Agricultural Lending Guidelines

Attached hereto as part of the Annex are Excel Spread Sheets that provide you with Templates that can be customized to serve your financial institution's needs. As you revise and implement the system you will need to ensure that your Core FIing System can be parameterized to accept the data you are collecting. The tools essentially for part of the Loan application and documentation process as outlined herein.

Customer Screening

Lending money is a risk - you might not get it back. So you will do everything possible to try and make sure you get it back through client selection, careful loan appraisal, asking for security or guarantees, building loyalty and so on. Using a mix of all of these has meant that even lending to very small scale entrepreneurs with limited assets is possible. It requires an initial investment of time, which is costly but less costly than making loans that cannot be repaid. The mix of activities typical of farm based households make collecting information on them particularly time-consuming, so an institution wishing to concentrate on this target audience should prepare a list of basic criteria that will rule someone in or out of a chance of getting a loan immediately. That way staff time will not be wasted gathering detailed information only to find that that person does not qualify for a loan due to some basic criteria not being met.

These eligibility criteria are highly context-specific and a financial institution (FI) must carefully consider what criteria it will include in such a list, in order not to exclude potentially good clients.

There are three core criteria to consider:

1. **Previous loans.** Lenders back office staff review whether the farmer interested in obtaining a loan already has a credit track record with the FI. This information is automatically checked in the computer system by entering the name and ID number of the farmer. If the person has accumulated more than 30 days overdue on the previous loans, access to future loans is denied and the loan request is turned down immediately.
2. **Previous or current loans with other lending institutions.** In the absence of a credit reference bureau in the country, the FI can agree with other rural financial intermediaries to circulate lists with overdue borrowers that are updated on a monthly basis. Whenever a farmer contacts the FI and presents a loan request, these lists are checked to find out whether the person has unpaid loans or has a loan that is currently overdue. If people are listed as overdue borrowers, the FI immediately refuses their loan requests.

3. **Borrower characteristics.** As a final step, FI staff check whether the potential borrower complies with FI specified eligibility criteria contained in the FIs lending policy and procedures.

In addition, the FIs staff who carry out screening interviews sometimes develop a "gut-feeling" about a client's probable creditworthiness. If there are indications that the loan applicant is hiding information or telling lies, the officer can stop the interview and tell the person they are not eligible.

In order to prevent the information being collected several times, e.g. during the screening interview, when the loan application is filled out, and during the field visit, the various forms used for these different purposes can be inter-linked in a database. If this is done, all the information that is collected during the screening interview will automatically appear in the loan application form.

The Loan Application

Once the eligibility of a potential client has been established, that person can proceed to make an application for a loan. FIs usually have application forms which may need to be filled out by the staff together with the loan applicant. Loan application forms should contain much of the information a loan officer needs to plan a visit to the applicant's business and carry out the loan appraisal at a later stage.

The following are key factors for successful loan analysis: character, capacity, capital, collateral and conditions. All these factors matter but for small farmers, the first two – character and capacity – are the most important.

In order to be able to visit the client, the home address needs to be documented. As official street names are lacking in rural areas, FI staff often add a little drawing on the back of the sheet and take note of reference points in order to be able to locate the loan applicant's home more easily. GPS if available is also useful.

It is important to know the civil status of the loan applicant and to find out more about his/her family background. So the loan applicant should provide information about the name and age of the spouse as well as about the time they have lived together. This will give an impression about the stability of the family and will also help to involve the partner in the credit process. The FI may require spouses to co-sign loan contracts in order to ensure that they know about the loan obligation and feel responsible for it.

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Knowing about the overall family situation is important to ensure that the loan officer appreciates the need to analyze the monthly family budget requirements in-depth during the field visit. The number of children and other dependents who do not generate income clearly has an influence on household expenditure. While young children generate school expenses, older children may contribute significantly to household income and help to diversify the family's income sources.

Another important part of a loan application form is the section on the economic activities carried out by the farm household. This information helps to build a risk profile for the farm household, particularly when analyzed together with the family structure and land situation. It also allows the loan officer to obtain insights into the variety of income sources and determine if they produce a continuous and reliable cash-flow.

