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BETTER PRACTICES FOR TERM LENDING TO AGRICULTURE
CASE STUDIES FROM INDIA

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LIST OF ABBREVIATIONS

AIDIS	All India Debt and Investment Survey
AP	Andhra Pradesh
Co-op	Co-operative
CSA	Customer Service Agent
GOI	Government of India
ICAI	Institute of Chartered Accountants of India
IDE	International Development Enterprises
IGS	Indian Grameen Services
JLG	Joint Liability Groups
MACS	Mutually Aided Co-operative Society
MFI	Micro-finance Institution
MI	Minor Irrigation
MCRB	Co-operative Rural Bank and Marketing Society, Mulukanoor
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Finance Company
NGO	Non-Governmental Organization
NSS	National Sample Survey
PACS	Primary Agricultural Co-operative Credit Society
RBI	Reserve Bank of India
RRB	Regional Rural Bank
SAO	Short Term Agricultural Operations
SHG	Self-help Groups
SJSY	Swarna Jayanti Swarozgar Yojana
TA	Technical Assistance

Part A

1.0 Introduction:

Indian agriculture on the whole has had a good run with twelve successive normal monsoons. The capital formation in agriculture is increasing. The private investment in agriculture is rising.

1.1 Supply of term loans in India: Institutions, purposes and trends.

In the formal sector, the term loans for agriculture comes from banks and co-operatives (co-op). The banking sector consists of commercial banks and Regional Rural Banks (RRB). All banks are mandated to earmark 40% of their advances to priority sector, including a sub-target of 18% for agriculture. Since RRBs work in the rural areas they have a greater focus on agriculture.

The agricultural portfolio of banks and co-ops is re-financed by the National Bank for Agriculture and Rural Development (NABARD). Table A-1 gives details of refinance provided by NABARD in 1999-2000. NABARD provides different levels of refinance ranging between 70-100% of the loan. The interest rate charged by NABARD varies between 8.5% to 10.5% per annum. The rate depends on the on the size of the ultimate loan - small loans are refinanced at low interest rates. In case of Minor Irrigation (MI) loans, NABARD provides refinance facility at 8.5% for all loans (NABARD 2000)[1]. The low interest rate for MI loans has yielded results. MI accounts for the second largest chunk of refinance after tractors. The tenor of the loans ranges between 3 to 15 years, depending on the purpose. As NABARD does not provide any activity-wise incentives for refinance, the tendency of the lenders is to take the safest route. They lend for activities that provide collateral, additional income stream for borrowers, lower moratorium and shorter tenor.

Within term investments (Table A-1) bulk of the financing is for farm mechanization - particularly the purchase of tractors. It is easy to create charge on tractors, simple to repossess and there is an additional income stream created for the borrower by hiring the tractor for farm as well as transport purposes. As there was undue focus on tractors, NABARD has now restricted its refinance facility on tractor loans to 40% for a second tractor.

In the past five years the term loans from banks and co-ops to agricultural sector has grown only at a CAGR of 4.16%. The policy changes initiated in the year 1999-2000 has resulted in increased assistance for other components of farm mechanization - harvester combines, second loan for improvement in pump set installations, floriculture and aquaculture (NABARD, 2000).[2]

In case of term lending most of the formal institutions have not done well. The figure of overdues beyond 3 years in the long-term credit was 40% of the amount outstanding (NABARD, 2000).[3]

Table A-1
Purpose wise Investment Credit Refinancing by NABARD, 31 March 2000 (US$ million)

Purpose / Agency	Co-op Rural Development Banks	Commercial Banks	Regional Rural Banks	State Co-op Banks & ADFC	Total (US$ = Rs.46)
Disbursement in 1999-2000					
Minor Irrigation	95.91	15.17	19.48	3.76	134.32
Land Development	10.84	1.72	2.59	6.91	22.06
Farm Mechanisation	156.02	128.41	29.76	56.54	370.73
Plantation/Horticulture/ Tree)	29.82	4.74	6.63	1.28	42.47
Poultry/Sheep/Piggery/Fishery	39.00	7.84	3.65	2.76	53.25
Dairy	88.15	11.78	22.00	4.46	126.39
Non Farm Sector	70.56	51.02	14.10	46.43	182.11
SGSY*	2.13	79.39	10.93	35.80	128.25
Others	17.5	36.15	8.15	12.30	74.10
Total	**509.93**	**336.22**	**117.29**	**170.24**	**1133.68**
Outstanding as on 31 March 2000					
Minor Irrigation	1455.57	611.76	125.50	66.56	2259.39
Land Development	83.13	43.84	8.50	2.78	138.25
Farm Mechanisation	1006.84	923.89	111.37	194.17	2236.27
Plantation/Horticulture	233.50	148.37	42.35	10.13	434.35
Poultry/Sheep/Piggery/Fishery	270.04	203.34	29.22	17.09	519.69
Dairy	410.28	86.15	69.61	33.91	599.95
Non Farm Sector	426.15	215.82	121.86	215.43	979.26
SGSY*	52.34	953.69	211.09	767.67	1984.79
Others	152.67	284.33	43.85	89.74	570.59
Total	**4090.52**	**3471.19**	**763.35**	**1397.48**	**9722.54**

Source: NABARD, Annual Report, 1999-2000.
*SGSY: Swarnajayanti Gram Swarozgar Yojana – a self-employment scheme for setting up microenterprises.

Table A-2 Distribution of Cash Debt of Rural-Cultivator Households According to Credit Agencies, 1971 TO 1991 (Percentage)

Credit Agency			Cultivator Households		
			1971	**1981**	**1991**
1.	**Institutional :**		**31.7**	**63.2**	**66.3**
	1.1	Government, *etc.*	7.1	3.9	5.7
	1.2	Co-operative Society/Bank	22.0	29.8	23.6
	1.3	Commercial Banks, *etc.*	2.4	28.8	35.2
	1.4	Insurance	0.1	0.4	0.2
	1.5	Provident Fund	0.1	0.3	0.5
	1.6	Other Institutional Agencies	-	-	1.1
2.	**Non-Institutional :**		**68.3**	**36.8**	**30.6**
	2.1	Landlord	8.1	3.7	3.7
	2.2	Agriculturist Moneylender	23.0	8.3	6.8
	2.3	Professional Moneylender	13.1	7.8	10.7
	2.4	Trader	8.4	3.1	2.2
	2.5	Relatives/Friends	13.1	8.7	4.6
	2.6	Others including Doctors, *etc.*	2.6	5.2	2.6
3.	**Unspecified**		**-**	**-**	**3.1**
4.	**Total**		**100.0**	**100.0**	**100.0**

Source: All India Debt and Investment Survey (AIDIS), 1991-92 – Indebtedness of Rural Households as on 30 June 1991, Report 2 (Part-1). NSS 48th round. Delhi: NSSO, GOI.

The efforts of most Micro-finance Institutions (MFI) are restricted addressing short-term credit needs. There are private institutions lending for tractors. Precise figures of their involvement in agricultural lending are not readily available. However, it is clear from Table A-2 that institutional credit from the private sector is only 1.1% of the indebtedness of cultivators (GOI, 1997)[4]. Most credit from private sector comes from informal sources, accounting for 30.6% of indebtedness.

1.2 Legal and Institutional Framework for Agricultural Term Lending in India

The legal framework for term lending is seen as unfavorable. The land records are not updated in most places. It is not easy to create a charge on the landed property. The borrower does not have a clear title or the procedures for creating a charge are cumbersome. There is a tendency to seek land records for any loan and it becomes difficult if the borrower is borrowing from different sources for his short-term and long-term needs.

The second constraining factor is the process delay in case of default. The debt-recovery tribunal covers only large bank loans of over Rs.1 million (US$ 21000). Under normal process it is difficult to repossess the asset. Therefore the tendency of institutions is to lend to purposes where it is easy to create a charge (an endorsement on the ownership papers in case of tractors), repossess the asset and sell it. Innovative institutions examine alternatives to address the issue - working at the quality of record keeping, creating tied contracts, and using to social collateral.

The third factor that influences the term lending market is the targets imposed by the state. Term lending to agriculture is seen as an obligation towards the State. The institutions in rural areas lend reluctantly. It is found that when there are market opportunities, small players enter fast and exploit the situation. In a recent survey carried out in rural Andhra Pradesh, (AP), it was found that institutional loans for well irrigation was around 20%. The moneylenders accounted for nearly 60% of the loans - thereby occupying the market for term loans. It is said that lack of formal credit has overburdened the farmers (Venkateshwarlu and Srinivas, 2000)[5]. The moneylenders are seen as flexible and more effective than institutions. They have tied contracts and recover the amount over a period of time. There is scope for micro-finance type of lending, if only the MFIs are willing to look at longer tenors and other linkages.

1.3 Regulatory Framework

The lending institutions are usually banks or as co-operatives. Both these institutions are highly regulated. Most of the regulation pertaining to term lending for agriculture is controlled by the Reserve Bank of India (RBI). The banks have to meet their mandatory targets for lending to priority sector. The regulation is rigorous in applying the prudential norms for income recognition and non-performing assets. This has made the banks bottomline oriented, affecting the attitude towards lending to agriculture, which is considered risky. The longer tenor loans are considered even more risky. So lending to agriculture is seen more as an obligation than as an opportunity.

In case of co-ops, the control of the State is even more acute. Co-operation is a State subject. The provincial governments control co-ops. Each state has its own Co-op Act. However, with the economy being liberalized, there has been a call for changing the archaic Co-op Acts to provide more autonomy. AP was a pioneer in passing a more progressive legislation for the co-op sector.

In this paper, we have profiled two cases. The Mulukanoor Co-op Rural Bank (MCRB) provides an example of how a traditional institution has been able to perform well and innovate in spite of a difficult regulatory environment. BASIX, operates as a Non-Banking Finance Company (NBFC) and provides a new-generation market savvy example. It is an example that highlights the advantages of using social collaterals – a popular method used by several MFIs. While this methodology has its advantages, the study also highlights the limitations of using the MFI technology in expanding term finance rapidly. It is incidental that the two organizations are headquartered in AP. An example like MCRB could have happened anywhere in the country. Similarly, though BASIX is headquartered in AP, it has presence spanning more than 6 states. Both have not seen the regulatory environment ever as an overruling constraint.

1.4 Users of Term Finance for Investments in Agriculture

As far as term finance is concerned, there are two distinct segments that are being serviced by the institutional sector. The institutions like the co-ops, and banks clearly target the individual farmer and address their needs (though partially). The needs of enterprises are met by specialized financial institutions such as the National Co-operative Development Corporation, State Finance Corporations and the National Dairy Development Board. In the current paper, we will restrict our discussion to the institutions catering to the needs of individuals.

From the perspective of users, the availability of credit is far lesser than required as evidenced by the figures of the AIDIS. The AIDIS indicates that of there has been a substantial reduction in the proportion of cash loans sought by cultivators for investment purposes (Table A-3).

