

Agricultural Lending - Self Study Guide for Loan Officers

LESSON THREE

The loan application

Objective: to remind ourselves of the key factors in loan analysis - character, capacity, capital, collateral and conditions - and see how an initial screening process and loan application form contribute to providing this information.



1. THE INITIAL SCREENING

All financial institutions should have a mission statement that sets out the purpose and objectives of the business. An agricultural bank, for example, quite clearly is targeting farmers and other businesses operating in agricultural sector. Many microfinance service providers are targeting extremely poor or excluded groups for their core business. Most organizations wish to survive and continue their operations. Surviving in the business of providing financial services means mobilizing funds, lending out funds, recovering those funds and charging sufficient interest to cover the costs of doing this.

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 can 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 criterion not being met.

AGLEND exemplifies an institution which intends to target farmers with some minimum commercial potential, which in their view will ensure repayment of loans. They do not have a social mandate to reach, for example, extremely poor or landless families. So they have a list of criteria which can be reviewed within 5 - 10 minutes that will determine whether or not a potential applicant meets their basic eligibility criteria for a loan. These eligibility criteria are highly context specific and any lending institution must carefully consider what criteria it will include in such a list, in order not to exclude potentially good clients or fulfil the institution's mission statement.



There are three core criteria that AGLEND consider:

1. **Previous loans from AGLEND.** AGLEND back office staff review whether the farmer interested in obtaining a loan already has a credit track record with AGLEND. 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, AGLEND and other rural financial intermediaries have agreed to circulate lists with overdue borrowers that are updated on a monthly basis. Whenever a farmer contacts AGLEND 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, AGLEND immediately refuses their loan requests.
3. **Borrower characteristics.** As a final step, AGLEND staff check whether the potential borrower complies with specified eligibility criteria. These criteria may be region or even branch specific. For example:

	YES	NO
1. <u>Minimum age</u> : Older than 21 years	[]	[]
2. <u>Location of the farm</u> : Potential borrower from districts other than Magambe and Sobiri	[]	[]
3. <u>Crops eligible for lending</u> :		
What is the main crop or livestock production? _____		
Potential borrower produces crops other than: flowers, fruits	[]	[]
4. <u>Length of time that the farmer is carrying out his/her main economic activity</u> : Minimum track record of at least 2 years.	[]	[]
5. <u>Farm property</u> : Farmer owns his land and can provide adequate proof	[]	[]
6. <u>Farm size</u> : Minimum 1.5 ha. in Caron and Pramot	[]	[]
7. <u>Mix of income sources</u> :		
Potatoes or coffee as main crop: Minimum 3 different income sources	[]	[]
Maize as main crop: Minimum 4 different income sources, at least one off-farm activity	[]	[]

The checklist shows that AGLEND wishes to screen out some client groups that are considered a high risk to serve. If any of the questions is answered with "no", the screening process can be stopped and the client informed that he / she is not eligible.

In addition, the AGLEND staff carrying 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.



1. *Which client groups are screened out by using the AGLEND checklist of borrower characteristics you have just looked at? Do you think it is a sensible policy to screen out these client groups? Is there an alternative?*

2. *What criteria would you set for screening agricultural clients in your institution?*



2. THE LOAN APPLICATION

Once the eligibility of a potential client has been established, they can proceed to make an application for a loan. Financial institutions like AGLEND 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.

Let's remind ourselves of the key factors for successful loan analysis: character, capacity, capital, collateral and conditions. All these factors matter but for micro entrepreneurs like small farmers, the first two - character and capacity - are the most important. Here is a list of questions that can help to provide information on each of these key factors:

Character: Personal integrity of the business owner(s) and family

- How is the business managed?
- Are they honest and trustworthy?
- What is the physical and mental health of the person(s) running the business?
- Have they repaid bills and previous loans on time?
- Do they have family problems (alcohol, frivolous spending, etc.)?
- What is the innovation and creativity of the business in creating new business and growth opportunities?

Capacity: Ability of the business to repay the loan

- What does the business plan indicate about income and profitability of the business?
- Can the business generate enough cash to make the loan payments with interest, including a margin of security?
- When can the loan be repaid?
- What are the family needs?
- What are the effects of seasonal fluctuation and production and price variations?
- How does the business compare to others within the same sector or activity?

Capital: Money invested in the business

- What money and assets are invested in the business?
- What is family contribution to the business?

Collateral: Backup sources of repayment for the loan

- Are the personal guarantees of the group or persons trustworthy?
- Are the assets of the business and personal guarantees adequate to cover the loan if necessary?