The number of years of professional experience for each economic activity gives an indication of the level of production skills in the farm household. The variety of crops that are under cultivation, for example, provides an indication about how well the farmer manages crop rotation systems and how well the different crops complement each other. When we analyze this information in the light of the location and size of the plots, we will have the possibility to project very roughly the expected yield of the farm household.
Because in rural areas the location of the area under cultivation is not always in the same place as the home, it is important to get a very clear and detailed description of the location of the plot. These descriptions are especially important for planning the field trip. GPS as noted earlier can be used as well.

In addition, the exact location of all properties is also important in order to know about the land property situation in legal terms as well as in terms of land quality. A classification of the borrower in legal terms regarding land titles and possible disputes over them can be based on this information. Also, later in the appraisal process, estimations of yields can be cross-checked against the known quality of the cultivated land used by the farmer.

Finally, the information about the number of plots that are cultivated, their size and precise location provide further insights into the production strategy of the farm household and the associated cost-income structure and risks. For example, very small plots do only allow manual production, requiring a lot of labor. The existence of several very small plots that are spread over a larger area might contribute to mitigate climate risks but increase transportation costs.

Previous and current loans

Obtaining information about previous loans shows how familiar the loan applicant is with borrowing money. The name of the lending institution or person might provide an insight into the potential creditworthiness of the loan applicant. Previous loans from a highly subsidized program might give warning of lax repayment morale. Information on current loans is particularly interesting as it shows the current level of indebtedness and how much of the current income is already absorbed by servicing other loans.

Details of the Proposed Loan

Information about the applicant's preferences regarding the proposed loan gives FI the opportunity to tailor the loan to customer needs. The desired disbursement date, for example, is particularly important for agricultural production as a delay in planting crops can result in significant income losses due to the reduced yield. At the same time, the information provided in this section indicates how realistic the borrower is as regards his financial needs, the term required to repay and the repayment schedule. It gives a clear indication how well a loan applicant knows and manages his cash-flow.

In addition, this section of the application can show whether borrowers are interested in a partnership with the FI that is frank and honest or whether they are distorting the facts. In many cases, for example, borrowers overestimate their loan amounts and required repayment period. However, once the loan applicant describes in more detail what he or she needs the loan for, FI is in a better position to assess the loan amount and term structure in the light of the actual needs.

References

Each loan applicant must name at least two personal references who can provide further information. If loan applicants refuse to provide this information, FI will turns down the loan application immediately as it suggests a high degree of moral hazard.

Once the information provided by a farmer during the loan application process has been checked, the loan officer can schedule an on-site visit to the farm household. The objective of this visit is to capture further information about those crucial "C" factors:

Repayment Capacity

Small farm businesses are family-based, involve multiple economic activities and income and expenditure is generally shared. There is no clear distinction between the family and the business. The repayment capacity of a borrower depends on whether there is enough cash available in the “family pot” to service the loan. Loan installments normally do not represent “ear-marked” funds but are simply taken out of the cash reserves of the household. Thus the lender needs to figure out if there will be sufficient cash inflows to offset all the outflows, including loan repayment.

Cash flow analysis is the single most important analysis a lender has to do. The diversity of enterprise activity on a small farm makes it seem complicated but it can and must be done.

Some of the cash flows will be regular, while others will be irregular. For agricultural producers, most production-related cash flows are irregular, i.e. seasonal in nature. Regular income may come from petty trade or the regular employment of some family members, although even trading activities may peak around festival dates for religious or national commemorations.

Analyzing the current income and expenditure pattern of a farmer provides a picture of the cash fluctuation and risk profile of the farmer. We must, however, remember that a loan has to be paid back from future income. Therefore, income and expenditure must be projected into the future in order to determine whether the farmer is able to repay a loan or not. Historic data about past cash-flows do not reflect the true future repayment capacity. As we all know, price volatility is particularly high in the agricultural sector. Weather conditions can change from one year to the next as can international crop prices. It is therefore important to make a cash flow projection based on past experience and trends but oriented to take account of future predictions.