With the introduction of green revolution technology, the decade of 70s and 80s demanded more credit. The policies of the state were focussed towards expanding credit facilities for agriculture. Nationalization of banks, setting priority targets and having schematic lending programs were a part of the State policy. However, in the 90s with the opening up of the economy, the institutions operating in the social sector have succumbed to the pressures on the bottom lines. There is risk aversion. The banks choose to invest the shortfall in lending targets in NABARD bonds fetching lower interest rates than lend to agriculture. The financing of land development, plantation and tree crops has not been substantial and it is easy to find the reason for this.

Table: A-3
DISTRIBUTION OF CASH DEBT HELD BY CULTIVATORS BY PURPOSE OF LOAN 1971-1991

Purpose of loan	Cultivators		
	1971	**1981**	**1991**
1. In Farm Business			
Capital expenditure	34.7	45.2	14.4
Current expenditure	15.0	18.5	3.2
2. In Non-farm Business			
Capital expenditure	3.2	6.3	4.7
Current expenditure	1.1	1.6	1.5
4. Household expenditure	37.8	20.1	36.1
5. Other purposes	0.3	0.2	25.2
6. Unspecified	7.9	8.1	14.9
All Purposes	**100.0**	**100.0**	**100.0**

Source: AIDIS (Op.Cit)

In mapping of assets owned by cultivator households, AIDIS found that machinery and equipment represented 3.8% of the total assets in 1991. This was less than the proportion held in consumer durables. About 86% of investments was held as land and building (GOI, 1997).[6] The reduced use of cash loans for capital expenditure as well as the low level of investments in machinery together indicate a huge potential for a flourishing term loans market to be operating in the agricultural sector. However, due to uncertainty and the underlying risks associated with the cash flows of activities primarily dependent on agriculture, there is a hesitation to lend for a longer duration. The problem could be addressed in innovative ways. For instance, NABARD had introduced a scheme known as the "Cyclical Credit", which addressed continued credit in case of genuine default. The bank stood by him in providing required loan irrespective of the repayment difficulties induced by the vagaries of nature. This experiment could be revived (RBI, 2000)[7].

If the market for short-term loans stabilizes and repayment culture goes up, lenders would see agricultural lending as a profitable activity. While dealing with the rest of the paper, we examine innovations in term lending for agriculture. The case studies represent diverse activities, using different models. Ultimately these innovations are to be seen from the perspective of the users.

Part B: Case Studies of Term Lending Institutions

2.0 BASIX: A New Generation Rural Livelihood Promotion Institution

A. Background and General Issues

BASIX was set up in the year 1996. After years of research on the rural financial system, the promoters of BASIX found that basic issues needed to be addressed as far as the financial services for the poor was concerned. Their critique about the rural financial system was:

- It was target driven and saw the borrowers as beneficiaries rather than as customers;
- Access to credit was extremely unfriendly because of excessive paper work;
- The bankers were collateral oriented and not cash flow oriented in appraising proposals;
- The transaction costs for the borrower was extremely high, though the nominal interest rates looked very attractive. Delay, paper work and need for security added to costs; and
- The schematic lending assumed that rural people wanted to be self-employed and therefore was not oriented to lend for projects by the non-poor to generate wage employment.

When BASIX started operations, it was designed as a critique of the existing institutions. It blends the positive aspects of traditional banking and MFIs in its operations. It broke banks' orthodoxy of security based lending to favor cash flow based lending. It also broke MFI orthodoxy of dealing exclusively with the poor. BASIX lent for agriculture, including term loans - recognizing that rural economy depends on agriculture and basic issues pertaining to agriculture were to be addressed.

Traditionally, banks and co-ops source funds from the refinance of NABARD. MFIs get funds from developmental sources. BASIX decided that to be sustainable, funding had to be from both developmental and commercial sources. Accessing mainstream resources is a part of its mission.

B. Main Features of BASIX

<u>Incorporation</u>

At the operational level BASIX has three entities under its fold. Bhartiya Samruddhi Finance (Samruddhi), a for-profit NBFC, Indian Grameen Services (IGS) a not-for-profit technical services company and KBS Local Area Bank, a banking company. All lending operations are handled through the Samruddhi and the Local Area Bank (LAB). IGS operates on grants, offering technical assistance to the borrowers. The belief is that rural lending would not be successful without the provision of technical assistance. For the purposes of this paper, we focus on Samruddhi and will use the term BASIX interchangeably. The LAB is new and has not disbursed any term loan.

The RBI regulates financial institutions. All financial institutions need to register themselves with the RBI. There are entry barriers for new institutions. The start-up capital needed to seek license for an NBFC is Rs. 20 million (US$ 435,000). It is Rs. 50 million (US$ 1,087,000) to set up a LAB covering three districts; and Rs. 3000 million (US$ 65,220,000) for a regular commercial bank.

NBFCs like Samruddhi can offer a limited range of financial services - loans and investment banking are usually permitted. They can get fixed deposits from public with maturity periods of more than a year and less three years. There are some controls to raise these deposits. They do leasing business. Insurance is regulated separately and cannot be offered by NBFCs.

Financial Products offered by BASIX

The products offered by BASIX are restricted by regulation. BASIX would eventually provide several products. Currently it offers loans. It does not offer savings. It is testing an insurance product to cover yield risks. If it is viable, BASIX will establish another entity to extend those services. BASIX also has agency for an insurance company to sell life cover to its borrowers.

BASIX operates in ten locations spread in six states serving around 12,000 borrowers. Since the purpose of this study is to examine the role of BASIX in provision of term lending for agriculture, all other linkages and services of the institution will be examined from that perspective.

The purpose for which BASIX lends is classified in six categories as detailed below:

- Crop loans
- Agri-Allied loans and irrigation (most of these are term loans)
- Non-farm micro-enterprise loans (some of these are term loans)
- Non-farm small and medium enterprise loans (most are term loans)
- General purpose loans given usually to self-help groups, but also to individuals
- Housing loans (all of these are term loans)

Lending Modalities

BASIX has a mix of delivery channels, as detailed below.

Direct Loans:

- To individuals, for non-farm enterprise, agri-allied activities and investment purposes
- To individuals, organized as self-selected Joint Liability Groups (JLGs) in collaboration with agro-processing firms. This technique is used for crop loans and has been sparingly used in term lending. The issues pertaining to JLGs in term lending will be discussed in detail later.

Indirect Loans:

- Through intermediaries – like input suppliers and produce buyers for farmers and others
- Through intermediaries – like seed production organizers, with or without a collaboration with an agro-processing firm for farmers
- Through self-help groups in collaboration with NGOs - for women and landless members.

The term loans are given directly to the borrower. While some attempt has been made to lend through equipment suppliers the experience has not been very encouraging. Most of the term loans of BASIX are direct loans and get classified under agriculture and allied activities. As of March 31, 2001 the outstanding of agri-term loans were about 4.4% at Rs.6.8 million (US$ 147,000) of a total outstanding of Rs.155 million (US$ 3.36 million). The on-time repayment of the agri term loan portfolio was at 80.4% as against the total on-time repayment performance of the entire portfolio (agri-term included) of 91.4%. This percentage is to be seen in the strictest sense of the loans being repaid on the due date. However, several of these loans are recouped with a slight delay. The loans that are overdue for a year without any payment of interest or principal are written off. Sometimes even amounts written off are recovered. In the estimates of the company, it is said that around 5% of the loans are finally written off, while rest is recovered.

Portfolio and Purposes

The total portfolio of BASIX as on March 31, 2001 is given in the Table B-1. As it is evident, the portfolio of BASIX is broadly divided into three broad segments. Table B-2 gives the detailed break-up of the lAgri-Term loans.

Table B-1
Details of Loan Portfolio of BASIX (in US $)

Purpose	Loaning Apr 2000 – Mar 2001	% of item on total term lending	Amt o/s – Mar 2001	% of each to total term outstanding	On-time Repayment %	Overall on-time repmt %
Farm Loans						
Crop Loan with JLG	863,978	21%	689,630	20%	87.2%	88.3%
Crop Loan thru On-lenders	20,434	< 1%	70,848	2%	77.3%	77.6%
Agri Term (Irrg & Land Devt)	92,304	2%	141,196	4%	85.8%	86.5%
Agri-Allied (Dairy, Poultry)	774,543	19%	639,296	19%	91.9%	92.2%
Non-Farm Loans						
Micro-Enterprises	1,593,848	39%	1,238,809	37%	93.8%	94.0%
Growth Micro Enterprises	36,109	< 1%	39,217	1%	89.4%	89.4%
Small Enterprises	10,000	< 1%	24,326	< 1%	74.2%	74.2%
General Purpose Loans						
General Loan (SHG)	130,717	3%	141,457	4%	96.7%	96.9%
General Loan(Individual)	8,130	< 1%	4,717	< 1%	92.6%	93.1%
Gen. Prp.- Indv S&C	11,674	< 1%	8,239	< 1%	100.0%	100.0%
SHG without CS	207,935	5%	102,022	3%	99.4%	99.4%
Federtions of SHG/MACTS	281,522	7%	215,000	6%	99.2%	100.0%
House Repair&Expansion	16,326	< 1%	13,609	< 1%	100.0%	100.0%
Vehicle Loan- Emplys/CSA	44,848	1%	36,792	1%	97.8%	98.0%
Total	**4,092,370**	**100%**	**3,365,158**	**100%**	**90.9%**	**91.4%**

Source: Company records, Conversion US $ = Rs.46.

BASIX has been progressively reducing its exposure to term loans. In 2000-2001 term loans were only 2% of the disbursals. This is partly caused by the overall upper ceiling put on the loan size.

Client Base

Most borrowers of term finance are farmers with about 0.5 to 2 hectares of land. This is also the overall profile of the borrowers involved in cultivation. BASIX is moving towards small borrowers and the lower end of the retail loan segment. Most borrowers from self-help groups (SHG) are landless. The loans for non-farm sector were being given to small borrowers and borrowers putting up large units generating employment. The present credit policy (discussed later) orients BASIX towards small enterprises. A reason why the client profile is undergoing a change is due to the pressures of the MFI lending methodology. BASIX has positioned itself as a MFI and therefore all funders monitor performance parameters as applied to MFIs. For instance a surrogate used to assess lending to the poor is average loan size. Term loans by definition being larger loans tend to push this figure up. Though this is not explicitly stated, the reporting requirements have a mention of the average loan size. It is natural therefore, for BASIX to lend smaller amounts.

Table B-2
Details of Agri-Investment Loans of BASIX (in US $)

Purpose	Loaning Apr 2000 – Mar 2001	% of item on total ter m lending	On-time repyment % cur lending	Amt o/s – Mar 2001	% of each to total term outstanding	Overall on-time repmt %
Agri implements	3,413	3.8	89.0	9,668	6.5	64.8
Fencing	652	0.7	100.0	1,746	1.2	77.3
Horticulture	3,261	3.6	100.0	2,174	1.5	100.0
Land Devpment	21,870	24.3	86.0	24,660	16.7	90.8
Pumpset/Pipelines	46,815	52.0	87.0	91,289	61.8	78.6
Well repair	4,087	4.5	73.0	4,316	2.9	79.5
Others	9,935	11.0	87.0	13,885	9.4	73.4
Total	**90,033**	**100.0**	**86.0**	**147,738**	**100.0**	**79.6**

Source: Company records, Conversion US $ = Rs.46.

