's measure of an individual's or company's ability to meet debt obligations. An assessment of the likelihood that a borrower will default on their debt obligations. It is based upon factors, such as their history of repayment and their credit score. Lending institutions also consider the availability of assets and extent of liabilities to determine the probability of default. Several firms have developed rating systems to determine an individual or company's credit worthiness. It is important for each person to keep track of their credit score because this is the main metric used by institutions when determining if the individual is worthy of a favorable rate.

Creditworthiness has to do with the ability of a borrower to pay current debt in a timely manner. Within the context of the ability, several basic factors come into play. An evaluation of the creditworthiness of a borrower involves identifying the presence of resources that may be used to repay debts, the willingness of the debtor to use those resources for repaying debt, and a history of choosing to repay debt obligations in a timely manner. When creditors choose to extend credit to an individual or business, that extension of credit is based on the understanding that the borrower will have resources that can be used to repay the debt. The resources are normally thought of in terms of some type of cash flow. The cash flow may be from income earned from a job, or income that is received in exchange for goods and services provided to clients. Even a cash flow that results from regularly scheduled disbursements from a trust or interest income payments may be considered a verifiable type of cash flow.

Once it is established that the borrower has a flow or resources that can be used to honor the debt, it is necessary to determine if there is a willingness to follow through and actually make the payments. This is where the past credit history of the individual or business becomes important. When the borrower has a history of paying outstanding debt within terms, this is a strong sign of past creditworthiness. Using past history as an indicator, a creditor can reasonably assume the borrower will demonstrate a similar pattern in the future. Creditors will also look at the current amount of indebtedness that the individual is carrying. By comparing the ratio between current debt and income, it is possible to determine if the borrower can reasonably handle another obligation without significantly increasing the risk of default. This element of the evaluation process is in the best interests of the borrower, as it helps to prevent establishing an obligation that could have a negative impact on overall creditworthiness. Proper management of available resources goes a long way toward establishing and maintaining creditworthiness. By keeping debts in line with available income and paying off the debts in a timely manner, the credit rating of the individual will be healthy and attractive to prospective creditors.

Agricultural Credit Markets:

Agriculture sector is the mainstay of the economy of Pakistan. It accounts for 21% of GDP. It employs 45% of the population directly engaged in agriculture. Agriculture contributes about 65% of export earning. Though agriculture is an important large market and industry, yet it is far away from the availability of financial resources. Agricultural credit is linked with growth of agriculture, whereas rural finance covers all the aspects of socio-economic life of rural area. It covers a wide variety of farm and non-farm productive activities such as agriculture, animal husbandry, fisheries, forestry, small agro-based industries as well as development of physical and social infrastructure in the form of transport and communication, water and power, education and health.

Need for Agricultural Credit:

Credit is required in every type of business and agriculture is not exception of it. The need for agriculture credit becomes more important when it moves from traditional agriculture to modern agriculture. The agriculture sector at present is best with number of handicaps. The land holding is very small. The population is growing at a fast rate. Agricultural labour is often underemployed. Production suffers from weather risks. The capacity of farmers to save and invest is very low. The agricultural productivity is low due to low use of inputs. The farmers therefore, need credit to increase productivity and efficiency in agriculture. This need is increasing over the years with the rise in use of fertilizers, mechanization and rise in prices. Briefly the need for agricultural credit can be summed up as follows;

1. **Purchase of new inputs:** The farmers need finance for the purchase of new inputs which include seeds, fertilizers, pesticides, irrigation water etc. If the seed of high yielding varieties and other modern inputs are made available to the farmers they can increase productivity not only of land but also of labour.
2. **Purchase of implements:** Credit is required by the farmers for the purchase of tractors, threshers, harvesters, water pumping sets etc. The use of appropriate machinery in land will increase production by growing more than one crop on the same piece of land at the same time.

3. **Better management of risk:** Credit enables the farmers to better manage the risks of uncertainties of price, weather etc. They can borrow money during raining days and pay back the loans during peak years of crops.
4. **Permanent improvement in land**: Credit also helps the farmers to make permanent improvements in land like sinking of wells, land reclamation, horticulture, rotation of crops etc.
5. **Better marketing of crops**: If timely credit is available to the farmers, they will not sell the produce immediately after the harvest is over. At that time the prices of agricultural goods are low in the market. Credit enables the farmers to withhold the agricultural surplus an sell in the market when prices are high.
6. **Facing crises:** The credit is required by the farmers to face crisis. The crisis can be caused by failure of crop, draught of floods.
7. **Balanced development:** Agricultural sector generally remains neglected compared to industrial sector in the country. For balanced development, it is essential that credit should be provided at concessional rates to the agriculture sector so that it should also expand and help in “take off” process of the country.

Types of Agricultural Credit:

Agriculture requires the following three types of credit;

1. **Short-Term Credit**:

   The short term credit ranges upto one year. The farmers need short term credit for meeting the working capital arrangements of agriculture. For instance, they need short term credit for the purchase of seeds, fertilizers, pesticides, bullocks and other casual expenses. Sometimes short term credits are also raised for paying rents, revenue and also meeting the financial requirements of the family. The short term credit is repaid after marketing the produce of next crop.

2. **Medium Term Credit:**

   The medium term loan extends from 1 to 5 years. The farmers require medium term credit for the purchase of cattle, purchase of implements, improvements in water courses etc. The loan is obtained on the security of movable and implements.

3. **Long Term Credit:**

   The duration of long term credit exceeds five years. The farmers need long term credit for making improvements of permanent nature in land such as sinking of tubewells, reclamation of land, building, purchase of machinery and implements etc.

Sources of Agricultural Credit:

Credit in the farm sector is available from following two sources;

1. **Non-Institutional Sources/ Informal Sources:**

   The major non-institutional sources of farm credit are money lenders, friends, relatives, shopkeepers and commission agents. Before 1947, the money lenders mostly non-Muslims were the main suppliers of loans to the farmers. After partition, however their importance has decreased to a great extent and the short term credit needs of the farmers are met from commission agents, friends and relatives which supply roughly 50% of total rural borrowing. The traders and commission agents advance loans to the farmers for short period. These loans are provided mostly for productive purposes before the maturity of crops. The commission agents force the farmers to sell the produce to them which generally is purchased at low rates. The lenders of the informal sources (friends, relatives etc) have certain advantages over the formal credit sources. The informal lenders usually know the borrowers personally. They require little security for advancing loans. The loan are given for consumption as well as production purposes. The lenders are approachable at all times. They are also lenient in rescheduling loans. However, informal lenders are also accused of charging higher rates of interest. They extract monopoly profits from the borrowers.

2. **Institutional Sources/ Formal Sources:**

   The major institutional sources of agricultural credit are Zarai Taraqiate Bank Limited (ZTBL) formally known as Agricultural Development Bank of Pakistan, State Banks, Commercial Banks, Cooperative credit and Taccavi Loans.

A. **Zarai Taraqiate Bank Limited (ZTBL) formally known as Agricultural Development Bank of Pakistan (ADBP):**

   The ZTBL was established in 1961 through merger of Development Finance Corporation and Agricultural Bank of Pakistan. The ZTBL is an important source for supply of credit to agricultural sector in Pakistan. The ZTBL provides short, medium and long term credits for farm and off farm activities. The bank have five windows of investment. (1). Development loans (2) Production loans (3) Agri-business loans (4) Cottage industry loans and (5) Off farm income to farmers generating activities loans.