The FI's loan officers are expected to capture information on the amounts, timing, frequency and probability of future income and expenditure flows during their farm visits. They must consider seasonal and perennial crops, livestock with periodic sales of products (wool, meat) and those with daily sales (milk, eggs), temporary and permanent non-farm activities, and all kinds of regular and sporadic family expenditures.

In order to make realistic cash flow projections, the loan officers must obtain insights into the production methods, farm management skills and other external factors that may affect the farm household during the repayment period of the loan. These external factors can include weather forecasts as well as problems in the loan applicant's irrigation co-operative or marketing problems.

During the field visit, the loan officer should keep the following in mind:

- **Possibility of delayed payments.** Some applicants may purchase raw materials on credit or sell their crops on credit. When asking about income and expenditure, it is important, therefore, to check when the cash inflows and outflows actually occur. Current and proposed agreements should be discussed to provide a complete picture.
- **Underestimated household expenses.** It is important to obtain information not only about regular consumption expenses, e.g. food, transport, gas etc., but also expenses for extraordinary events. These can include expenses for pilgrimages, weddings or the annual village festival. Since family expenditures do tend to be underestimated, FI include an additional 10% for unforeseen expenses.
- **Unrecorded debts.** Although information about existing loans is recorded on the loan application form, it is important to cross-check this information again during the interview. In many cases, farm households have additional obligations that they do not

consider to be loans as such. These can include, for example, pawning transactions or lease agreements for a lorry.

- **Importance of cross-checking.** FI's loan officers cross-check data by asking for support documentation (e.g. receipts, invoices etc.). Another cross-checking method is to include various family members in the interview. Suppliers and traders who were mentioned by the loan applicant during the field visit can also be contacted to reconfirm information. FI's loan officers do not just take information at face value from the farmers. They analyze the information in the light of the risk profile and management capacity associated with the potential borrower and adjust the income and expenditure accordingly. They also compare the collected information with data available from similar farm households. If there are major deviations, the loan officer tries to reconfirm the information and generally opts for the more conservative figure.

The following list presents a sample of other aspects that are reviewed during the field visit to ensure realistic income and expenditure projections:

- **Weather and pest risks.** Agricultural production can always be hit by bad weather conditions or pests. Many farmers mitigate these risks by applying different techniques. Some farmers, for example, deliberately use various small plots that are spread out over a larger region instead of producing in one large plot. The advantages associated with the former approach are obvious: While one plot might be hit by bad weather, another plot might not be affected, so only part of the harvest would be lost. Other techniques to reduce weather and pest risks range from the simple use of seed-boxes to facilitate germinating in cold climates or using disease resistant varieties, to the installation of complex irrigation systems.
- **Rotation of crops.** Appropriate crop rotation is important to maintain the soil fertility and structure, control diseases and pest and facilitate weed control. If this is not done properly, soil quality deteriorates, resulting in decreasing yields and, hence, income.
- **Erosion control.** Erosion results in a loss of land for production. To prevent erosion and maintain the maximum area of fertile land possible, there are many different techniques. These range from reducing grazing pressure to the introduction of cultivation practices like terracing or planting trees and hedges.
- **Crop storage.** Selling the harvest at the right moment is difficult for many farmers. Only few have sufficient and appropriate storage facilities to keep the harvest for a longer period and benefit from higher prices later. Most farmers are forced to immediately sell their harvest. Therefore it is important to know whether the loan applicant might face marketing constraints.

This list is merely illustrative and is not intended to be exhaustive at all. There might be many other aspects a loan officer should have a look at. If any of the factors considered give cause for concern, the loan officer might opt to adjust income projections towards more conservative figures. In extreme cases, loan officers might even decide to reject the loan application following the field visit, if risks are considered to be too high and not manageable by the farmer.