C. Lending Technologies

Screening and selection of borrowers:

Screening of borrowers is done at registration, before they seek a term loan. BASIX accepts registrations from villages where it works. The first check is an informal inquiry. The customer service agent (CSA) is a local person, moves around the villages, and therefore knowledgeable. In addition, the CSA makes a check on borrower's record. In case of doubt, CSA asks one of the other borrowers to introduce or stand guarantee. After registration, BASIX starts with a small loan and monitors performance. A term loan is given after a few cycles of short-term lending. If a borrower starts with a term loan, a guarantee is compulsory. BASIX depends on relationships and past behavior in selection, irrespective of the loan purpose. At the time of registration details regarding the borrower are collected - land holding, experience, income sources, assets, etc. These details are used in appraisal to determine the appropriateness of the amount and activity.

Loan appraisal

The appraisal for the loan is done based on the information and the asset base of the borrower given at the time of the registration and any updates thereafter. If term loans are given to an existing borrower, the history of repayment is analyzed for delays in payment and patterns in cash flow. This not only includes factoring in the cash flows from agriculture, but also from other activities of the household including remittances from migrant members of the family. The experiences of the borrower in the activity, the extent of finance sought, other sources of finance are all analyzed. Other liabilities making a demand on cash flow are factored. In case of farm machinery an estimate of the net savings of cash outflows due to mechanization is studied. When an assessment of a borrower is made, not only is the ability to repay checked, but also the borrower's willingness to honor commitments is assessed. BASIX uses household as a unit for determining the repayment capacity. The schedule is fixed taking these factors into consideration rather than relying purely in the incremental cash flows created out of the new asset. This accelerates repayment. However if the activity fails such a schedule is difficult to be serviced.

Apart form the borrower being assessed the economic activity is examined. If the purpose for which the loan is sought is a new activity, the CSA and the field executive make a quick study of the market - input costs, output realizations, and experience of others in similar activities - particularly the downsides. This process is cost intensive when detailed investigations are done for each proposal. BASIX realizes that unless there are standards established, every proposal becomes a research project. To address this issue, BASIX looks at clusters. BASIX commissions studies on activities in clusters using a sub-sectoral approach. This gives BASIX an understanding to set standards without compromising on the flexibility of packaging the loan. However this methodology has not been extensively used in agri term lending.

The time spent in evaluation of the viability of an activity depends on its past experience. If there is potential for similar loans, BASIX invests ample time in understanding the activity thoroughly. If a risk is perceived in the investment, like in case of wells, loan is given only after the borrower has made substantial progress - when there is evidence of water. BASIX uses other measures to minimize risks. It reviews its performance under each loan product constantly and examines the reasons for failure if any. This learning is built into future appraisals and into the annual credit policy. As a part of such review, an internal report was generated. It lists the typical errors made in appraisals and major reasons for default of agri-term loans:

- Mistake in estimation of project cost
- Borrowing from several sources
- Mismatch in estimated and actual cash flows
- Eagerness of the borrower to get returns in the shortest possible time, thereby indicating a failure of technical guidance
- Failure to follow up defaults at an early stage
- Collateral being either inadequate or illiquid
- Borrowers' inadequate experience in commerce
- Failure of the project, particularly bore-wells
- Lack of incentive for good borrower behavior
- Improper scheduling of the investments to be made by the borrower.

(Srinivas and Vasumathi, 1998)[8]

Based on the learning, the policies have been modified. For instance, they found that when financing bore wells, it is better to finance a storage tank. The tank helps salts to settle before wetting the fields. It avoids the risk of power cuts, by helping in storage when power is available.

In summary, the following measures are looked into as a part of appraisal risks:

- Known borrowers with a repayment track record are selectively given term loans
- The underlying investment is thoroughly studied and efforts are made to ensure that the entire borrowing is from a single source. Thus there is no conflict. Insisting that the borrower invests a significant amount (25%) from his/her own resources minimizes the risk.
- The repayment schedule is fixed in a manner that accounts for the uneven cash inflows that the borrower might have, while not compromising on the frequency of contact.

BASIX does not have different appraisal methods for different purposes. Every loan is examined carefully. However, depending on experience, the time spent on appraisals may vary. Till now, BASIX has not funded start-ups, unless the borrower has experience in the activity.

Collateral and related issues

Having learnt extensively from the MFIs, BASIX relies a lot on social collaterals in its lending methodology. It explicitly does not seek collateral on small loans. The credit policy prohibits collateral for loans under Rs.20,000 (US $ 437). BASIX insists on other borrowers, like the person introducing or somebody from the JLG being co-obligants for term loans. This is effective because CSA maintains a contact with the co-obligant also. If there is indication of default, apart from chasing the borrower, the CSA chases the guarantor as well.

Collateral is sought only on loans, which are larger in size (>Rs.50,000, US $ 1087). BASIX believes that the collateral should be liquid enough for encashment. The guiding feature in seeking collateral is the loan amount and not the activity. The collateral need not necessarily be the asset bought out of the loan. For instance it is difficult to enforce the collateral in pipeline loans because of the complexity of repossession. It is easier to enforce and encash collateral in case of a tractor loans. There is an internal pecking order of what collateral is more desirable. Acceptability is decided on case-to-case depending on the value of the collateral and its liquidity.

Another problem is the complexity and costs involved in documentation and charge creation. Since the loans are of low value, the cost of charge creation is high per transaction. It is expensive to resort to legal process because of time over runs. BASIX avoids this by having a shift towards smaller loans on a collateral-free basis.

BASIX uses chattel mortgage selectively. Chattel mortgage could be useful where the title of the property is established through a paper trail and endorsements. It is easy to get an endorsement on financial assets like fixed deposits. However, it is difficult to establish a paper trail something like a pipeline. The mortgage of standing crops - the collateral offered for crop loans hardly has meaning in case of adverse behavior of borrowers. So chattel mortgage is useful in two scenarios. Where it is possible to get endorsements and establish the identity of the asset (used by BASIX). Or where the asset itself is deposited with the lender - like jewelry (not used by BASIX, as they do not have the facility to keep such pawned assets safely).

Other risk mitigation techniques

There are three levels at which BASIX is addressing the issue of risk mitigation. First provision of support services. For instance, it has entered into a collaboration with International Development Enterprises (IDE) to provide its borrowers with micro-drip irrigation kits (around 100 kits provided till now) thereby linking the issue of risk with support services. Unlike inter-linked transactions for supply of inputs (discussed later), provision of TA has worked out well for BASIX. Till now most of the technical assistance has been in the form of advise on right usage of inputs - rather than actual supply of inputs. The support services arranged by BASIX are generally seen as de-linked from the loan. IDE has been providing the farmers with micro-drip irrigation kits at very reasonable costs. This has helped the farmers to conserve and use water appropriately. The kits have very simple technology and have worked well. Since the investment on the kits is not very significant, it has not affected the lending program of BASIX. A similar arrangement was done for dairying loans - arrangement of milk procurement, training on hygeine and milk storage etc.. through the co-operative milk federation and that has worked well.

Second, ensuring the safety of the borrower. BASIX has entered into collaboration with Prudential ICICI Insurance Company to address the risk associated with the life of the borrower. Third, ensuring the safety of the economic activity that is financed. In this case they are looking for collaborations where the risks of economic activities could be addressed by insuring the underlying assets. Currently this risk is addressed through asset insurance offered by the state controlled insurance corporations. With the insurance sector being thrown open for private sector participation, it is likely that more corporations will be set up. BASIX is also trying out an insurance product on its own for dealing with yield losses. This is at an early phase of experimentation. The features of the product are:

- A three tier scheme, starting with self-insurance, group insurance and reinsurance.
- Two component premium - compulsory savings, withdrawable under certain conditions and a non refundable premium;
- The claims are linked to certain multiples of own funds and group funds and decision making is through group processes thereby addressing the issue of moral hazard.

Loan terms and conditions

Interest rates and other costs

BASIX charges a loan-processing fee of 2% of the approved amount and an interest rate of 24% per annum. Since the repayment schedule is fixed where at least the interest component is paid once a month, the effective yield is higher for BASIX. This is because so much incremental cash is released into the system which could earn further interest from the next month onwards. While BASIX encourages the borrowers to pay on time by giving a timely closure incentive of 2%, it also penalizes defaulters with a penal interest of 2% for payments that are delayed. The other costs of documentation and transmittal of funds are borne by the borrower. The disbursement can be either on-site of off-site as preferred by the borrower. The borrower bears no other cost.

The interest rates are high compared to the formal systems. Again, while this is seen as a flaw by the mainstream institutions, it is seen as perfectly legitimate in the MFI sector. This has been repeatedly captured in the customer satisfaction audits carried out by BASIX. The report says "*BASIX would find it difficult to compete with formal sources on rate of interest, BASIX therefore needs to rely on other advantages, - timely and fast processing of loans, simple procedures."* (CMS, 1999)[9].

The structure of interest rates is also fixed and does not vary across sub-purposes in the term loan category. The original intention of BASIX was to eventually graduate all its borrowers from an activity based lending to a relationship based lending. The path to this was to start the loan pegged to a specific activity and then gradually expand the loan size and relax the loan purpose – eventually leading to a purpose-free loan – the size of which was in the loan run determined by the borrowing history. For this purpose it was necessary for BASIX to have the interest rates for individual borrowers common, irrespective of the purpose. Since BASIX deals with borrowers who are largely uneducated, it was necessary for BASIX to charge easily understandable, uniform interest rates – the BASIX loan is packaged as a 2% a month interest loan.

Another reason why a unified interest rate is charged is because BASIX does not get any special purpose refinance for its portfolio. Since BASIX accesses finances from the commercial sources, it is difficult for the company to charge differential rates across sub-products. However, in case of lending to SHGs, where refinance is at sub-commercial rates, they have been charging lesser interest (However, in most cases the SHGs charge interest rates comparable to BASIX to the ultimate borrower, thereby removing any competition amongst its own products).

The interest charged by BASIX is dictated by the sources of finance rather than the risk profile. In fact the interest rates do not even vary across the term of the loan. In India interest rates - particularly at the retail level have been determined on the basis of the purpose, the inherent risk of the activity and the sources of finance available. Most institutions differentiate interest rates by purpose and term but do not differentiate at the borrower level. No credit scoring models are being used at the individual level. In case of BASIX there is little difference in terms of a loan across purposes. Collateral is seen more as an additional comfort rather than as a surrogate for reduced risk. No benefit is passed on to the borrower as reduced interest rates even if the collateral is good. This may be because too much has been read into fungibility of money.