Conditions: Key economic factors that impact on the ability to repay the loan

- Is there an adequate and stable market to sustain the business?
- Are the loan terms (lengths, interest rate, etc.) adequate for repayment capacity of the loans?
- What are the price and production risks?
- What are the general market trends of the sector?



Now let us look at the details of AGLEND's application form and how they start to gather the information they need. There are six sections:

- i. Personal and family data;
- ii. Economic activities;
- iii. Previous and current loans;
- iv. Details of the proposed loan;
- v. References
- vi. Declaration

i. Personal and family data

Name: _____ () Male () Female	ID Number
Civil Status: () Married () Single () Widowed () Divorced () Other 2	Birth day: / /
Home locality: Street and House N° _____ Community: 1	District Province
Reference points: For how long have you been living there: ____ years	
Name of wife or husband: 2	ID Number
N° of household members: _____	
N° of children: _____ 3	Ages: / / / /
N° of other dependents: _____	Ages: / / / /
N° of household members who generate income: Regularly _____ Irregularly _____	

- 1** 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, AGLEND 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.
- 2** 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. AGLEND, for example, require spouses to co-sign loan contracts in order to ensure that they know about the loan obligation and feel responsible for it.

- ⑤ Knowing about the overall family situation is important to ensure that the loan officer appreciates the need to analyse 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 lead to school expenses, older children may contribute significantly to household income and help to diversify the family income sources. Do you remember the Crespo family we introduced in Lesson 1? Their sons work as construction workers in the town and generate additional income.

ii. Economic activities

Primary activities in agriculture and livestock management carried out by household members:	Agriculture	Years of experience	Livestock	Years of experience
④	_____	_____	_____	_____
	_____	_____	_____	_____
	_____	_____	_____	_____
Other economic activities carried out by household members:			Regularly	Irregularly
④	_____		_____	_____
	_____		_____	_____
	_____		_____	_____
N° of plots: _____	Size: / / / /			⑤
Location of plots:			District	Province
Community:		⑤		
Reference points:				

- ④ 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 analysed together with the family structure and land situation. It also allows the loan officer to obtain insights into the variety of income sources and if they produce a continuous and reliable cash-flow or not.

The number of years of professional experience for each economic activity gives an indication of the 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 analyse 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.

- ⑤ 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.

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, which size they have and where they are precisely located provides 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 labour. The existence of several very small plots that are spread over a larger area might contribute to mitigate climate risks but increase transportation costs.

iii. Previous and current loans

Did you borrow in the past?	YES / /	NO / /	6
If yes, where did you borrow in the past?	_____		
Do you currently have a loan to repay?	YES / /	NO / /	7
If yes, who is the person or institution you owe money to?	_____		
What was the original loan amount?	How much is the remaining balance to repay?	When is the loan envisaged to be fully repaid?	
_____	_____	_____	

You will remember that AGLEND screens out borrowers with unpaid loans during the screening process prior to filling out the loan application. However, additional information is required to obtain further insights into the complete credit history of the loan applicant.

- 6 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 subsidised programme might give warning of lax repayment morale.
- 7 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.

iv. Details of the proposed loan

Amount applied for: _____	Term applied for: _____		
Activities to be financed with the loan:	_____		

Desired date of disbursement: _____	Desired repayment plan:	Monthly / /	Irregular / /
		Bimonthly / /	One final payment / /
		Quarterly / /	

Information about the applicant's preferences regarding the proposed loan gives AGLEND 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 AGLEND 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, AGLEND is in a better position to assess the loan amount and term structure in the light of the actual needs.

v. References

Reference persons:	Address and telephone number:
_____	_____
_____	_____
_____	_____

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

vi. Declaration

Once the loan application is filled out, AGLEND asks the loan applicants to sign two statements:

1. **Self-Declaration:** I herewith state that all the information that I provided is correct and true and provided in good faith. I am aware that any untrue information will result in the immediate refusal of this loan application and exclude me from accessing any future loans.
2. **Authorization:** I herewith allow AGLEND to obtain information about previous and current loans from any financial institution, lending organisation or individual lender I have borrowed from. I also authorise AGLEND to contact the persons indicated in the reference section of the application form and use any other source of information deemed necessary to process this loan application.

These statements show that AGLEND is very strict as regards customer transparency. Before visiting the loan applicant at his/her home or fields, the loan officer to which the loan application is assigned, should carry out several cross-checks to review the information that has been provided. This can be considered a **third screening mechanism** that should prevent a costly field visit taking place with borrowers that have little or no creditworthiness.



3. *Review the 5 information sections of the loan application form presented above and the list provided of how to assess the five "Cs" of loan appraisal. Would you include any additional information at this stage?*
4. *Prepare a check list for an AGLEND loan officer to use in conjunction with the loan application form to remind him which details to verify?*