Character and Willingness to Repay

The field visit should be used to gain an insight into the character of the prospective borrower and whether there is any risk of moral hazard. While farm income may be sufficient to repay the loan, a client may decide not to repay for a variety of reasons – maybe due to urgent family needs, or a desire to reinvest directly etc.

The most important methods used for character assessment include a personal presentation by the applicant about his / her business plans, an assessment of the quality and reliability of the information given, and the applicant's credit history with the FI. Character assessments of rural smallholders focus on the same issues, but differ in the methods used to obtain the information and the key aspects to focus on.

Another key element FI loan officers focus on is the client's openness in disclosing information and sharing it with the FI. Does the loan applicant voluntarily identify his assets? Does he readily provide receipts and other documentation that the officer asks for?

Reputation in the community. How do the leaders of the village community see the loan applicant? What kind of reputation or image does the loan applicant have? Is he known for being a drunkard or addicted to gambling? Is he seen as reliable and trustworthy, someone his family and the community are proud of?

Finding reliable answers to these questions is a sensitive issue. FI loan officers use a very indirect approach. They listen while having lunch at local restaurants or while travelling on the bus. They go to the local events like football games or religious ceremonies and use these occasions to obtain more information about the villagers.

The only people that are interviewed directly are the referees that the potential borrower has indicated in the loan application. Loan officers usually decide on a case by case basis whether it is necessary to follow these references up.

Previous track record with financial institutions. The most reliable source of information for a lender is the individual client records within the institution itself, i.e. FI account details or loan records. Evidence that previous loans have been repaid remains the key source of information on the repayment willingness of the applicant. If payments have often been late, it is very likely that the next loan again will perform irregularly.

FI loan officers are encouraged to stop a field visit if they have the feeling that the client is hiding important information or is not co-operative. However, there is a thin line between good and bad judgment. There is a difference between people who are just too shy to talk or have very little capacity to provide accurate figures and others who deliberately hide information and openly tell lies. Distinguishing between these two groups requires an experienced loan officer who has good communication skills and knows how to deal with different people.

Capital and Collateral

A balance sheet is the key document for understanding the capital position of a potential borrower. Of course, small farmers do not usually prepare accounts but it is not difficult to construct a balance sheet during the course of a field visit. It comprises two lists - on the one hand all the assets of the farm household and on the other all the liabilities. The difference between the value of all the assets and the liabilities to people outside the family equals the net capital or net worth of the farmer. This is a measure of the loan applicant's ability to withstand possible adverse circumstances. Net capital is largely built up by ploughing profits back into the business.

Constructing a balance sheet is like taking a snap shot of the business at that particular moment. You can see everything the family owns - the land, buildings, machinery, livestock, growing crops, crops or inputs in storage, vehicles, goods purchased for resale and so on. Things that you cannot "see" but are still part of the asset picture are the cash the farmer has in his pocket or saved in the FI, post office or cooperative, and the money that other people may owe the farm (accounts receivable or debtors) because this will become cash in the future. The liabilities picture includes all the short, medium and long term debts that the farmer has - unpaid bills (accounts payable or creditors), leasing charges, informal and formal loans from other people or institutions. Most small farmers have no idea how much they may have invested in the business themselves over the years, so working out the net capital can prove quite a surprise. It is certainly indicative of whether the family's enterprises have been profitable enough to allow them to save and reinvest.

In preparing a balance sheet we have to consider (again) the fact that rural smallholders do not clearly differentiate between the household and the farm/enterprise sphere. Therefore, a balance sheet including only farm-related assets and liabilities may seriously misrepresent the financial situation of the applicant. Some agricultural lenders do only analyze the specific investment project to be financed. Others focus only on the assets and liabilities related to the economic activity to be financed. Inclusion of household assets and liabilities will require more loan officer time, but will also lead to substantially more reliable figures.

A practical benefit of including assets not directly related to the loan purpose or the economic activity to be financed is the signal to the borrower, that he/she will not be let off the hook if the financed activity does not turn out to be as successful and profitable as envisaged. The borrower is accountable to the FI with all his/her assets, including household goods.