B. **Commercial Banks:** Commercial Banks were introduced into the field of agricultural credit under the Banking Reform Act of 1972. The Banks, since then, are providing loans to the farmers for meeting their short and medium term requirements. The loans are advanced to the farmers against the security of land, crops, fixed assets and even on personal security. Commercial Banks disburse agricultural credits for the purchase of inputs, cattle, tractors, dairy farming, installation of tubewells etc. Banks provide loans under the Supervise Credit Scheme and outside the Supervise Credit Scheme.

C. **Cooperatives:** The cooperatives are oldest institutional sources of farm credit in Pakistan. The performance of cooperatives in the spread and utilization of credit to the small farmers is not satisfactory. The loans are mostly utilized by big farmers who have got their pocket societies registered with their cooperative department.

D. **Taccavi Loans:** Taccavi loans are handled by the Provincial Revenue Department. Necessary funds are allocated for different areas each year in the provincial budgets. The Taccavi loans are primarily given to the farmers for meeting emergencies such as flood, earthquake, famine etc. The farmers take these advances in the spirit of gift or relief given in the calamity and are not serious in repaying them. Now this source is now occupying insignificant position in the disbursement of overall credit to the farmers. Agricultural loans are being made available to the farmers at low mark up.

Role of State Bank of Pakistan/ Central Bank in Agriculture Financing: State Bank of Pakistan (SBP) is playing an active role of improving the quantitative and qualitative targets of rural credit. In start, the State Bank's charter did not allow the Bank to play some major role in agricultural financing except to advance short term loans for nine months to Cooperative Banks. In 1956, the "State Bank of Pakistan Order, 1948" and was replaced with the State Bank of Pakistan Act, 1956" and the Bank was given greater opportunity to participate in financing of agricultural sector under the Act, Bank was permitted to advance credit to agriculture for longer periods including loans through the discounting of bills of exchange for a period upto fifteen months, medium term loans to specialized rural credit institutions for periods to be determined according to the purpose of loan. After the enactment of the said Act, the State Bank took some major steps for having greater participation in agricultural finance in the country. A brief account of such steps is given s under;

i. The Bank established a separate Department of agricultural credit for research, assessment of credit needs and supervision of rural credit operations.
ii. The Bank created a special Rural Credit Fund in 1961, to advance credit to institutions engaged in agricultural financing in the country. This fund is fed from the profits of the State Bank and is advanced to rural credit agencies at 2% below the usual bank rate for lending for agricultural purposes only.
iii. The Bank also set up a Rural and Cooperative Credit Advisory Committee in 1961, to coordinate the activities of rural credit agencies and to give suggestions for solving rural credit problems.
iv. In 1968, the State Bank appointed the Rural Credit Survey Committee to make a rural credit survey on national basis.
v. In the close of 1960, the State Bank took important steps to encourage commercial banks to offer credits to agriculturists. The main difficulty in the way was the nature of security offered by the farmers.

vi. In order to increase the share of commercial banks in the rural credit, a Mandatory Credit Target Scheme was introduced in 1972 to force the commercial banks to enhance the flow of credits to the rural areas.

vii. The State Bank of Pakistan introduce refinance and guarantee scheme in 1970 to induce the commercial banks to initiate rural credit. The Bank under this scheme bears 50% losses on loans advanced to agriculture.

viii. The Interest-Free Production Loans Scheme was introduced in 1976 by State Bank of Pakistan.

ix. A share of 75% loans has been allocated by State Bank to small farmers holding lands upto 25 acres.

x. To promote Cooperative Credit Societies, the State Bank helped in establishing the Federal Bank of Cooperatives in 1976. The Federal Bank of Cooperatives was set up to advance agricultural credit through organizing cooperative societies in villages.

Hence, the State Bank of Pakistan has played a very important role in inducing various credit institutions to advance agricultural and rural credits in the country. The Bank provides heavy funds to the Agricultural Development Bank of Pakistan, Federal Bank of Cooperatives and the Commercial Banks for its further disbursements to the growers for their short, medium and long term credit requirements.

Supervised Agricultural Credit:

National Bank of Pakistan introduced this scheme in 1972 while other nationalized commercial banks introduced it in between 1975 to 1978. Loans could be distributed properly, could be utilized properly and their repayment could be made in time. Again with the help of this scheme the advisory facilities are provided to the farmers regarding the use of inputs and techniques of cultivation. Agricultural Development Bank of Pakistan adopted the system of Supervised Agricultural Credit at the close of 1970s. Under the system of supervised credit, the credit and technology are provided together and it is assumed that the credit is utilized for the purpose for which it has been issued. This system involves supervision and control on the use of credit. Moreover, the lending agencies help the farmers in planning of farm operations and assure that the farmers follow improved farming techniques. The Bank supervised only 2% of its general loans with the help of 14 Mobile Credit Officers (MCO), but during short span of time, it made remarkable achievements. Agricultural Credit Advisory Committee decided that, in future, all the commercial banks would provide loans under supervised credit scheme. All the nationalized commercial banks will follow this scheme where a commercial bank in each in each union council and town committee will be deputed to grant agricultural loans.

Following are the salient features of Supervised Agricultural Credit Scheme;

1. The purpose of this scheme was to provide the seasonal loans regarding production and medium and long term loans for developmental purposes.
2. The farmers will be contacted in their farms regarding their loan requirements. They will not have to go to bank branches, rather MCOs will prepare all documents regarding loaning.
3. The MCOs will be given enough authority regarding sanctioning of loan. The bank managers and other banking staff will sanction the production loan under 48 hours and developmental loans under 15 days.
4. While advancing loans, the reputation of farmers, his abilities, his hardworking an his spirit to enhance production with the borrowed money will be considered. Again no farmers could be deprived of the loan, just because of non-existence of "Mortgage". Moreover the principles of project evaluation will be kept in view while advancing loans.
5. The farmers who owns land will be entitled to borrow for production purpose just on the basis of 'Pass-book'. If he has nothing to offer for collateral he can entail upon loan on the basis of guarantee from one or two persons of the locality.
6. The developmental loans in the form of agricultural implements and equipment could be obtained just by mortgaging the land. If any farmers does not have land, he can pledge his urban poverty or other assets.
7. The agricultural loans to farmers will be provided in a form of package which will be consisting of provision of necessary inputs in suitable amount at a appropriate time, provision of extension services and technical consultancy concerning farm management and agriculture marketing. To meet their consumption and

production need the farmers will be given 20% of its loan in the form of cash. This loan will be given before the seasons sets in and the farmers will repay it back within two months after harvesting. If he makes the repayment of loan by this method, he could be able to get new loan automatically.

8. If there is crop failure of the farmer who has borrowed and the government declares the area as “Affected Area”, the bank will make the installment of the loan to be recovered by the farmers. Again, he will be able to get the loan for the coming years.

9. As there exists uncertainty in agriculture the banks will insure agriculture crops along with collaboration of National Insurance Corporation. While for the protection of borrowed families the bank will cooperate with State Life Insurance.

10. A block will be formed having four villages where 200 farmers will be selected for loaning. Their matters will be dealt by an agricultural credit officer, who will contact the local farmers with the help of motor-cycle. He will guide the farmers regarding technical and production matters as he himself is an agriculture graduates well aware of with sowing and harvesting of crops. He will also guide regarding agriculture marketing of agriculture produce. In this way, he will be able to recover the borrowed money in time.