Other terms

The policy on agri-term loans in the past three years were as follows:

- 1998-1999: Agri-term loans were given for land development, irrigation or agri-equipment. Any loan having a moratorium of more than 2 months needed special approval. However, the moratorium was given as a matter of routine. No upper limit specified for the loan size. Repayment had to be cash-flow based but not exceeding a three year period.
- 1999-2000: Agri-term loans were given only to repeat borrowers or crop-loan borrowers who had closed their past loans in time. The upper limit for an agri-term loan was Rs.50,000. (US$ 1,087). Repayment to be cash flow based, usually twice a year during the harvest season. The term of the loan was not exceeding three years.
- Policy for the year 2000-2001: Upper limit of Rs.50,000 (US$ 1,087) per loan. The loans could be for new customers in existing villages which has at least 10 borrowers and the village has an on-time repayment rate of >95%. Repayment will be monthly but amount will be scheduled on the basis of cash flows. Moratorium of six months could be given for principal repayment. Usually moratorium is given to loans that do not generate immediate incremental cash flows. The borrower should not concurrently hold other term loans such as housing, general purpose loans.

The change in the lending policy is a result of an internal review. The upper limit for exposure of Rs.50,000 (US$ 1,087) for loans to individuals applies to all loan products. While there is a minimum payment of interest on a monthly basis, the installments are scheduled as per the cash flows. Repayment can be to the CSA during the scheduled visits at the branch counter.

Flexibility has been given in disbursements and repayments of loan. Even the number of installments in which the borrower would like to draw down of the loan is given as a choice, based on the activity. Disbursement is in cash or kind as per the choice of the borrower. They do not insist on kind disbursement, but if the borrower chooses, vouchers are issued on recognized collaborators who supply the inputs and then bill it to BASIX. For repayment, if the borrower supplies the produce to recognized collaborators, check off from the amounts due is done and paid in directly to BASIX. But BASIX does not want to tie its borrowers in contract with a third

party - therefore the choice of kind repayment is that of the borrower. Most of these facilities are available for short duration loans like crop loans. Term loans are invariably repaid in cash.
The moratorium permitted by BASIX could hardly be termed as moratorium when we look at the term lending practices of several institutions. This is a result of the MFI techniques being applied to all loan products. BASIX can be considered as one of the liberal MFIs. Usually most of the MFIs in India do not even consider the underlying seasonality while insisting on weekly/monthly repayments. They could in fact turn out to be counter productive and drive the borrower into deeper problems.

Repayments and Recoveries

BASIX differentiates between repayments and recoveries. Repayments are amounts that are voluntarily paid back, while recoveries are amounts where additional efforts are required to collect the amount. The objective of the lending program is to maximize repayments. For this there are incentives built in the loan. While the company has entered into agreements with produce buyers for direct deductions through product prices, the experience has not been all that encouraging.

There are two reasons why this has not worked out very well for BASIX. In the first year, they had aligned with a large agro-processing firm for both input supply as well as output marketing. It turned out that a part of the crop failed and the reason was attributed to low quality seeds supplied by the input supplier. The farmers withheld paying back BASIX loan because they thought it was because of this arrangement that the crops went bad. So the farmers were given the choice of identifying their preferred input supplier. Since BASIX does not have control over the quality and price of the inputs supplied, any adverse behavior of the partner institution puts the BASIX loan in peril. This was the reason why the inter-linked arrangement was resorted to at the absolute discretion of the borrower.

Similarly there was a problem about the price offered by the agro-processor for the product. In some cases it was at variance with the prices prevailing in the market. So it was in the interest of the farmer to sell it to a third party. It effectively took away the advantage of an inter-linked transaction. In addition there were some problems in timely recovery of money from the collaborators. While the loan was closed from the date on which the farmer supplied the produce to the company, the actual flow of cash came in with a lag and sometimes with considerable effort from BASIX. So the apparent advantage of gaining from reduced transaction costs was being negated. There were also problems in squaring up the transactions. BASIX again found this to be too cumbersome to be followed. It would make sense to have inter-linked transactions only if there is a very good arrangement and some quality checks with the partner institutions. In case of MCRB the inter-linking works well because the same institution has these linkages.

This has turned out to be even more difficult in the case of term loans. As long as the collaborations are non-financial in nature - like technical collaborations, the experience of BASIX has been extremely good. Wherever there have been collaborations with financial flows on behalf of third parties it has not worked very well.

BASIX has its own customer service agents (CSA) who move around in a given area as per a specified route. This is a weekly route and it is made known to all borrowers that he is expected on a fixed day in a week. Thus the CSA covers the area once a week. He spends a day in the unit office doing paper work. He also gets the updated statements and a list of defaults. This helps him in working out a strategy for the visit to the village. However, every visit to the location need not necessarily mean contact with every borrower. The CSA is expected to establish borrower contact at least once in a month - which is also the frequency for collection of interest. A large part of the recovery is effected through routine visits. All recoveries effected by the CSA are in the form of cash. In case of problems, the social collateral is effectively used.

In case of default clear-cut norms are laid out in the company. The following are the guidelines:

- When a loan is defaulted for the first time the Unit or the branch office is supposed to follow up and also submit a report before the 5th of the subsequent month on action taken.
- The status of follow up on all loans in default beyond 60 days are to be individually reported by the CSA, and the unit head has to personally follow up on these loans.
- Any overdue beyond 90 days will be personally reviewed by the Vice President.

In addition, reminders and legal notices are sent to the borrower at the pre-specified intervals. The incentive for prompt closure of the loan is a reduction in the interest rate by 2%. For delay a penalty of 2% is levied over an above the specified interest rate. While this is an incentive, BASIX believes that the key to repayment is regular contact and monitoring. BASIX has sophisticated accounting software that handles the monitoring requirements and specific queries. Since the staff is provided incentives based on portfolio performance, they make every effort to adhere to the norms laid out. The details of the incentive system are discussed later.

Dealing with Default

BASIX believes that a major reason for default is loss of contact. This risk is avoided by giving short moratoriums (upto six months, for principal), scheduling regular token payments, and designing a repayment schedule that is flexible to build uneven cash flows of borrowers. That is why, BASIX insists on giving term loans in locations where other activities are going on, to borrowers who borrow for other purposes, where regular contact could be maintained. BASIX has tied up with some technical assistance providers through IGS to give non-financial technical advice. This helps the borrowers to follow the right practices.

BASIX has been analyzing default in detail. Due to the regular contact and due to the fact that there are several levels of social collateral exercised, the cases of willful default are few. However there are defaults due to mismatch between expectations of returns on investment and the actual returns. There are also defaults due to failure of the basic activity. BASIX believes that such defaults have to be dealt in a different manner. The prudential norms do not permit NBFCs to reschedule loans. BASIX also believes that by rescheduling the loans they are only postponing the inevitable difficulty in repayment. The approach of BASIX in this matter is to address the issue of risk rather than rescheduling or restructuring.

Apart from the efforts to evolve a de-risking strategy, BASIX has little choice but to effect a recovery by liquidating the collateral. This is the last, least preferred, and an inevitable method of addressing overdues. It is important for a young institution like BASIX to send the right signal about repayments, before willful defaults set in. BASIX initiates foreclosure if the installments are not paid for an entire year. Even in foreclosure BASIX prefers to do it through a negotiated settlement. However, necessary legal action is taken to keep the option open and alive.

One of the reasons why BASIX has to deal with default in such a stringent manner, even if the default is for genuine reasons is because of the pressures of being an MFI. It is well documented that in the microfinance sector the repayment rates are traditionally near 100%. There are several studies examining the ill effects of having a zero tolerance for default and what it does to the borrower at his/her household level. However, since BASIX operates as an MFI for sourcing funds, it is natural for the organisation to succumb to the pressures of high repayment rates. So the natural route apart from the de-risking strategy discussed above it to weed out products which have not been performing very well as far as repayment is concerned. Agri-term loans are a prime target for culling on this single parameter.

Though, BASIX has very little exposure to term loans in terms of its overall portfolio, it has experiences that are worth documenting. In the initial years, there was no upper limit specified on the loans. The loans were usually for a period of three years. Any loan with a moratorium of greater than two months needed special permission. The performance of the agri-term loans has not been on par with the performance of other loans. This made BASIX to review its exposure norms and loan approval process. An analysis on the basis of loan size was done recently and the default rates are as follows *(Please note that the amounts do not agree with the March 2001 figures as the analysis was done earlier and there have been further recoveries).*

Table B-3:
Analysis of Default on the Basis of Loan Size of Term Loans
(In US $, Conversion US $ = Rs.46)

Loan size	Outstanding amount	Overdue amount	On-time Repayment % as per schedule
Upto $ 217	9,347	3,260	77%
$ 218 to $ 326	23,913	6,521	81%
$ 327 to $ 544	47,174	6,521	84.3%
$ 545 to $ 1087	60,218	8,260	76.1%
Above $ 1087	18,478	3,478	68.4%
Total	159,130	28,040	

Table B-4
Details of Defaults in Agri-Investment Loans based on No. of accounts
31 March 2001(in US $)

Purpose	Amt outstanding 31 Mar 2001	Current Overdues	No of A/cs	No of A/cs in default	Average loan size	% amt o/due on demand	% A/cs in default
Ag implements	9,668	3,398	32	19	302	33.2	59.38
Fencing	1,746	841	5	4	348	22.7	80.00
Horticulture	2,174	0	2	0	1087	0	0.00
Land Devpt	24,660	2,769	67	15	368	9.2	22.39
Pump & Pipes	91,289	12,148	209	83	437	21.4	39.71
Well repair	4,316	299	12	3	360	20.5	25.00
Others	13,885	3,360	43	19	323	26.6	44.19
Total	**147,738**	**22,815**	**370**	**143**	**399**	**19.6**	**38.65**

Source: Company records Conversion US$ = Rs.46

While the loan size may yield leads, the number of defaulting accounts under each sub category has some interesting numbers. Table B-4 indicates that the number of defaulting accounts is high in agricultural implements, fencing, pump-sets and pipelines. In the case of horticulture there are no defaults because the loans have not fallen due. This does not tell us if the ease of liquidation of the underlying asset is a significant factor dictating the repayment behavior. It is important, because the expectation is that if repossession is easy, the repayment is expected to be better.

Other modes of Financing - JLG lending for LT loans

We need to see if the concept of JLG could be extended to term lending. As the purposes for which term loans are sought and the maturity periods of individual borrowers are usually different, it is difficult to convince people to form self-selected groups. However, BASIX has attempted making collective loans. A loan of Rs.750,000 (US$ 16,304), was given for a lift irrigation project where the borrowers were jointly liable. This resulted in dramatic improvements in yields in the vicinity. Similarly BASIX made a loan of Rs.100,000 (US $ 2,174) to a SHG to revive a defunct lift irrigation scheme. The loan has helped in increasing access to irrigation for about 500 hectares of land. The AP government is keen on promoting water users associations. BASIX has opportunities to lend for group owned assets. BASIX has been dealing with groups – particularly SHGs and is experienced. The concept could be extended to other collectives, provided the lending agency has a fair understanding of dealing with groups.