An important side effect of constructing a balance sheet is the potential identification of assets which can be pledged as collateral for the loan. Being certain of the accuracy of balance sheet information is not an easy task for a loan officer. Loan officers have identified the following problems in setting up a balance sheet with reliable data:

- **Asset ownership.** Farm assets are often located or stored in many different places, so it is a challenge to identify and record everything and to make sure that these assets are actually owned by the farm household. For example, if a farmer claims that cattle grazing on community grassland are his, this statement must be reconfirmed. Some farmers may claim that they own certain machinery that is currently lent to others so that it cannot be shown to the loan officer. FI's loan officer must carefully check the situation to obtain reliable figures.
- **Asset valuation.** A particular challenge is determining a reasonable value for each of the existing assets. It is imperative NOT to just take down the historical purchase price of an item or simply accept selling prices suggested by the farmer. Loan officers need to develop a good understanding of valuation, particularly for machinery. The FI inventory form asks the loan officer to evaluate the condition of items. Machinery must be seen in running order to be able to evaluate it. Items which need repair or maintenance in order to become useable should be limited to, say, 20% of its resale value. Raw material should be valued at purchase price after a thorough check of the quality. The same procedure applies to stored agricultural produce. Loan officers need to check with their own eyes the quality of the stock and the quality of the storage facilities. A good knowledge of current prices on the agricultural market is vital for the valuation of these asset items. Growing crops are usually valued at cost of inputs used to date.
- **Cash and deposits.** The cash in hand noted in the balance sheet should only be the amount actually shown to the loan officer. By the same token, only those cash savings that are shown in savings passbooks should be recorded. This is a conservative approach as many loan applicants might still have a "reserve for a rainy day" that they do not want to disclose to the loan officer. However, it is better to underestimate the available short-term liquidity than to overestimate it.
- **Accounts receivable and payable.** Though many farmers might sell on credit or purchase input goods on credit, they might not appreciate that these future cash transactions should be included in the current information. Therefore, it is very important to ask directly for these transactions.

- **Loans from informal funding sources.** Liabilities to friends, family, neighbors and informal moneylenders are difficult to trace and require experience, a good interview technique and a lot of asking around in the applicant's environment.
- **Pawn loans.** In some countries, pawning gold or jewelry is widespread, particularly in rural areas. However, as the repayment of these loans may be several months ahead and not very certain, many farmers forget to mention about them. Loan officers, therefore, should always ask specifically about pawn loans.

Successful field visits require many skills - officers must be alert, sensitive, observant, knowledgeable and able to quickly check figures in their heads. Supportive documentation should always be cross-checked whenever available (i.e. receipts, ownership documents) and the process should not be hurried. It is too costly to go back to ask about things you have forgotten. The greatest investment of time will be in first time borrowers. Working with existing clients is much quicker because much of the essential information is already known.

Cash Flow Analysis

All the income and expenditure information that has been collected during the field trip is now consolidated in a cash flow projection. The exact period of the projection depends on the envisaged loan term. In agricultural households, one year projections are common because they encompass the majority of crop growing seasons. Loan projections beyond 12 months are very uncertain so it is recommended that cash-flow projections are renewed annually for medium and long-term loans.

A typical layout for a cash flow projection can be found in the spread sheets provided as sample templates. The instructions are quite simple – you have to write down all the money coming in each month and all the money going out and find the difference between them. This gives the monthly balance or net cash flow. It may be positive or negative. Positive balances can be regarded as net income or surpluses which can be saved provided all the household expenses have been taken into account in the plan. Cumulative net income is cumulative savings from which loan repayments can be made. Information can be grouped together by economic activity, e.g. crop type or product categories, e.g. fertilizers, pesticides, machinery costs. All the facts that were assembled regarding weather impacts, price trends, market conditions, management capacity, risk reduction, etc. should be taken into account when deciding on what figures to put in the cash flow budget. As a general rule it is best to be conservative with estimates especially for new or expanded enterprises.