11. The staff providing loan under supervise credit scheme will have a contact with agriculture universities, agriculture research centers, provincial agriculture departments and agriculture extension departments so that they could become aware of with new invented seeds, different types of fertilizers, pesticides and their effects. In this way, they could transfer the required information to the farmers.

12. Alongwith cooperation of provincial govts and fertilizers companies the following steps will be made to benefit the farmers;

- **i.** The soil and water testing laboratories will be set up in each union council.
- **ii.** The agriculture extension center will be set up.
- **iii.** The agriculture centers will be set up, which provide agriculture machinery on rent.

- **iv.** The depots of fertilizers and agro-chemicals will be set up.
- **v.** The workshops of agriculture machinery will be set up.
- **vi.** The market committees will be set up for fruits, vegetables and other perishable goods.

13. In order to encourage agriculture production, the commercial banks will give prizes to the borrowed farmers.

Problems of Agriculture Credit and Agriculture Credit Policy:

There is need to discuss the issues which are obstructing the supply of credit to farming sector;

1. **Uncertainty element in agriculture**:

   In Pakistan the agriculture cannot be industry. More than 50% of the cultivable land is consisted of uneconomical holdings. The farmers are illiterate, they follow the orthodox techniques of production and fail to make investment in farm due to poverty. They cannot store their produce. The farmer is poor because he is poor. Above all, our agriculture sector is furnished with uncertainty. We have floods as well as droughts. The rains are untimely. The pests badly affects the crops. The financial position of the farmers remains weak. Not to talk of ADBP and Commercial Banks even the Cooperatives are not prepared to give loans to farmers. Thus because of poor financial status, more affects of natural uncertainty in agriculture, the commercial banks an other financial institutions are not prepared to lend to farmers. They think that the cost of advancing loans to farmers are more than their revenues. The relation which existed between banks and industry and commerce is missing in case of banks and farmers. The farmer who is poor and illiterate can not frequently visit the banks as the businessmen do. The supervised credit scheme could not be successful in the presence of our socio-economics set-up.

2. **Lack of Securities**: If we sum the area of small farmers and medium sized farmers their share is 92% of total cultivable area. In such area most of the farms are commonly owned. While borrowing the farmers have to pledge their lands.

But in our rural society land is like the mother of the farmer and he is not prepared to be separated from it. He will prefer not to get the loan rather mortgaging the land. If he is prepared to pledge the land, it will be difficult to ascertain its value as we donot have efficient market for the sale and purchase of lands. It is too difficult to eject the farmers from his land, if he fails to pay the debt. The farmers lacking the pass books will not be able to draw upon the banks. They have to go registers and patwaris for the sake of registration of this lands where lot of formalities and malpractices exist. In such situation, they prefer to move to "Informal Sector" for borrowings. The cattle donot serve as good security. They can not be transported easily and their health standard will be affected. The unharvested crops can also serve as security. But the problem of estimation of crop will rise there. If the debtor does not pay the borrowed money he will lose his position. The personal security loans are also taken away by the big landlords as no body is prepared to give security of small farmers.

3. **Non-Institutional Credit:** So many farmers in Pakistan do not have any way out except to go for non-institutional credit. But the friends and relatives are limited source, they fail to supply enough funds. They could not provide loans for consumption and limited production purposes. They hardly provide developmental loans. Then, the farmers move to landlords and commission agents to get the loans. The landlords provide loans to marginal extent. Hence the commission agents help the farmers, but they provide the loans on the promise that the borrowers will sell the crops to them. They give low price for the produce and exploit the farmers. Hence, the non-institutional loans are also advanced in lesser amount.

4. **Improper Use of Agriculture Credits:** So many experts are of view that agriculture credit will be least beneficial if they fail to increase the agriculture output, increase the cultivable area and improve the lot of farmers. But in our country, the productive use of agriculture loans is limited. Most of loans taken by the farmers are for social needs and consumption. The farmers are prepared to sell their seeds, bulls and ploughs to perform their horse and cattle show fairs, marriages and funerals ceremonies. Thus agriculture loans are fail to alter the lot

of small farmers. The burden of debt on them goes on to increase and they may leave this would even without making payment of such loans. Against small loans, the big loans taken away by the landlords are diverting towards power, prestige, litigation and politics. Thus the agriculture loans are not bringing changes in our agriculture sector. In certain cases, the agriculture loans are becoming responsible for increasing inequalities in rural sector.

5. **Complicated Procedure and Strict Conditions:**

   The farmers have to face very strict conditions and complicated procedures while getting the loans. They have to give their pass-books where all the information regarding land are entered. According to Rural Credit Survey (1985), the farmers with land of 60 acres and above had the pass-books while 1% of the farmers with less than 2 acres were having pass-books. Thus, the farmers who were not having pass-books how they could get the loans. Again, the official formalities, the behaviours of patwaris, tehsildars and strict conditions of Bank obstruct the small farmers to get loans. Again, the weak financial position and higher interest rate also hamper loaning on the part of farmers.

6. **Recovery of Credit:** The process of recovery of loans is very much low. As told earlier that due to financial position the small farmers fail to pay back the loans. The big landlords make their credits to be written-off. The farmers should have repaid their loans after harvesting. But this does not happen. The Bank Officers and employees of cooperatives are found wandering in the village to find the debtor so that they could recover the loan. Often the arrest warrants are issued. But the process of loan recovery limited, as the farmers hardly care for repayment of loans and arrest warrants.

Measures to Remove Problems of Agriculture Credits: Following measures are adopted to remove the problems of agricultural credit;

1. The uncertainly elements in agriculture be minimized. The farmers must be hardworking so that they could utilize the farms efficiently. As a result, the agriculture production increases and agriculture sector will become profitable in this way, the flow of agriculture credit will go up.

2. The provision of agriculture loans be linked with productive capacity and efficiency of land, rather securities.
3. The farmers be provided with complete package of agriculture inputs instead of just loans as the case of supervised credit. Therefore, this scheme should be effectively implemented.
4. The better advisory services be provided regarding agriculture marketing. In this way, the farmers could be able to get fair prices of their produce and easily repay loans.
5. A revolution in agriculture sector be brought about so that people could pay more attention on developmental works, rather social traditions.

Risk Analysis and Management:

Risk management consists of - risk perception, risk analysis, and risk preparedness. Risks may be divided into three tiers. In the lower band, the public readily accepts risks because benefits are felt to outweigh the disadvantages. In the upper band, risks are regarded as completely unacceptable and must be reduced even at very high cost or, if not possible, the activities must cease. The intermediate region is one in which decisions on risk reduction are made by trading off associated costs and benefits. Traditionally, the field of risk management has three elements - identification of risks, risk assessment and implementaton of solutions and plans.