Leasing

While leasing is an option, it is seen as a surrogate for collateral. Instead it is seen more as a tax planning mechanism. While BASIX has examined this issue in the past, it has never implemented a product based on lease. Now the Institute of Chartered Accountants of India (ICAI) have issued the accounting standards for leases, applicable for all leases starting from 1st April 2001 (AS-19, ICAI). This clearly specifies that, if the lease satisfies some significant conditions, it would be treated as a "financial lease". The lease product that might be offered by BASIX will get defined as a "financial lease" and the tax deferral benefits accruing out of such leases will be available to the lessee rather than the lessor. The ICAI has also issued an exposure draft on accounting for deferred taxes which makes it impossible for BASIX to defer reporting of taxes, while payments could be deferred. This makes the option of leasing unattractive to BASIX from the tax angle.

The cost of recovering a leased asset and encashing is high. It might not be worth the while of BASIX to use this as a surrogate for collateral. Leasing could be considered if the asset could be re-leased or liquidated in case of foreclosure. Both these are not seen as options by rural lending institutions. In India leasing has been used as a tax-planning mechanism. It might take time before institutions try out leasing. However the possibility of this working is not to be ruled out.

Analysis of Main Issues

From the above description it can be seen that, while BASIX has had a high degree of innovation in the agricultural credit sector, the term credit has not been a very pleasant experience for them. While BASIX thinks it is a viable proposition to undertake term loans, they have not found a viable way of extending the micro-finance methodology to term loans. Part of the problem is recognized as the moratorium to be given in case of term finance, which militates against the micro-finance orthodoxy of immediate and regular repayments. Moreover, BASIX is in a stage of aggressive growth. In such a stage it makes immense sense to turnover the loans faster rather than lock up amounts for a long period. As the experience of BASIX goes up, they would be able to innovate and undertake higher denomination and longer duration loans.

Measures to Reduce Transaction Costs

BASIX operates on a three axes philosophy of reducing transaction costs, increasing access and mitigating risks both to the borrower and itself. The operational aspects of reduction of transaction costs, are:

- Simple documentation - form filling at village, in public - which improves information quality
- Disbursement in cash and kind through a network of input distributors
- Repayment collected from village/point of sale
- Arranging for technical assistance and support services

BASIX believes in leveraging existing structures, by creating positive synergies between the borrower and the service provider. The extent of the savings due to such arrangement has not been measured. It is evident that all the costs of the BASIX loan are stated up-front and there are no hidden costs. The borrowers save on trips for chasing the loan, on expenses for documentation and getting a series of clearances that are usually incurred in case of alternative sources. BASIX also saves on transaction costs by deepening the transactions with the existing customers – by giving term loans to crop loan borrowers, penetrating in a geographical area by an explicit policy of making term loans only to new customers in a village where they already have substantial presence. The costs are also cut because of computerization of borrower database that helps in monitoring loans simple and easy.

Apart from this, BASIX has built its systems in a manner that it seeks borrower information only once at the time of registration and uses this data for processing of all transactions. It also effectively uses the borrowing history of the customers. In addition, it collaborates with other local institutions with whom the customers have a regular contact thereby reducing lending risks.

C. Internal management

Portfolio management

BASIX has internal guidelines and exposure norms for each of the activities it undertakes. There are upper limits for exposure to agricultural lending and agriculture allied activities. The upper limit for a single loan is Rs. 50,000 (US $1087). There are minimum limits for lending to non-farm activities so that the portfolio is well diversified and a minimum cash flow comes through activities producing regular income stream on a monthly basis. Overall these limits are reviewed constantly on the basis of defaults and field situation and changed in the annual credit policy.

Sources of Funds

The BASIX group has received funds from a combination of developmental and commercial institutions. The initial capitalization of BASIX was done through a complex design of a soft-loan from the Ford Foundation and Swiss Development Co-operation. It has also received a soft loan from the Canadian International Development Agency. All later financial support has come in the form of equity commitments from the International Finance Corporation, Shorebank Corporation, Chicago, Triodos Bank, Netherlands and Indian financial institutions like ICICI, HDFC and Global Trust Bank. In addition BASIX has received loans from Cordaid Netherlands and Sidbi Foundation for Micro-credit. It has a line of finance from the Global Trust Bank and ICICI Bank. The level of financing and the current mix of developmental and commercial funds help BASIX to balance out the risk in lending to vulnerable sections of the society and the returns got from larger loans.

Given the type of finances lined up, there is a need to turnover the loans faster. BASIX being a young organization with limited resources would rather have the same amount of money amidst more number of clients rather than a few. There is no internal or external pressure to do term loans, no separate lines of finance, no incentives and the short term portfolio is doing much better than the long term portfolio. There is a natural focus on short-term loans. However, it might be a good idea to move towards term loans to retain their good short-term customers.

The Flagship Company of the group being a NBFC, the source of finance is likely to be costlier than other banks. NBFCs are not eligible for refinance from NABARD as NABARD refinances only banks and co-ops. However BASIX has recently received a license to operate as a Bank in three districts where the cost of funds are likely to be much lower. The bank could also seek refinance facilities from NABARD and this benefit is likely to be passed on to the borrower, thereby reducing the interest rates at least in the three districts. All the above funds have been raised for the general portfolio of BASIX. There is no line of finance to specifically address term lending.

Decision making structures

All decisions pertaining to loans are made through a system of powers delegated to the respective officers. For instance all loans upto Rs.50,000 (US $ 1,087) is approved at the unit level by a loan committee. Executives who have a repayment of greater than 98% on the portfolio attached to them can directly approve loans upto Rs.10,000 (US $ 217). There could be some loans given to SHGs which has an upper ceiling of Rs.200,000 (US$ 4,348) per group. The CEO approves this. Usually the originator of the loan presents the proposal and defends it.

The current portfolio limits specified by the management of BASIX are as follows:

Product/ Purpose of Loan	**Limit**	**Product/ Purpose of Loan**	**Limit**
Farm Loans	<= 45%	Micro-Enterprise loans	> = 45%
Of Farm Loans:		General Purpose Loans –SHGs	> = 15%
Crop Loans	<= 25%	General Purpose Loans –Individuals	<= 5%
Agri Term Loans	< = 5%	Housing Loans	<= 5%
Agri Allied loan	< = 15%		

Staff Incentive System

While the job of the CSA encompasses identifying borrowers, originating the loan and monitoring and repayment, his remuneration is exclusively based on the performance of his portfolio. If at any time the overall recovery goes below 90% of the dues, the CSA is warned and if the situation does not improve, s/he loses the agency. The CSA gets payments based on performance of portfolio beyond 90%. The commission given to the CSA is an eighth of the interest collected on due amounts. Similarly all staff members from the loan officer to the chief executive are given a pay having fixed and performance based components. They are provided semi-annual incentives based on the performance of the portfolio assigned to them. Apart from financial incentives, there are other non-financial signals given to the staff members. The limits to which they could approve a loan is determined on the basis of the performance of the portfolio.

Conclusion

As an NBFC, BASIX has restrictions in accessing savings from its customers. However, the constraint would not be operational on banks. BASIX has been a successful demonstrating that rural lending could be done in a commercial and sustainable manner, if structured properly. BASIX also illustrates the limits of extending MFI methodology in term lending. Unless thought is given to the longer tenor loans, it would be difficult to extend the MFI methodology to new frontier areas. BASIX is a much-admired organization as evidenced by the fact that other MFIs are taking to the organizational design of BASIX. Imitation after all is the best form of flattery.

2.1 Co-operative Rural Bank and Marketing Society, Mulukanoor (MCRB)

A. Background and General Issues

The Co-operative Rural Bank and Marketing Society Mulukanoor (MCRB) was established in 1956. MCRB is a co-op, heavily regulated and falling under the straightjacket of schematic lending seen through the decades of various plan periods. MCRB is an example of successful performance where the external environment was not conducive for growth. In this case we document the internal insularity built in by the co-op, while looking at the regulatory controls exercised on it.

MCRB is an integrated co-op, providing financial services, input supply, output marketing, technical assistance (TA) and consumer services. MCRB made a modest beginning with 343 members and a lone employee and a loan of Rs. 2,000. By the year 2000 the co-op had nearly 6000 members, 115 employees and an outstanding of Rs.80 million (US$ 1.73 Million), a sales turnover of Rs.370 million (US$ 8.04 million) in input supply and output marketing. MCRB operates in 14 villages in the Karimnagar District of AP. More than 75% of the eligible households in the area are members of MCRB. Only households engaged in farming are eligible to seek membership. Thus, 50% of the households do not benefit directly from the services of MCRB.

B. Main features of MCRB

<u>Incorporation</u>

MCRB was incorporated as a co-op society under the AP State co-op act. Almost all primary agri co-operatives in the country are incorporated under their respective state acts. The agrico-ops fall under the three-tier structure - with the State Co-op Bank at the apex level, District Co-op Bank at the intermediary level and the Primary Co-op at the village level. The State Co-op Bank gets refinance on its portfolio from NABARD. This is passed on to the district and the primary level co-ops. This structure largely dictates the refinance rates and some general policies across the state. In the State Act, there are several provisions that could be used to interfere in the day to day activities of the co-operatives, including a blanket take over of the management of the co-ops under certain conditions. This makes the co-ops at all levels very vulnerable to manipulation.

MCRB, was under this regulatory regime till the AP government passed a new and parallel Mutually Aided Co-operative Socities Act (MACS) in 1995. The new act has lesser controls built in and provides more autonomy to the co-ops provided that they do not seek any state funding for equity or any other sort of assistance. The new act also provided that the co-ops registered under the old act could convert into MACS if they wished. MCRB was one of the earliest institutions to seek registration under the new Act to get a greater autonomy.

Even when the co-op was governed by the old act, it enjoyed a relative degree of autonomy. It first broke away from the three tier co-op system, when the District Co-op Bank, could not keep pace with the growth of MCRB and was unable to refinance the portfolio, because of its own weak capital structure. MCRB then got special permission to seek refinance through a commercial bank and the arrangement continues even to this date. For a long time since its inception, MCRB was prohibited from disbursing term loans since there was already a specialized institution (land mortgage bank) operating in its area. In 1965 the co-op started lending medium-term (5 year) loans. It was only in the late 1970s that MCRB got permission to do long term (7-year and above) loans. Currently, AP has a unified structure for both long and short term lending. Therefore, MCRB is to be seen as an exception rather than a rule of an institution working under a highly regulated environment and also quickly adapting itself to the new liberal regime.

Financial Products offered by MCRB

MCRB has a whole range of services being offered to the members. It supplies agricultural inputs including seed, fertilizer and pesticides. It processes its own brand of seeds in case of paddy and acts as an agent for other seeds. It offers a range of financial services described in the next paragraph, sells agricultural implements, pipelines and pumpsets. It also has cotton ginning unit, a rice mill and a seed-processing unit, which processes the produce of the members. In addition, it procures the produce of the members and arranges for marketing them. It has its own transport fleet and a series of shops selling the consumer goods. In short, it would not be an exaggeration to say that the co-op meets every need of the members' trade and commerce.