Remember the quality of your loan portfolio and the health of your FI are going to depend upon the quality of your cash-flow projections and your assessment of each applicant's repayment capacity. You need sound data from the field, good judgment, and accurate arithmetic. You will need a calculator and should work in pencil until you have got it right, unless of course you have a computerized spreadsheet to help you.

A cash flow can be prepared first without including any loan assumption or the proposed amount can be included from the beginning.

Once a cash-flow projection has been prepared for all the economic activities of all household members, and all the family expenditure has been incorporated, it needs to be assessed in relation to the loan proposal. The most commonly used indicators for doing this are:

- the accumulated repayment capacity; and
- net cash flow after loan repayment or "free net cash flow"

This indicator is calculated by adding up all the monthly balances during the envisaged loan term and comparing this figure to the total amount to be repaid (including both principal and interest). Since the cumulative net cash flow needs to be higher than the total repayment obligation which the applicant would have towards the lender, this indicator must be above 1.

Since it is advisable to have a substantial security cushion for unforeseen events, it is recommended that the ratio should be at least 2:1. Needless to say, the higher the benchmark is set for this ratio, the more conservative is the lender’s risk-taking approach.
Due to seasonal variations in agricultural activity, the net cash flow of a farm household generally varies from month to month. Between planting and harvest periods there is always a period of reduced cash availability that has to be bridged by the applicant. Loan repayments, if required by the lender during this period, may not be at the top of the borrower’s priority list for using scarce cash.

However, accumulated repayment capacity is more important than monthly free net cash flow. As many farm households have a highly variable income and expense structure, loan products which require equal repayment installments are not really appropriate. Ideally, a more flexible repayment schedule is required. A number of variations are possible:

- Monthly interest payments combined with lump-sum repayment of the capital at the end;
- Various irregular payments of interest and capital;
- The entire loan amount plus interest paid at loan maturity.

In these instances the monthly free net cash-flow will not be of much help. However, the accumulated repayment capacity ratio will be very critical to decide whether a loan should be approved or not. In addition, the free net cash-flow must be positive in all those months where payments are planned.

Sensitivity analysis

In order to find out how a cash flow might be affected by adverse factors, the loan assessment may include a sensitivity analysis. The objective is to know whether adverse circumstances would undermine the repayment capacity to such a degree that the loan repayment will be at risk. Factors to be considered in the sensitivity analysis of cash-flow projections could include:

- Reduced yields due to bad weather conditions, diseases or pests;
- Delays in payments, e.g. delays in payments for crops after harvest;
- Lower than expected sale prices;
- Higher input costs;
- Additional labor costs, e.g. replacing a sick family member with hired labor.

The cash flow indicators should be carefully assessed regarding their sensitivity to possible changes. In this way, a specific risk profile for the individual loan can be constructed. Financial institutions need clear policies which state what level of tolerance in relation to cash flow indicators is acceptable. For example, it could be stated that the monthly free net cash flow should not fall below zero more than three times within a year.

It is important not to take too simplistic an approach to sensitivity analysis, by just recalculating numbers in a mechanical fashion. We learned earlier how farmers use different risk mitigation techniques to keep their vulnerability to risks at a reasonable level. When analyzing a cash-flow, these risk mitigating techniques must be taken into account as part of the risk profile of a farm household. Here are some examples:

- **Diversification of income sources.** Prudent farmers tackle income insecurity by diversifying income sources. Potential losses in one agricultural activity may be offset by other agricultural or non-agricultural income-generating activities. Many farmers have off-farm activities, such as wage-based seasonal labor at other farms, work for large agri-business enterprises or the production of handicrafts. Family members may carry out exclusively non-agricultural activities, such as running a small grocery shop or working in the nearby town for a wage. Relatives may also regularly send payments from distant places, or even from abroad. Many farmers try to quickly diversify their sources of income under a crisis scenario, particularly by selling their labor to others.
- **Liquidation of assets.** The majority of farmers have savings in-kind. One of the most popular forms of saving is buying livestock. So confronted with an emergency, many farmers sell a pig or a goat to obtain funds.
- **Family safety networks.** In many countries, informal safety networks exist within extended families or clans. If one person has a problem, family support is mobilized. In many cases however, this support structure is not without cost. Farm households must

constantly contribute to maintain it. When festivities take place, cash contributions from all invitees are expected.