Risk Assessment consists of
identification
quantification
evaluation
acceptance
aversion
control

<table>
<tr><th colspan="4">Risk Management</th><th></th></tr>
<tr><th colspan="4">Risk Assessment</th><td rowspan="4">Risk Control

implement:
- protection works
- non-structural measures</td></tr>
<tr><th colspan="2">Risk Determination</th><th colspan="2">Risk Evaluation</th></tr>
<tr><th>Risk Identification</th><th>Risk Estimation</th><th>Risk Acceptence</th><th>Risk Aversion</th></tr>
<tr><td>identify:
- new risks
- change in risk parameters</td><td>determine:
- probability of occurances
- magnitiude of consequence value</td><td>establish:
- risk references
- risk referents</td><td>determine:
- degree of risk reduction
- degree of risk avoidance</td></tr>
</table>

Steps in Risk Management:

Risk assessment is defined as "The overall process of risk identification, quantification, evaluation, acceptance, aversion and management." Risk management is the managerial response based on the resolution of various policy issues such as acceptable risk. Risk management decisions are made by considering risk assessments within the context of political, social and economic realities. Such decisions are frequently controversial due to the difficulty in determining risks that are acceptable to the public.

Risk assessment includes risk determination and risk evaluation. Risk management includes risk assessment and risk control.

- Risk determination involves the related processes of risk identification and risk estimation. Risk identification is the process of observation and recognition of new risk parameters or new relationships among existing risk parameters, or perception of a change in the magnitudes of existing risk parameters. Risk, at the general level, involves two major elements: the occurrence probability of an adverse event and the consequences of the event. Risk estimation, consequently, is an estimation process, starting from the occurrence probability and ending at the consequence values. Risk evaluation is a complex process of developing acceptable levels of risk to individuals, groups, or the society as a whole. It involves the related processes of risk acceptance and risk aversion.
- Risk acceptance implies that a risk taker is willing to accept some risks to obtain a gain or benefit, if the risk cannot possibly be avoided or controlled. The acceptance level is a reference level against which a risk is determined and then compared. If the determined risk level is below the acceptance level, the risk is deemed acceptable. If it is deemed unacceptable and avoidable, steps may be taken to control the risk or the activity should be ceased. The perception and the acceptance of risks vary with the nature of the risks and depend upon many underlying factors. The risk may involve a "dread" hazard or a common hazard, be encountered occupationally or non-occupationally, have immediate or delayed effects and may effect average or especially sensitive people or systems.
- Risk aversion is the control action, taken to avoid or eliminate the risk, regulate or modify the activities to reduce the magnitude and/or frequency of adverse affects, reduce the vulnerability of exposed persons, property or in this case urban systems, develop and implement mitigation and recovery procedures, and institute loss-reimbursement and loss-distribution schemes.

Insurance in Agricultural Sector:

Agricultural production faces a myriad of risks. Nevertheless, two major risks are of concern to the agricultural sector—price risk caused by potential volatility in prices and production risk resulting from uncertainty about the levels of production that primary producers can achieve from their current activities. It is likely that these major risks will increase in the future—price risk due to liberalization of trade and production risk caused by the effects of climate change. The trend towards agricultural specialization is likely to continue which will increase these risks as producers rely on the production of a smaller range of crops and consequently cannot diversify risks as effectively. Agricultural risks not only affect farmers, they also affect the whole agribusiness value chain. Each of the participants along the supply chain, from the suppliers of inputs to the end consumer, are subject to these risks. As the interconnections between the participants in the value chain are becoming more close and complex, the possibilities of adverse events being transmitted between participants are increasing.

Agricultural risk management relies on an optimal combination of technical and financial tools. Agricultural value chain participants can use several tools, whenever they are available, to deal with these multiple sources of agricultural risk. Agricultural value chain participants may avoid risk; for instance, by choosing not to select a particular crop or crops which they consider of high risk for the area in which their farms are located. They may also mitigate risks; they may seek to lessen the risk through, for example, planting crops only in very favourable conditions or developing further their infrastructure to improve irrigation or minimize the effects of frost. Lastly, they may transfer all or part of the risks to a third party through an insurance contract. Of course, they may mitigate the financial effects of these risks by creating emergency reserves from profits in good years—a form of self-insurance This primer is concerned exclusively with the use of agricultural insurance by firms in the agribusiness value chain to manage their risks. The primer defines what is meant by agricultural insurance, gives an overview of the market and explains the challenges of this type of insurance. Further, it discusses the range of agricultural insurance products and their practical application in the sector. It concludes with a description of the reinsurance market for agricultural insurance and an overview of public sector participation.

In general, insurance is a form of risk management used to hedge against a contingent loss. The conventional definition is the equitable Agricultural Insurance 3 transfer of a risk of loss from one entity to another in exchange for a premium or a guaranteed and quantifiable small loss to prevent a large and possibly devastating loss. Agricultural insurance is a special line of property insurance applied to agricultural firms. In recognition of the specialized nature of this type of insurance, insurance companies operating in the market either have dedicated agribusiness units or outsource the underwriting to agencies that specialize in it. Agricultural insurance is not limited to crop insurance, it also applies to livestock, bloodstock, forestry, aquaculture, and greenhouses.

Importance of Micro-Credit in Agricultural Lending and Development:

The farmers in Pakistan have always been in need of micro-credit in order to perform their social needs, in addition to purchase the farming inputs or making improvements on lands. But on other hand, they have always been refused to give enough micro-finance and credit. In this regard, neither the non-institutional sources (friends, relatives etc), nor the institutional sources (ADBP, Cooperative Banks, Commercial Banks, Provincial Revenue Department) have fulfilled the need of needs of the farmers. Most of the backwardness of agriculture sector is attributed to non-availability of funds. Therefore, to remove the paucity of funds with rural farmers, efforts will have to be made to mobilize more credit and finance towards farming sector. The question arises, who will provide funds to this sector when it is surrounded by;

1. Uncertainty of output and prices.
2. Poverty of the small farmers who are more than 50% in Pakistan and they lack the securities in order to get loans.
3. The friends and relatives provide the meager amounts as credits.
4. The recovery of loan from agriculture sector is a difficult job.
5. Majority of farmers are illiterate, rigid and orthodox and they do not know any thing about banking practice.

As micro-credit is life blood of agriculture production. Therefore, the financial needs of farmers can not be under-estimated and they will have to be provided more funds, despite all of the problems attached with agriculture credit. Therefore, to provide more credit and finance to farmers in future we will have to depend upon the experiences of West as well the experience of Bangla-Desh in the form of Greeman Bank. Thus the future of credit and farming in agriculture will be bright if farmers are given the loans;

1. In terms of agriculture inputs alongwith consultancy services- The case of supervised credit. This can better be done through NGOs working at village level. They will follow less tedious loaning procedure and they will have complete supervision over the funds used and output produced.

2. The loans given by NGOs and micro-financing institutions like Greeman bank will advance smaller amounts. The recovery of such advancing is also easy when the bankers are having a gross-root link with the villagers.
3. The Commercial Banks and Agricultural Development Bank should come forward to rescue the dying farmers of Pakistan. They must relax the loaning conditions; loans be advanced on personal security, instead of physical security; the greater contact be maintained between the banking staff and the poor rural borrowers; and State Bank of Pakistan should provide cheaper loan to commercial banks so that they could lend the funds to farmers at cheaper rates.