MCRB offers the following financial services:

- Savings products - including compulsory thrift, savings accounts, term deposits.
- Loan products - short term for agriculture, agri-allied loans for animal husbandry and other off farm activities, term loans for farm mechanisation, irrigation, plantation and horticulture.
- Welfare products such as death relief assistance from the resources of the co-op in case of a death during the continuation of membership
- Accident insurance with the General Insurance Corporation of India, premium paid by MCRB
- Life Insurance cover under the group insurance scheme, premium paid by MCRB
- Life insurance cover to the extent of borrowings to ensure that the loan is no longer payable in the event of the death of the borrower, premium paid by MCRB

MCRB has been giving loans for both short and long term purposes. The co-op has a long history of excellent repayments and has stood the test of time. While there is a lot to be written about the non-financial services of the co-op, for the purposes of this study we shall confine to the term loan segment of their operations.

Lending Modalities

All loans given by MCRB are direct loans. Most of the loans are given in kind, as the co-op deals with most of the inputs required by the borrowers. Tractor loans are necessarily given as a joint loan to two members. Otherwise the co-op deals only with individuals. It however requires a guarantee from another member. Monitoring is done through village committees.

Portfolio and Products

The purpose for which MCRB lends is classified into three broad categories. This includes loans for working capital – called the short-term agricultural operations (SAO) loan, term loans for various purposes and normal loan for consumption purposes. The detail and purposes for which MCRB gives loans is listed in Table B-5 below. The share of the term loans in the entire portfolio of the co-op is more than 20% of the outstandings. The short term agricultural loans account for around 56% of the portfolio. The rest of the portfolio consists of normal loans including gold loans, which are given against specific pledge and could be for a period upto three years.

Table B-5
Disbursements & Outstandings of Term Loans – CRB Mulukanoor
(as on 31 March 2000, in US $)

Purpose	**Term**	**Moratorium**	**Disubrsements Apr'99 to Mar '00**	**Outstandings as at 31 Mar 2000**
Tractor	7 years	1 year	54,565	113,478
Citrus plantations	14 years	5 years	3,043	4,565
Mango plantations	14 years	5 years	652	2,174
Pumpsets	5 years	1 year	38,913	80,435
Pipelines	5 years	1 year	18,043	27,609
Well repair	5 years		26,739	37,826
Poultry	5 years	1 year	30,652	38,913
Animal husbandry	5 years		20,652	42,174
Sheep	5 years		60,000	58,913
Looms	5 years		2,609	1,522
Power tillers	5 years	1 year	6,739	10,000
Thresher	5 years		435	3,261
Others (bio gas, rig, drip irrigation)			217	19,348
Total			263,261	440,217

Source: Annual Report 1999-2000 Conversion US $= Rs.46

Client Base

MCRB lends only to its members. Currently there are around 6000 members in the co-op. Only persons having some land and residing in the 14 villages covered by MCRB are eligible to become members of the co-op. By this criterion, 75% of all eligible households are already members of the co-op. MCRB does not lend to agricultural laborers or landless people. Thus about 50% of the households in that area are not eligible to avail of the services of MCRB directly. The client base ranges from small farmers owning less than two hectares to large farmers owning more than 10 hectares of land. Thus the credit activity of the co-op is concentrated around agriculture. MCRB does not lend non-members. More than 75% of the members have less than 2 hectares of land.

The break up of the land holding of borrowers of term finance is not available. However, based on the experience we could conclude that most of the term loans for pre and post harvest equipment are given to the larger farmers. Similarly, loans for plantations - citrus and mango would have gone to the large farmers, while the small farmers would have borrowed for animal husbandry, poultry, sheep and other agri-allied activities. The well and well repair loans are most likely to be distributed across the spectrum of the membership.

C. Lending Technologies

Screening and Selection of Borrowers

The screening of potential borrowers is done at the time of the membership to the co-op. All potential members submit the membership application to the board of directors who after due consultations decide on whether to admit a person into the membership or not. The staff processes all further loans. MCRB follows the guidelines issued by the state co-op bank on the procedure to be followed in case of deciding on each loan. Since MCRB has been following the schematic lending, all appraisals are done according to the book. If the borrower is eligible to take a loan then the papers are again put up to the board for approval.

Since MCRB operates in a very limited area of 14 villages covering an area of around 18,000 hectares, there is a very good knowledge of the local conditions – weather, markets, resources and success rates of economic activities. By virtue of it being a co-op, most of the members are known. This effectively weeds out the undesirable borrowers right at the beginning.

Loan Appraisals

Usually since all the members are agriculturists, no further checks are done on the experience of the borrowers. Similarly calculations are done to factor in the incremental income from the new activity as well as surplus income from the existing activities to check if interest amount could be serviced during the moratorium. If this is satisfied, then the loan application is processed further. A major consideration in looking at a loan proposal includes the accumulated savings of the member. Member borrowings have a ceiling of a multiple of 5 times the accumulated savings. If the member is new who is building up savings, this might be relaxed. In any case a term loan is not considered for a new member straightaway.

Apart from the knowledge gained out of experience, there is no other specific risk assessment carried out by MCRB. The schemes are laid out and the levels of finance, moratorium and repayment schedules are fixed schematically. However, an assessment of the repayment capacity of the borrower is undertaken. Usually it is assumed that repayments would not only come from the current loans, but also from the income arising out the new loans. A thumb rule is: about a third of the repayment would come from the new loans, while for the rest the borrower should be in a position to service from the existing cash flows. The member is expected to invest 25% of the cost of the asset in case of all term loans. Even in case of asset purchase, the member is expected to deposit the margin money with the co-op before venturing out for the purchase. This ensures the member takes the investment seriously. MCRB has never considered other ways of lending to the members. The current inter-linked arrangement is working very well.

There are a few reasons why MCRB does detailed borrower assessment and only rudimentary project appraisal. It is very unlikely that a borrower of the co-op would seek a loan for a purpose that is not approved as a scheme. If it is approved as a scheme, the calculations are made as per the handbook to satisfy that the basic economics are working out. Beyond that, MCRB believes that it is the borrower who needs to be assessed. The staff of MCRB consists of only local people who are also agriculturists. Therefore they have intimate field knowledge. They are also not very well qualified and are unable to carry out any sophisticated analysis. The knowledge of the ground situation as well as the knowledge of borrower behavior more than compensates for any lack of sophisticated analysis. Moreover, the co-op invariably carries out the processing and marketing of all the major produce of the members and offers the best deal in the area. These inter linkages along with the high savings retained in the co-operative removes the risk of adverse behavior that might arise out of erroneous appraisals.

It is not that MCRB is prohibited from getting out of the schematic lending business. Since the finance for the term loans is from internal resources, they would be within their rights to do lending differently. But initially MCRB was seeking refinance from the NABARD schemes through either the co-op bank or the commercial bank and continues to follow the schemes, by force of habit. Most of the innovation of MCRB has come from responding to the marketing requirements of the borrowers rather than the credit requirements.

Collateral and related issues

At the time of membership, MCRB calls for all the land records, and clearance certificates from the local authorities to ensure that the land is un-encumbered. Once the records are lodged with MCRB, it remains with them till the cessation of membership. The MCRB on its part will ensure that it meets all the credit requirements of the member. This drastically reduces recurring documentation whenever a loan is taken. Of course, when a term loan is taken, the asset created out of the loan is also sought as collateral, but the paper work for this is very simple.

In addition, the MCRB has village development committees for each village. The village development committee acts as a watchdog for the co-op and any adverse behavior by the borrower, which might affect the repayment of the loan, is immediately attended to. The membership of the village development committee is prestigious and their recommendations are taken seriously by the co-op with the understanding that they would stand by the co-operative in case of default. Every term loan is secured by the guarantee of another member (who also has substantial financial stake in the co-op). This acts as effective social collateral. Enforcing a chattel mortgage is quite time consuming and cumbersome. However, due to the inter linkages and the members' own financial stakes in the co-op, the occasions in which this will have to be used is few and far between.

When a loan is approved, it is usually given in kind, unless the loan involves a significant amount of labor (like digging a well). Since MCRB is an integrated co-op, it has its own shops that stock equipment and other inputs. For loans such as poultry, animal husbandry and tractor a person from MCRB goes with the borrower to the market to ensure that the member buys the asset and makes a direct payment. This effectively eliminates any misuse of the loan at the initial stage. By ensuring that the members buy the equipment they need through the co-op, they ensure that there is no diversion of funds. Then the offer of buying the output of the member is made so attractive, that the member would lose out if s/he does not sell the produce to MCRB. Due to its distance from the nearby markets and its advantages of scale, the offer made by MCRB is more attractive than any other competitor.

MCRB minimizes its lending risks primarily through inter-linked transactions. The members pay in a compulsory thrift of 5% of their short-term borrowing every time they borrow. These thrift deposits are repayable to the members only on termination of membership. Typically a term loan is given to a borrower only after s/he has had a few cycles of short-term loans. By the time the borrower becomes eligible for a term loan, s/he has substantial financial stakes in the co-op.

MCRB also has a range of welfare services. It is the intangibles involved in the following social security service that makes the member maintain his/her relationship with MCRB properly. The social security net offered by MCRB includes accident, life and loan insurance, for which the premium is paid by MCRB. This effectively covers the risk in case of unforeseen circumstances.

These measures act in two beneficial ways – firstly it is very unattractive for the member to leave the co-op and secondly in case of a death of a member it ensures that the co-op does not suffer. MCRB deals with only its members. Becoming a member in MCRB has several advantages apart from the term loans. A major benefit is in the minimal documentation that is to be done after a person has taken up the membership.

Loan Terms and Conditions

Interest Rates

Most of the loans carry an interest rate of around 15 to 16% p.a. on a diminishing balance. For defaults a penal interest of 3% p.a. is charged. None of the interests are compounded. These interest rates are to be termed as low compared to what the private sector lenders and the local moneylenders charge. The interest rates are comparable to those of the formal credit institutions. The interest rates charged on term loans are higher than the rates charged for crop loans (13.5%) and lower than the rates for consumption loans (18%). There are no other fees or costs to be borne by the borrower. The borrower also does not incur too much of transaction costs as there are no delays in approving the loan and s/he need not run around for purchase of inputs after the loan is approved.

MCRB might be losing money in the loaning activity. This is because a significant chunk of the term finance is done out of resources raised locally as compulsory thrift. The co-op pays 15% p.a. interest on this deposit, thereby leaving a spread of just about 1% on this category of loans. Since the thrift is repayable only on termination of membership, this source is growing over the years, which triggered MCRB to stop seeking refinance. The co-op is conscious of this, but continues providing this service to its members since it believes that offering a lucrative savings product to its members is a service that is necessary. The loss on this activity is more than offset by profits earned on produce procurement and processing where the margins are much higher.

All the term loans disbursed by MCRB have a moratorium as described in Table B-5 above. Repayment terms are also fairly standardized. Interest on loans has to be paid through the period of moratorium at six monthly intervals. Principal payments are also effected through equal half yearly installments beginning from the expiry of the moratorium until the term of the loan. At the time of appraisal the thumb rule that is followed is that the current cash flow should be able to meet the interest as well as two thirds of the installment amount. Only a third of the installment is to be paid out of the incremental cash flows from the new activity. So interest payment is to be met from the current cash flows of the borrower. MCRB does not have flexibility in the terms and conditions of the loan. It implements its loan program in copybook style.