In many countries, it is very popular to borrow money at 0% interest rate from family members and repayment conditions are very lax. However, if a person has lent to others, he obtains the right to gain immediate access to money when he needs it. Understanding how these informal networks work is helpful in determining whether a borrower is likely to be able to mobilize money at short notice from within his extended family to repay.

Capital

As the next step of the loan appraisal, a brief analysis of the balance sheet should be carried out to assess the applicant's capital position. It is not as critical as the cash flow projection but we can gain some useful insights into a business, even that of a small farmer, from a balance sheet.

1. Large amounts of cash - especially outside harvest time – should trigger a closer investigation as to why this available cash has not been invested and where it is coming from. Comparably low amounts of cash after harvest combined with a lack of investment in visible household or farm assets on the other side will also signal a potential problem. A close analysis should then be carried out by the loan officer.
2. The existence of savings in a deposit account indicates that the loan applicant does not consume or invest all his/her income but rather sets a certain amount aside. On the one hand, this could be a sign of thriftiness and creating a safety reserve for rainy days. On the other hand, it could mean that there are little investment opportunities and there is a lack of entrepreneurial initiative. It would therefore be very important to scrutinize the reasons for savings.
3. The value of the existing agricultural stocks – supplies or harvested crops – provides insights into how successful the farm business is. Very low stocks prior to the start of the agricultural season can indicate the farm's dependence on external funds to keep on running. In contrast, large quantities of stored crops show that the farmer is able to postpone selling crops until prices are more favorable.
4. Accounts receivable (debtors) is an important figure as they can cause severe liquidity problems if they are not received on the due date.
5. The composition of fixed assets reveals key information about production methods. In addition, the figures indicate how modern the equipment is and whether the farm household is able to maintain its machinery.
6. The amount of total assets indicates how successful the household has been and how much wealth it has accumulated over the years. This figure is particularly interesting when farm households with similar family and production patterns are compared.

Source: USAID's Lending to the Agriculture Sector Toolkit – December 2012

7. Accounts payable (creditors) indicates that the potential borrower already has obligations with other funding sources. This means that there will be cash outflows in the future that must be taken into account.
8. Level of indebtedness – expressing liabilities as a percentage of total assets indicates what proportion of the farm's assets has been financed through borrowing.

Collateral

Another purpose of examining the asset and liability structure in the balance sheet is to identify appropriate collateral. Compared to the repayment capacity that is the most crucial element in lending, collateral is only of second priority. FIs consider collateral primarily as a repayment incentive, putting pressure on the borrower to repay in a timely fashion. They have defined the following conditions for any asset that they would accept as collateral:

1. **Importance to the borrower.** The asset must be of high personal value to the borrower. He/she must be psychologically hurt if the asset were to be taken away by FI.
2. **Value.** The asset must be known to have a value that is sufficient to cover the loan amount, interest for the entire loan term and a possible penalty charge. The minimum value of the asset(s) must be 1.35 of the loan amount.
3. **Marketability.** The asset must be easy to sell. Transfer of property rights should take place at little cost and with little formalities. In addition, the assets must be free from liability of third parties.

According to these three factors, the economic value of the collateral is only one side of the story. It is even more important that the borrower feels attached to the asset and that losing it would cause him/her considerable – even though psychological - damage. Against this background, the FI can accept a wide range of collateral, including household goods like TV sets or bicycles, personal guarantors, livestock and land. In the majority of cases, a combination of collateral items is used.

In order to avoid lengthy legal procedures, FIs ask the borrowers to sign a document agreeing to hand over ownership of certain assets to FI at the moment of signing the loan contract. With this document, FI becomes the owner of these assets during the entire loan period. FI allows the borrower to continue using these assets but is allowed to remove them at any time, if the loan becomes overdue. This allows FI to immediately enforce repayment without a court decision.