Role of NGO's in Agricultural Lending and Development:

Experience shows that small credits play a significant role in poverty eradication. Also, when these loans are used by women, the benefits have been observed to include better education and food and health care for their families. On the other hand, men have the tendency to utilize a substantial amount of their income outside their homes, on social activities and personal enjoyments. Rural supports programme (RSP) have been initiated by the Govt. of Pakistan in order to improve the social and economic conditions of the rural masses. The largest among these is the National Rural Support Programme (NRSP) followed by the Sindh Rural Support Corporation (SRSC), Balochistan Rural Support Programme (BRSP) and Punjab Rural Support Programme (PRSP). All these follow the successful model of Aga Khan Rural Support Programme (AKRSP) based in Pakistan's Northern Areas and Chitral. Performance of two of these Programmes-Aga Khan Rural Support Programme (AKRSP) and the National Rural Support. The Aga Khan Rural Support Programme (AKRSP), a non-profit project initiated by the Aga Khan Foundation, started operating in 1982 to improve the extremely poor socio-economic conditions of about one million inhabitants of Pakistan's five northern mountain districts. AKRSP derives its success from a two pronged focus on institution-building and community participation. AKRSP has worked to accomplish its mission through several types of operations, including: (1) organising village-level institutions; (2) funding physical infrastructure projects; (3) promoting natural resource management in agriculture, livestock and forestry; (4) training and human resource development; and (5) marketing and enterprise development. By the end of 1994, 1,834 Village Organisations (VOs) and 763 Women's Organisations (WOs) had been established with 101, 304 total members. These VOs and WOs covered over two-thirds of the rural households in the programme area. AKRSP's inception, provisions were made for small-sized loans from AKRSP to the VO/WOs for distribution to members; and medium-sized loans were taken primarily by the VOs themselves. AKRSP introduced obligatory savings to mobilise capital and the use of credit from village organisations to assist small farmers. Later on, AKRSP shifted its focus to village organisation/women's organisation credit programmes (VOCP/WOCPs) that linked amounts borrowed to money saved. The VOCP/WOCPs made savings a more attractive proposition. AKRSP launched a micro enterprise programme. This is a considerable departure from the basis on which AKRSP had historically allocated credit and the micro enterprise programme has been far more risky. It was followed in 1995 by a new programme of corporate and commercial credit designed to support enterprises linked directly with village and women's organization commercial interests. The Village Organisation Credit Programme (VOCP) of ARKSP involves a number of conditions: all short term and medium term loans have to be paid off and the VO must have a generally good repayment record as well as sufficient trained management. The basic purpose of the credit policy of National Rural Support Programme (NRSP) is to bridge the gap between what the small farmers and the rural poor need and what is accessible to them. Loans are offered neither free nor at heavily subsidised rates. The advantages of NRSP credit are: (i) accessibility, (ii) simple procedures and short time lag, and (iii) group collateral. There are four major credit lines for which NRSP extends its loans:agricultural inputs; livestock purchase and fattening; enterprise development; and small infrastructure as individual enterprise. A vast majority of the poor in Pakistan reside in rural areas, and the severity of their poverty is greater than in the urban areas. Most of the rural poor are in the households of small landholders, cultivators (tenants), and the landless. Moreover, given the evidence on accessibility to food, nutrition, health care, education, and employment opportunities, there are glaring disparities between male and females in rural Pakistan.

The experience of AKRSP, has shown that it can work well, provided the rural poor effectively participate and the support organization has the institutional and technical capacity to provide assistance in the development of the social organization at the community or village level. There is also some evidence that these activities and services have contributed significantly, by creating trust and confidence, to the growth and strength of the COs. These relationships, however, need further analysis and study. Indeed a major reason for the relative success of the Aga Khan Rural Support Programme (AKRSP) in the Northern areas has been a commitment to the long-term sustainability of the programme through financial autonomy. NRSP in Pakistan has followed the dependency model by which the rural people have been kept for so long at the mercy of a paternalistic state. This, however, can be prevented only if NRSP enjoys financial autonomy on a long-term basis as it is noticed in the case of AKRSP. While the international donor agencies channelled more of their financial and technical assistance through the NGOs to stimulate the process of ‘democratization’ and increase the effectiveness of aid, the governments in Pakistan have often remained ambiguous about their relationships with NGOs, particularly with regard to establishment and development of the rural community (grassroots organizations). It is fair to say that, at least in Pakistan, the idea of increased empowerment of the poor vulnerable in the society has not been given unequivocal support by the entrenched political èlite and the state bureaucracy. Therefore, the NGOs as support organizations have to establish their autonomy, credibility, and competence in this environment to assist the poor in rural areas in their quest to acquire greater control on their lives and improve their standards of living. Besides the need for voluntary codes of conduct concerning the behaviour of non-state actors within a community, NGOs in Pakistan need to be provided positive incentives, alternative financing, and better government access to improve their mobilization of, and level of service for, the poor. When power is shared between the government and the informal institutions of civic governance, democracy and the rule of law can be strengthened.

Thus we conclude that if a better understanding is promoted between NGOs, micro financing institutions, commercial banks, State Bank of Pakistan and small farmers, the future of agriculture credit and finance will be very much encouraging and promising.

Glossary:

Abstract: A written, chronological summary of all deeds, mortgages, foreclosures and other transactions affecting the title to a tract of land. Also called abstract of title.

Acceleration clause: A common provision of a mortgage or note providing the lender with the right to demand that the entire outstanding balance be immediately due and payable in the event of default.

Accrual income: See **net income**.

Adjustable-rate loan: An adjustable rate loan has provisions to change the interest rate at prespecified points in time based on changes in a market index, a lenderâs cost of funds or other factors as determined by the lender.

Administrative costs: A lenderâs operating and fixed costs charged for completing and servicing a loan.

Agricultural bank: A bank that has a significant involvement in agricultural lending. Three methods are commonly used to identify an agricultural bank: 1) location in an agricultural community; 2) a specified proportion of agricultural loans to total loans (e.g., above the average ratio for all banks or greater than 25% agricultural loans to total loans); 3) a specified amount of agricultural loans (e.g., $5 million).

Annual percentage rate (APR): The term used in the Truth and Lending Act. It is an *actuarial* representation of the total financing cost of credit expressed as a percent per annum. The annual percentage rate (APR) is calculated similarly across different institutions.

Appraisal: The written summary by a qualified individual setting forth an estimated value of a specific asset or group of assets, usually used in reference to real estate.

Appreciation: The increase in value of an asset over time.

Assets: The items and property owned or controlled by an individual or business that have commercial or exchange value. Items may also include claims against others. All assets are reported on a balance sheet at market or cost value less accumulated depreciation.

Assignment: The transfer of title, property, rights or other interests from one person or entity to another.

Average cost of funds: A method of determining the cost of funds at a lending institution. This method uses an average cost of existing funds. In contrast, the marginal cost of funds uses cost of new funds only.

Balance sheet: The financial statement that reflects the values of an individual or businessâs assets and the financial claims on these assets at a specific point in time.

Balloon payment: A lump-sum final payment of a loan. It reflects the entire remaining balance of a shorter term loan (e.g., 5 years) which is amortized over a longer term (e.g., 10 to 20 years).

Bankruptcy: The federal court proceeding by which a debtor (individual or corporation) may obtain protection from creditors. The two general types of bankruptcy are voluntary and involuntary. A voluntary bankruptcy is initiated when the debtor voluntarily files a petition. In an involuntary bankruptcy, the creditor forces the debtor into bankruptcy. Debtors qualifying as ãfarmersä may not be involuntarily forced into bankruptcy. Bankruptcy proceedings involving farmers are declared under one of the several chapters of the federal bankruptcy code: Chapter 7 - liquidation; Chapters 11 and 12 - reorganizations; Chapter 13 - adjustment and workouts of debt.