Repayments and Recoveries

Repayments can be effected either through cash or by supply of produce. MCRB has facilities to buy paddy (which is the main crop), paddy-seed, corn and cotton. In the past MCRB has procured citrus, eggs and other produce of the members. MCRB has infrastructure to store and process the produce. There are positive incentives for borrowers to get their produce to MCRB than take it elsewhere. The members save on transportation costs as the co-op has collection points in each of the villages. They also save on market yard cess that they need to pay if they take their produce to the nearby regulated market yard. In addition to these hidden incentives, MCRB also gives them some positive incentives to continue transactions with it. In case of paddy an additional amount of Rs.15 per quintal is given as an up-front price bonus to the extent of settlement of the loan and interest. In the past few years, an additional price differential of Rs.5 per quintal has been given to the borrowers at the end of the season. This makes it a very attractive proposition for any member to deal with the co-op. Once the produce is brought to the co-op, the value of the loan is checked off against the money payable to the members and only the differential is given.

In addition to building in positive incentives for repayment of loans, the co-op has also built up financial stakes of the members in the co-op to such a great extent that the older members always find that it is disadvantageous to sever themselves away from MCRB.

MCRB monitors the loans on a continuous basis. Since the borrowers undertake day-to-day operations with the co-op they are in constant touch. The General Manager of MCRB, Mr.Laxma Reddy elaborates on the difference between the erstwhile land mortgage bank and MCRB in their approach to monitoring and recovery of loans. "*The land mortgage bank being specialized had a limited number of clients and they were security oriented. In case of a first sign of default, they would rush to encash the security. This was a good enough deterrent to avoid default. However our approach is yield oriented. We are in constant touch with borrowers, we know what is happening to the local economy and any sign of deviation will be immediately dealt with, through social collaterals*".

Monitoring of the use of the loan is done on a continuous basis – through village development committees who act as watchdogs in case of diversion of the loan or sale of the underlying asset.

The guarantor is also constantly on the watch since his/her own stakes are deeply involved. Apart from this, the staff of the co-op visits the borrower at the first instance of default.

Dealing with Default

MCRB has identified the following as reasons for failure of a loan:

- Mis-utilization of the loan amount
- Delay in financing the project
- Inadequate financing of the project

Its disbursement strategy takes care of the above factors, by having effective control systems to check on the utilization of the loan amount, quickly processing the application and by striving to be the lone financier for all the borrowing needs of the members.

Though MCRB has fair amount of autonomy, they have traditionally been regulated. Even in case of default outside the responsibility of the borrower, MCRB has taken a very stringent stand. They have rescheduled of re-phased the loans of the borrowers only when there is an overall failure of crops and it is officially declared so. This is a very rare exception. Otherwise, they continue with the installments as usual. However if there is a genuine case of default due to reasons beyond the control of the borrower, the only concession the MCRB gives is a delay in the legal process and in enforcement of collateral. However, the co-op would continue to use persuasive techniques with the borrower and see if a part of the savings could be liquidated in such circumstances. MCRB strongly believes that they should not be giving a wrong signal to the borrowers. This has held them in good stead. Even in 1989 when there was a nation-wide loan waiver scheme, MCRB remained relatively unaffected because their members had paid most of the amounts. They even now cite this as an example of strict enforcement that has helped them to remain healthy while the rest of the co-op system has gone sick.

However, every year-end, the co-op has been showing a default rate of upwards of 25% in its reporting. While in reality, the actual repayments tend to be much higher. The reason for the difference is because of the way regulators have specified the due dates on crop loans. Every year, by the month of June, the co-op would have realised most of the loans after harvesting. But for this temporary anamoly, the co-op has been traditionally reporting a high repayment rate.

In addition, there are other social pressures exercised by MCRB. Every year, the co-op publishes the names of the defaulters along with the amount that is defaulted in the annual report. This acts as a significant deterrent in addition to the other social collaterals.

Analysis of the Main Issues

Measures to reduce transaction costs

MCRB has no well-articulated strategy of reducing transaction costs. By the inherent nature of design transaction costs are low. The co-op operates in a limited area of fourteen villages. This gives a great amount of focus and depth. Secondly MCRB operates on economies of scale by pooling in all the members' resources locally. The members depend on external resources only for residual transactions and requirements. This increases the overall efficiency of the local economy. Being a co-op, MCRB is not under pressure to service two sets of constituents – the owners and customers, unlike other forms of organizations. Therefore, MCRB is in a position to give a better deal to its owner-customers through higher produce prices and patronage benefits.

The benefits that the members enjoy are as follows:

- Simple documentation.
- Disbursement in cash and kind through own network of shops for inputs.
- Repayment collected from village/point of sale, in the form of cash/kind, at attractive prices.
- Arranging for technical assistance and support services.
- Using village development committees and co-obligants for monitoring and utilization of loans, thereby reducing costs of surveillance through social collaterals.

MCRB leverages its infrastructure in creating synergy between loaning, trading, marketing and processing activities. The borrowers save on trips to be made to the cash counter. They also save on the expenses for documentation and getting clearances needed in case of alternative sources.

D. Internal Management of MCRB

Sources of Finance

The main source of finance for the co-op is from the members as well as from the State Bank of Hyderabad, which refinances most of their activities. Initially the co-op used to borrow from the district co-operative bank, but it soon reached a stage where it was not possible for the bank to meet the requirements of the MCRB, thereby triggering a search for a larger bank. Currently the resources generated from the members is far overtaking the resources that the co-op needs for its activities – thereby leading to a situation where it is getting to be lesser reliant on external sources of finance. A condensed balance sheet of MCRB is given in Table B-6.

From the balance sheet it is very clear that the MCRB needs no external funds, including loans from State Bank. While this indicates a very healthy figure, there are some concerns that need to be addressed by MCRB. Since the members funds are far higher that what they are borrowing currently, there certainly is bound to be some level of disorientation because the members would have to pay a percentage more than the return they are getting on their own deposits. Over a period of time this might turn out to be a question of why the loans should be paid on time at all, since the co-op in any case has their funds. But it would be interesting for MCRB to look at this as an opportunity to get deeper into term financing and significantly enhance the income of the borrowers by financing assets that create larger income flows. Unlike other forms of institutions, co-ops can adopt the strategy of raising local resources without a regulatory overload and thereby turn out to be effective users of local resources. It was identified in a previous study that places where markets are not very well developed or dominated by a single player like Mulukanoor, it is easier to have the strategy of mutually inter-linked transactions, unlike areas where there is intense competition (Agrawal et.al, 1994)[10].

Table B-6
Co-operative Rural Bank and Marketing Society Mulukanoor
Condensed Balance Sheet as on 31 March 2000 (in US $)

Liabilities	Amount	Assets	Amount
Member Funds		Loans to members	
Share Capital	311,239	Short Term	1,065,413
Member Deposits	2,986,609	Normal and other loans	424,348
Reserves and Surplus	1,828,587	Medium Term	319,652
Undistributed Profits	179,913	Long Term	120,174
Total Member funds	**5,306,348**	Total Loans to Members	**1,929,587**
Loans from State Bank	793,109	Cash and cash equivalents	49,848
Other Payables	94,065	Investments	1,571,500
Adjustments	22,478	Net Fixed Assets	435,630
		Curent assets	2,229,435
Total	**6,216,000**	**Total**	**6,216,000**

Source: 44^{th} Annual Report, 1999-2000 Conversion US$= Rs.46.

MCRB thus provides us a model under mutuality as to how term credit could be directed through a series of interlinked transactions. The interlinked transactions are benevolent to the borrowing members because of the way in which the entire relationship is structured to enhance mutuality. If the same technique was applied in a profit maximising private sector investor oriented framework, it could have been turned into a negative cycle that exploited the borrowers. One needs to watch out for the downsides of inter-linked transactions before transplanting this model in other contexts and other ownership regimes.

Part C

Conditions constraining and facilitating the flow of credit

In trying to understand the constraints and the policy framework for term finance in India, we have looked at two innovative experiments. Though the two are not of the same scale, size and orientation, there are certain important issues to be learnt in the process. BASIX represents a case where the financial institution came up in response to a failure of the formal financial institutions have failed to cater to the market. The problem was perceived by BASIX at the national level and not at the local level. Now BASIX is rapidly expanding geographically as it sees promise in its methodology tried for the past five years. MCRB represents an old institution that flourished even in a highly regulated environment and minimized external shocks by internal financial insularity. But even within MCRB, we need to note that initially there was no permission to undertake term financing. The co-op had to lobby for getting permission.

While addressing the issue we are not arguing that the formal financial institutions have failed. In the area that we studied, it was clear that they were not performing a significant role. The fact is that, several organizations from different ideological backgrounds and innovative designs have come up is indicative of the financial institutions being unable to fulfill their role fully.

With liberalization putting pressure on the bottom line, even commercial banks are looking at lending to agriculture with suspicion. The old time thinking was largely focussed towards poverty alleviation, oriented towards large amounts of subsidy and emerged out of schematic lending – with sops offered by the State. Even organizations like NCDC had broad guidelines as to how much a typical rice mill would cost and what should be the limits of finance to be given to each business – add decided centrally. This was one of the reasons why the new institutions started their operations by counter-positing the traditional ways of lending.

The new generation institutions had to address the following issues as they started functioning:

- Credit culture - waivers, re-scheduling, and other issues of the nature of "political risk".
- Removing the excessive dependence on physical collaterals – but purposively looking at them. Use of social collateral, and carefully examining the quality of other collaterals.
- Looking at institutional arrangements that have a built in de-risking strategy and strongly addressing the issue of transaction costs
- Pricing and packaging of the loan products

Issues from the Borrowers' Perspective

It is better for the borrower to have one institution cater to all the credit needs. It helps foster relationships and reduces documentation. Both the case studies have very positive lessons to offer for other institutions as to how to make the borrowers' life much simpler, and thereby foster and nurture relationships. Both the institutions have addressed the issue of uneven cash flows and the need to have moratoriums. However, institutions using MFI technology like BASIX seem to be in a greater hurry than the traditional institutions.

It is better to have a high nominal cost and no hidden costs. Borrowers may not grumble about paying a higher interest rate if other hassles are kept at bay. There are however issues on how much is a good quantum to seek as upfront investment from the borrower. At what level are the institutions helping or troubling the borrower by putting in a high amount of margin investments?

None of the institutions address the genuine risk of the underlying economic activity adequately. While BASIX is making its own attempts at addressing the issue, it is nowhere near implementing a solution. The element of risk in agriculture, and heightened risk because of compounding effect on term loans is to be addressed adequately and carefully.

Issues from the lenders' perspective

The issue of credit culture:

While MCRB continued to exist during all the years of "directed credit" and the state performing an activist's role in the rural credit scenario, the other players are rather recent and could be said to be products of liberalization.

Both the institutions had to address the issue of credit culture. It is recorded elsewhere that the rural people were making a distinction between *"Sala"* (meaning a loan, in Kannada) and a *"Loan"* as disbursed by the formal financial institutions (Fernandez, 1998)[11]. So in the perception of the people, a *Loan* was not to be repaid but a *Sala* was to be.