Base rate: An interest rate used as a basis to price loans. A margin reflecting the riskiness of the individual or operation is added to or subtracted from the base rate to determine the loan rate. The bankâs funding, operating cost and required return are reflected in the base rate.

Basis point: Usually used in describing interest rate movements or interest costs. One basis point is 1/100 of 1%. For example, 50 basis points is 0.5%.

Blanket mortgage: A lien on more than one parcel of real estate.

Blanket security agreement: A security interest in favor of the lender covering all chattels.

Bridge loan: A temporary, single-payment loan used by creditors to ãbridgeä the time period between the retirement of one loan and the issuance of another. An example is a loan used for the down payment on a new real estate purchase.

Cap: Used with variable- or adjustable-rate loans. Refers to the maximum allowable adjustment in interest rate.

Capital debt repayment capacity (CDRC): Capital debt repayment capacity is a borrowerâs projected amount of funds available to repay principal and interest on intermediate- and long-term loans. Capital debt repayment capacity adjusts for noncash depreciation and accounts for net income, commitments for capital items and withdrawals.

Cash flow budget: A financial statement reflecting the projected sources and uses of cash. Items on the statement are usually categorized as business or nonbusiness with subdivisions for funds from business operations and funds from financing.

Chattel: Tangible personal property (e.g., tractors, grain, livestock, vehicles).

Closing: Process by which all fees and documents required by a lender prior to disbursing loan proceeds are executed and filed. Usually used in reference to the completion of a real estate transaction that transfers rights of ownership in exchange for monetary considerations.

Closing costs: The costs incurred by borrowers and sellers in completing a loan transaction. Included are origination fees, inspections, title insurance, appraisals, attorneyâs and realtorâs fees, and other costs of closing a loan.

Collateral: Property pledged to assure repayment of debt.

Commitment: A formal agreement between a lender and borrower to lend up to a specified amount of money at a specified future date subject to specific performance criteria and repayment terms.

Commitment fee: The fee associated with the establishment of a loan commitment. The fee is usually expressed as a percentage of the loan commitment.

Commodity Credit Corporation (CCC): The Commodity Credit Corporation is a wholly owned federal corporation within the U.S. Department of Agriculture formed to finance price supports for agricultural commodities. The objectives of the CCC are to stabilize and support income and commodity prices. In addition, the CCC facilitates the distribution and the balanced supply of agricultural commodities.

Compensating deposit balance: A minimum deposit balance that is sometimes required by a bank from a borrower. The balance is usually expressed as a percentage of the total loan commitment and/or a stipulated percentage of the amount of commitment actually used by the customer. In some cases, compensating balances can be used as a negotiating device by the borrower.

Compound interest: Compound interest means that each time interest is paid, it is added to or compounded into the principal and thereafter also earns interest. For example, a new deposit balance is estimated each day for daily compounding. Common compounding periods are daily, monthly, quarterly, annually and continuously. The more frequent the compounding, the higher the effective rate of interest.

Contract sale: A sale of property directly between buyer and seller. An agreement is made between the buyer and seller determining price, payment terms and title transfer.

Cooperative: An organization that is owned by and operated for the benefit of its patrons. An example is the Farm Credit System, in which member borrowers are the owners of the system.

Correspondent bank: A bank that performs specific functions for another bank (respondent bank). Functions may include loan participation, check clearing, data processing, cash management and consulting services.

Co-signer: An individual in addition to the borrower who signs a note and thus assumes responsibility and liability for repayment.

Cost of funds: Refers to the interest and noninterest cost of obtaining equity and debt funds.

Covenant: A legal promise in a note, loan agreement, security agreement or mortgage to do or not to do specific acts; or a promise that certain conditions do or do not exist. A breach of a covenant can lead to the ãinjured partyä pursuing legal remedies and can be a basis for foreclosure.

Credit scoring: A quantitative approach used to measure and evaluate the creditworthiness of a loan applicant. A measure of profitability, solvency, management ability and liquidity are commonly included in a credit scoring model.

Credit verification: The process involved in confirming the creditworthiness of a borrower.

Creditworthiness: The ability, willingness and financial capability of a borrower to repay debt.

Current ratio: A liquidity ratio calculated as current assets divided by current liabilities.

Debt-to-asset ratio: A solvency ratio calculated as total liabilities divided by total assets.

Deed of trust: A written instrument that conveys or transfers property to a trustee. Property is transferred by the borrower to a trustee, who holds it as security for the payment of debt, and upon full payment of the debt is reconveyed to the borrower. In some states, a deed of trust is used in place of a mortgage.

Default: The failure of a borrower to meet the financial obligations of a loan or a breach of any of the other terms or covenants of a loan.

Delinquency: The status of principal and/or interest payments on a loan that are overdue.

Demand loan: A loan with no specific maturity date. The lender may demand payment on the loan at any time.

Depreciation: A decrease in value of real property caused by age, use, obsolescence and physical deterioration. A noncash accounting expense that reflects the allowable deduction in book value of assets such as machinery, buildings or breeding livestock.

Down payment: The equity amount invested in an asset purchase. The down payment plus the amount borrowed generally equals the total value of the asset purchased.

Draft: An order for the payment of money drawn by one person or bank on another. Often used in the dispersal of an operating loan to a borrower for payment of bills.

Earnest money: Upon negotiation of the terms of sale, the portion of a down payment given to the seller (or escrow agent) as evidence of good faith in following through with the transaction.

Effective interest rate: The calculated interest rate that may take account of stock, fees and compounding, in contrast to a quoted rate of interest.

Employment verification: The confirmation of conditions of employment of a potential borrower.

Encumbrance: A claim or interest that limits the right of property. Examples include liens, mortgages, leases, dower rights of easements.

Escrow: The process of an agent providing safe keeping of cash, securities and documents and handling the paperwork and transfer of funds for the borrower and seller.

Equity capital: See **net worth**.

Farm Credit System (FCS): A system of federally chartered, but privately owned, banks and associations that lend primarily to agricultural producers and their cooperatives. The System is organized as a cooperative. The System is supervised and regulated by the Farm Credit Administration, an agency in the executive branch of the U.S. government.

Farmers Service Agency (FSA): A U.S. government agency operating under the authority of the U.S. Department of Agriculture. Programs principally provide or guarantee credit for agricultural and rural borrowers who show promise for financial viability but are unable to independently obtain financing from commercial sources. Loan programs include direct loans and partial guarantees of loans made by commercial lenders.

Fees: A fixed charge or payment for services associated with a loan transaction.

Filing: Giving public disclosure of a lenderâs security interest or assignment in collateral. In many cases this includes notice to certain government agencies.

Financial statement: A written report of the financial condition of a firm. Financial statements include balance sheet, income statement, statement of changes in net worth and statement of cash flow.

Financing statement: A statement filed by a lender with a public official. The statement reports the security interest or lien on the borrowerâs assets.

First mortgage: A real estate mortgage that has priority over all other mortgages on a specified piece of real estate.

Fixed-rate loan: A loan that bears the same interest rate until loan maturity.

Floating-rate loan: See **variable-rate loan**.

Foreclosure: The legal process by which a lien against property is enforced through the taking and selling of the property.

Graduated payment mortgage: A type of delayed payment mortgage where the payments increase over time.

Grantor: A person or entity conveying an interest in real property.

Guarantor: A person or entity that takes the financial responsibility of another personâs debt or other obligations in the case of default.

Income statement: Summary of the revenue (receipts or income) and expenses (costs) of a business over a period of time to determine its profit position. The income statement is also referred to as a profit and loss statement, earnings statement or an operating statement.

Intermediate-term loan: A loan to be repaid (or amortized) over a period of 18 months to 10 years, with 3 to 5 years being most common. Intermediate-term loans typically are used to finance machinery, equipment, automobiles, trucks, breeding livestock, improvements, and other durable, yet depreciable, assets.

Land trust: Legal entity by which a interest in real property is converted to an interest in personal property. Owners deed real property to the trust and receive an interest in the trust in return.

Lease: Acquiring the control of an asset (e.g., land machinery) by renting for a specified period of time. A rental payment is made by the lessee (or tenant) to the lessor (or landlord) to cover the lessorâs cost of ownership. Examples include operating leases, financial leases, real estate leases and custom hiring.

Lease-purchase: A financing arrangement in which an asset (e.g., a tractor) is leased for a period of time and then purchased at a price specified in the lease-purchase contract.

Legal lending limit: A legal limit on the total amount of loans and commitments a financial institution can have outstanding to any one borrower. The limit usually is determined as a specified percentage of the financial institutionâs own net worth or equity capital. Its purpose is to avoid excessive exposure to credit risk of an individual borrower.

Lien: A claim by a creditor on property or assets of a debtor in which the property may be held as security or sold in satisfaction (full or partial) of a debt. Liens may arise through borrowing transactions where the lender is granted a lien on the borrowerâs property. Other examples of liens include tax liens against real estate with delinquent taxes, a mechanicâs lien against property on which work has been performed, and a landlordâs lien against crops grown by a tenant.

Line-of-credit: An arrangement by a lender to make an amount of credit available to a borrower for use over a specified period of time. It is generally characterized by a master note, cash flow budgets, and periodic and partial disbursements and repayments of loan funds. A formal agreement of similar characteristics is a credit commitment.

Liquidation: The sale of assets to generate cash needed to meet financial obligations, transactions or investment opportunities.

Liquidity: The ability of a business to generate cash, with little risk of loss of principal value, to meet financial obligations, transactions or investment opportunities.

Loan agreement: Typically refers to a written agreement between a lender and borrower stipulating terms and conditions associated with a financing transaction and in addition to those included to accompanying note, security agreement and other loan documents. The agreement may indicate the obligations of each party, reporting requirements, possible sanctions for lack of borrower performance, and any restrictions placed on a borrower.

Loan commitment: A formal agreement to lend up to a specified dollar amount during a specified period.

Loan committee: A committee of loan officers, executive personnel and/or directors of a financial institution who establish lending policies and/or approve loan requests that exceed the lending authority of individual loan officers.

Loan conversion provision: An option provided by a lender to a borrower to change loan terms at a future date. For example, at loan origination a lender may provide a borrower with an option to convert from a variable- to a fixed-rate loan. Usually, the lender charges the borrower a fee for this option.

Loan guarantee: An agreement by an individual, a unit of government, insurance firm, or other party to repay all of part of a loan made by a lender in the event that the borrower is unable to repay. An example is the loan guarantee program available to agricultural lenders from the Farm Service Agency in which up to 90% of an qualified loan may be covered by the guarantee.

Loan participation: A loan in which two or more lenders share in providing loan funds to a borrower. An example is a loan participation between a local bank and a correspondent bank in which the loan request exceeds the local bankâs legal lending limit. Generally, one of the participating lenders originates, services, and documents the loan.

Loan-to-asset value: The ratio of loan balance to the value of assets pledged as collateral to secure a loan.

London Interbank Offered Rate (LIBOR): A worldwide base borrowing and lending rate between lenders. Often used as an index or a base for defining a borrowing rate for customers.

Long-term loan: A loan to be repaid (or amortized) over a period of time exceeding 10 years, with 20- to 30-year loans being common when financing real estate.

Marginal cost of funds: A loan pricing policy by a financial institution in which interest rates on new loans are based on the cost of new funds acquired in financial markets to fund the loans. This pricing policy contrasts with loan pricing based on the average cost of funds already acquired by the lending institution.

Master note: A note (promise to repay) often used in combination with line-of-credit financing to cover present and future borrowing needs through periodic disbursements and repayments of loan funds.

Maturity: Amount of time until the loan is fully due and payable. For example, a 5-year intermediate-term loan has a maturity of 5 years.

Mediation: Resolution of problem loans, disagreements, or conflicts between borrowers and lenders by means of a third party serving as a mediator.

Mortgage: A legal instrument that conveys a security interest in real estate property to the mortgagee (i.e., a lender) as an assurance that a loan secured by the real estate mortgage will be repaid.

Net income: A measurement of the net return to unpaid labor, management and equity capital. Also called accrual net income. The primary difference between cash and accrual net income is that accrual income includes adjustments for changes in inventory and changes in accrual items like prepaid expenses, accounts payable and accounts receivable. Accrual net income more accurately reflects the profitability of a business over an accounting period.

Net worth: The financial claim by owners on the total assets of a business, calculated as total assets minus total liabilities equals net worth. Also called equity capital and ownership equity.

Nonrevolving line-of-credit: A line-of-credit in which the maximum amount of a loan is the total of loan disbursements. Repayments do not make loan funds available again as in a revolving line-of-credit.

Note: A written document in which a borrower promises to repay a loan to a lender at a stipulated interest rate within a specified time period or upon demand. Also called a promissory note.

Off-farm income: Income earned by a farmer operator or member of the operatorâs family from employment off the farm or from investments made in nonfarm activities or ventures.

Operating loan: A short-term loan (i.e., less than one year) to finance crop production, livestock production, inventories, accounts receivable and other operating or short-term liquidity needs of a business.

Origination fee: A fee charged by a lender to a borrower at the time a loan is originated to cover the costs of administering the loan, evaluating credit, checking legal records, verifying collateral and other administrative activities.

Overline loan: A loan in excess of a financial institutionâs legal lending limit to any one borrower in which the institution has enlisted the services of another lender to participate in the loan.

Ownership equity: See **net worth**.

Partial release: Release of a portion of collateral to the borrower.

Participation loan: See **loan participation**.

Personal property: Any tangible or intangible property that is not designated by law as real property. Personal property is not fixed or immovable.

Points: A form of loan fee generally charged by long-term lenders at loan origination to cover a portion of the lenderâs administrative and funding costs. Points typically are expressed as a percentage of the total loan. For example, 3 points equals 3% of the loan amount.

Prepayment penalty: An amount charged by a lender on a loan paid prior to its maturity.

Prime rate: A nationally quoted rate believed to represent the interest rate charged by U.S. money-center banks to their most creditworthy corporate borrowers. Prime rate may also refer to an individual lenderâs interest rate charged to its most creditworthy borrowers, although the term **base rate** is more commonly used.

Principal: The dollar amount of a loan outstanding at a point in time, or the portion of a payment that represents a reduction in loan balance. Principal is distinguished from interest due on a loan or the interest portion of a loan payment.

Profit and loss statement: See **income statement**.

Profitability: The relative profit performance of a business, enterprise or other operating unit. Profitability comparisons often occur over time, across peer groups, relative to projections, and relative to norms or standards.

Pro forma statement: A projection into the future. Examples are a pro forma balance sheet and a pro forma income statement.

Rate adjustment: A change in interest rate on an existing loan. Rate adjustments may occur on variable- or adjustable-rate loans.

Rate of return on assets (ROA): A profitability measure representing the rate of return on business assets during an accounting period. ROA is calculated by dividing the dollar return to assets during the accounting period by the value of assets at the beginning of the period or the average value of assets over the period.

Rate of return on equity (ROE): A profitability measure representing the rate of return on the equity capital which owners have invested in a business. ROE is calculated by dividing the dollar return to equity capital during an accounting period by the value of equity capital at the beginning of the period or the average value of equity capital over the period.

Real property: Land, buildings, minerals and other kinds of property that are legally classified as real.

Refinancing: A change in an existing loan designed to extend and/or restructure the repayment obligation or to achieve more favorable loan terms by transferring the financing arrangement to another lender or loan type.

Renewal: A form of extending an unpaid loan in which the borrowerâs remaining unpaid loan balance is carried over (renewed) into a new loan at the beginning of the next financing period.

Repayment ability: The anticipated ability of a borrower to generate sufficient cash to repay a loan plus interest according to the terms established in the loan contract.

Revolving line-of-credit: A line-of-credit made available to a borrower in which the borrower can usually borrow, repay and reborrow funds at any time and in any amounts up to the credit limit, but not above, during a specified period of time.

Right of recision: A provision of the Truth in Lending Act which gives a borrower the right to rescind a borrowing transaction (i.e., change his or her mind) within three business days on any transaction in which the principal residence is used to secure the loan.

Risk assessment: The procedures a lender follows in evaluating a borrowerâs creditworthiness, repayment ability, and collateral position relative to the borrowerâs intended use of the loan proceeds. Risk assessment is similar to credit scoring and risk rating.

Risk premium: The adjustment of a lenderâs base interest rate in response to the anticipated level of a borrowerâs credit risk in a loan transaction. Higher risk loans may carry higher interest rates, with the rate differential representing the risk premium.

Risk rating: The relative amount of credit risk associated with a loan transaction. The lender may use credit scoring or risk assessment procedures to evaluate loan requests and group borrowers into various risk classes for purposes of loan acceptance or rejection, loan pricing, loan control, degree of monitoring and level of loan documentation.

Risk tolerance: The degree of safety an investor wished to have. Also called risk aversion or risk attitude.

Schedule F: The Internal Revenue Service form used to report farm income and expenses as a part of filing federal income tax returns.

Second mortgage: The use of two lenders in a real estate mortgage in which one lender holds a first mortgage on the real estate and another lender holds a second mortgage. The first mortgage holder has first claim on the borrowerâs mortgaged property and assets in the event of loan default and foreclosure or bankruptcy.

Secondary market: An organized market in which existing financial assets are bought and sold. Examples are the New York Stock Exchange, bond markets, over-the-counter markets, residential mortgage loans, governmental guaranteed loans, and the more recently formed secondary market for buying and selling farm mortgage loans (called Farmer Mac).

Secured loans: Loans in which specific assets have been pledged by the borrower as collateral to secure the loan. Security agreements and mortgages serve as evidence of security in secured loans.

Security agreement: A legal instrument signed by a debtor granting a security interest to a lender in specified personal property pledged as collateral to secure a loan.

Seller financing: A loan provided by the seller of property to its buyer.

Share lease: A leasing arrangement for real estate in which the landlord receives a share of the production as rent, and pays a share of the businessâs variable expenses. The landlord often shares in the management decisions with the tenant.

Shared appreciation mortgage: A financing arrangement for real estate in which the lender reduces the interest rate on the loan in return for a stipulated share of the appreciated value of the land being financed at a designated time in the future. The risk of land value appreciation is shared between lender and borrower, and the lenderâs compensation from value appreciation generally occurs through refinancing in which the loan balance is increased by the amount of the shared appreciation.

Simple interest: A method of calculating interest obligations in which no compounding of interest occurs. Interest charges are the product of the loan principal times the annual rate of interest, times the number of years or proportion of a year the principal has been outstanding.

Solvency: A business condition of financial viability in which net worth is positive and the business is expected to meet its financial obligations as they come due. An insolvent business has a zero net worth and questionable viability. Solvency indicators include the debt-to-asset ratio, debt-to-equity ratio and the equity-to-asset ratio.

Split line-of-credit: A financing situation in which a borrower obtains operating credit from two or more lenders.

Stock requirement: A method of capitalizing lending institutions such as the cooperative Farm Credit System. The borrower is required to purchase stock in the lending association to obtain a loan. The stock requirement generally is specified as a percentage of the loan or as a dollar amount. The stock requirement may be a low as 2% of the value of the loan or a maximum of $1,000. The purchase of stock is a financial investment in the issuing institution which is typically paid back at loan maturity, but the lender is not obligated to do so.

Surety: Person or entity that has been requested by another (principal) and agrees to be responsible for the performance of some act if the principal fails to perform as promised.

Tiered loans: Loans grouped according to the risk characteristics of borrowers. Higher risk classes generally are charged higher interest rates to compensate the lender for carrying the credit risk.

Title insurance: Insurance which protects a purchaser or mortgage lender against losses arising from a defect in title to real estate, other than defects that have been specifically excluded. A clear title is free of any claims, mortgages, liens and other encumbrances and has no ownership interest other than that of the owner of record.

Title opinion: A legal opinion rendered regarding the abstract of title.

Title search: The process of tracing all events and transactions affecting the title to a tract of real estate. Title search is essential to the preparation of an abstract.

Trend analysis: The use of financial measures or ratios over several time periods to evaluate business performance.

Truth in Lending: The federal Truth in Lending Act is intended to assure a meaningful disclosure of credit terms to borrowers, especially on consumer loans. Lenders are required to inform borrowers precisely and explicitly of the total amount of the finance charge which they must pay and the annual percentage interest rate to the nearest .01%. Excluded transactions include loans for commercial or business purposes, including agricultural loans; loans to partnerships, corporation, cooperatives and organization; and loans greater than $25,000 except for owner-occupied, residential real estate mortgages where compliance is required regardless of the amount.

Unsecured loans: Loans for which there are no guarantors or co-signors and no specific assets have been pledged by the borrower as collateral to secure the loan.

Usury laws: Laws which establish legal ceilings on the interest rates charged for various types of loans. In states where usury laws exist, most usury limits are well above market interest rates and often are indexed to change with changes in market interest rates or other leading rate indicators.

Variable-rate loan: A loan transaction in which the interest rate may be changed within the period of the loan contract. Generally, rate changes occur in response to changes in the lenderâs cost of funds of a specified index. The frequency and level of rate adjustments may or may not be established in the loan contract.

Warehouse receipt: A receipt issued by a warehouseman providing evidence of title to stored goods (especially commodities) and thus validating the existence of collateral which may be pledged to secure a loan. Negotiable warehouse receipts are documents of title. A warehouse may be used to transfer ownership of the goods or commodities it represents.

Working capital: The differences between current assets and current liabilities. Often used as a measurement of liquidity of a business.