While MCRB had a history of low tolerance for default, and had built up its defence systems right from the beginning. BASIX on the other hand had to establish a different identity. MCRB continued with its strict systems while launching newer and newer products that indicated responsiveness to the members' needs. As it progressed, MCRB built in systems of inter-linkages which gave the borrowers little escape route from the credit culture.

BASIX addressed this issue by positioning itself as a private sector player. The décor of the office of BASIX did not even resemble a bank. The employees of BASIX discouraged the borrowers from visiting the office, instead they went to the customers – thereby driving home the point that they were different. Not only this, they also turned up at the borrowers' doorsteps on the due date to drive home the point that the loans were to be repaid on time. BASIX also developed and leveraged existing institutions wherever it was possible.

Both the institutions have clearly articulated that legal process is the least desired in case of a problem with repayments. This process is confrontationist and adds to mistrust in an already vitiated atmosphere. Instead systems and processes that build mutual trust have to be fostered. Social collateral is a powerful tool to tackle this issue. At the same time, being formal institutions, both could not do away with documentation and collaterals - particularly when it came to term lending. During the interactions it was clear that the major impediment in term lending was pertaining to collateral. This is because land records are not in good order in most places. Even where records are in order, it is difficult to liquidate the collateral – particularly in the rural areas. BASIX has faced problems in liquidating collateral when a borrower defaulted. The solution is in using more powerful social pressures rather than legal recourse.

Each of the institutions have found their own solutions to the problem of charge creation – MCRB insists on land records, once in the lifetime of the member. Once the land records are submitted, the member is provided with all types of loans. Because of the insistence of MCRB, the land records in the area of operation of MCRB have been in good shape. MCRB uses social collateral for monitoring and recovery, recognizing that legal action is the most cumbersome method. Over a period MCRB has negated the need for legal action by building financial stakes of the members.

BASIX has used social and peer pressure as collateral, by lending to joint liability groups. Whenever BASIX has lent to individuals, it has faced problems. In fact BASIX has reduced its exposure to term lending till it finds a mechanism of building in long-term social collaterals and a way of extending MFI methodology to term loans as well. They have found that they could do that by linking the term loan with a recurring crop loan or by undertaking term lending activities in areas where they have a regular contact.

The issue of de-risking

The institutions have all looked at different strategies for de-risking. De-risking has to be seen at two levels. First, at the level of the institution and second at the level of the borrower. BASIX uses leveraging institutional structures and tying up with local service providers to de-risk its portfolio. MCRB uses backward and forward linkages of products and services to address de-risking. Both BASIX and MCRB have a portfolio of loans that are diversified into different purposes, loan sizes and loan terms.

The second level of de-risking is to look at the underlying activity for which the loan has been given and what is happening to the borrower individually. Here also both BASIX and MCRB have a de-risking model, which use a combination of insurance and savings. While the strategy of BASIX is to address this issue as long as the loan transaction is valid, MCRB has a strategy of de-risking at the borrower level not only by insurance, but also de-risking over time by building up savings. So in a sense the model adopted by MCRB is more lasting, and can be so only because it is a co-op having lasting owner-user relationships with all its members.

The issue of transaction costs

Both the organizations have addressed the issue of transaction costs. One common feature is that decision making is de-layered. This reduces the transaction costs in terms of number of trips to be made to get the loan as well as the time taken to process a loan. In addition the institutions are geographically very near the borrower, thereby having a control on those transaction costs as well. In all the cases it appeared that nominal interest rate was not a significant issue in determining the purpose or the capability to recover a loan.

Issues pertaining to repayment terms and moratorium:

In most of the mainstream institutions the repayment terms do not appreciate the fact that a new activity takes time to settle down and yield revenues. For instance in irrigation it is commonly found that the yields initially go down in a couple of years before yielding enhanced results (Kulkarni, 2001)[12] – the repayment schedules do not capture this. MCRB has been able to address this issue more effectively and still be successful. As it relies heavily on the MFI methodology, BASIX has not been able to tackle this issue very effectively. The response of BASIX has been a temporary withdrawal. In fact, BASIX has not been able to find more effective mechanisms of maintaining regular borrower contact. While MCRB weaves a web of inter-linkages, BASIX is only trying to enhance contact by ensuring that annual loans continue to be given to the borrower. BASIX has a disadvantage of being a specialized financial institution.

The case studies indicate that given the right amount of operational freedom, the term-lending institutions can come out with innovative ways of addressing the issue. We have seen from the case studies how each of the players have packaged the loans and dealt with the issue of collaterals in an innovative way. While it is true that the overriding constraints are the following:

- Poor quality land records
- Inadequate mechanisms of creating charge on them

- Overloaded legal system – inclding the institutions like debt recovery tribunals being loaded with many cases making its speed comparable to the courts
- Difficulty in liquidating the collateral

But the above issues can be addressed only with a larger agenda of reforms. In Andhra Pradesh, from where all the cases for this study have been drawn, the computerization database is underway and administrative reforms are being carried out. It is largely functioning in the urban areas, but the clean up has to percolate to rural areas. This is a mammoth task. Similarly reforms in the judicial process have to be addressed at the national level. While analyzing these cases, we presume these constraints as given and look at what could be done within those constraints rather than make a hand waving recommendation that everything should change.

While the debate on the structure of the delivery institution could be debated endlessly, the case studies clearly indicate that any form of institution could effectively deliver credit. What is holding back the current players? It is not that any of these institutions have expressed their constraint as funds. But still none of these institutions have aggressive plans for the term financing of agriculture and related activities. BASIX is talking of reduced exposure to term financing – both in overall share as well as on the individual loan size, while MCRB has not had a negative stance on their term lending portfolio.

Dealing with borrower-level risk

A deeper look indicates that the activity is perceived to be extremely risky without compensating returns. The risk stems out of two factors – the inherent risk in the project for which the amount is financed. Wells may fail, cattle may die or may not yield sufficient milk, and plantations may not give proper yields, or when they do, may not fetch a good price. The second level risk is that the alternative activity in which the borrowers are engaged – usually agriculture is also risky. The crops may be too dependent on monsoons, there could be pest attacks reducing the yields, and there are again issues of price not being lucrative even if the yields are. The term loans for implements and tractors, which are to an extent dependent on the inherently risky agriculture, may not fetch cash flows to service the loan. So the portfolio is always on a shaky ground.

While the policy should look at providing greater finance for term loans through lines of credit, refinance facilities and lower interest rates, there is a great need to look at a borrower level de-risking strategy. From the case of MCRB it is very clear that if the borrower level de-risking is taken care of through various measures of social security. Spread of risk across time by self-insurance through proper savings mechanisms, spread of risk across borrowers by asset and life insurance and spread of risk across activities by crop and related insurance. We can see that BASIX is also trying to grapple with its de-risking strategy at the borrower level.

Here we need to learn from MCRB. The co-op has been in a position to give a higher up front price to the borrowers, only because of its confidence in the utilization of capacity to process and its experience in the market place in assessing the right timing to sell the processed produce in the market. If a co-op starts paying a high up front price even before stabilization, there are bound to be problems. Achieving the break-even volume does require experience and expertise.

The critical factors for success

To analyze the critical factors for success, we could look at the issues and responses of the organizations studied in the current context. We list the issues that are identified and the strategies adopted by the institutions studied.

Issue 1:

The credit culture is not good in the country due to political interference.

- Keep in touch with the customer; know the customer and the project well.
- Convey a sense of professional behavior right from the beginning. Loans are not to be considered as freebies.
- If possible, resort to inter-linked arrangements – thus avoiding the problem of moral hazard.

Issue 2:

Land records are not well kept, it takes a long time to get a solution through legal recourse.

- Collaterals are good only if they can be encashed immediately
- Social collaterals are powerful tools that can be unleashed
- Create socio-legal collateral like guarantee of a co-borrower, joint liability groups or lend to assets having multiple stakeholders as co-obligants.
- Legal action only helps in proving a point, but is to be used sparingly when all other recourses are addressed.
- Use innovative mechanisms even while resorting to legal recourse – speed up the process through personal contacts; take coercive action by filing criminal cases in addition to a civil lawsuit.

Issue 3:

Most term lending institutions do not have adequate de-risking strategies thereby making the entire operation very vulnerable

- Address the issue at institutional level by diversifying the portfolio across geographical regions, loan sizes, loan purposes and loan terms
- Address the issue at the borrower level by interlinking transactions through institutional arrangements, or by backward and forward linkages.
- Address the issue at the borrower enterprise level by applying risk mitigation products such as savings and insurance.

- Try and get the existing providers of risk mitigation products see a market in the borrowers.

Issue 4:

Transaction costs of most of the lending institutions are high.

- De-layer decision-making. Have good systems and norms of lending and delegate the powers. The employee also feels responsible for the loans s/he has made
- Build in incentives for good behavior – interest rate rebates for prompt payments, higher loan amount, additional loans etc.,
- Build in disincentives for default – penalty for late payments, publishing names of defaulters. This ensures that the repayments come in effortlessly.
- Take exemplary actions wherever possible. Liquidate the most liquid collateral.
- Design human resource system wherein costs are related to performance. Convert as many fixed costs into variable costs.
- Utilize existing structures and market players to leverage support services and also to seek repayment.

Issue 5:

Unrealistic repayment terms, inadequate moratorium.

- Give adequate moratorium depending on the activity – at least for the principal
- Try and match the repayment terms with the cash flows of the borrower
- While assessing take into consideration the flows from the current activity and the enhanced income from the new activity.
- Ensure that even the new activity could be serviced from the current flows to a sizeable extent.
- If possible have repayment terms which build in the price and the yield risks that the borrower might face, if other de-risking measures are not in place.

Scope for replicability

It is very evident from the study that there are several experiments happening in the term financing of agriculture and post harvest technologies. It is also interesting to note that the new experiments are not only coming in from financial institutions, but also from other institutions. While some of the learning can be replicated easily across all institutions, some of the aspects seem to be peculiar to a particular form of incorporation and there could be legal hurdles in replicating. However, the following aspects seem to be crosscutting across forms of organizations and we should not lose sight of it.

Firstly, there seems to be enough indication to believe that at the individual borrower interface level it might be better to have the delivery of short term and medium-long term credit bundled from a single outlet. This addresses one significant issue of borrower contact and also having a feel for the other sources of cash flow which could be effectively used for addressing the risk involved in the activity for which finance has been given. The lessons from the study seem to provide enough evidence on the positive rub-off effect in bundling all credit from one institution.

Secondly, there has to be an element, which measures the involvement in the borrower. The leveraging has to be carefully watched. MCRB addresses this issue by building member-savings unrelated to the project but by having a control on it. BASIX ensures this through seeking higher margin money requirements to demonstrate involvement.

Thirdly we have found that it might be better to diversify. Diversification would reduce the risk of one single large project failing and thus affecting the balance sheet of the lending institution significantly. One way of diversification if resources are a constraint is to lend to smaller projects. BASIX has seriously looked at this option.

If the above elements are applied in designing the loan products and institutions, the likelihood of creating a significant impact is much higher.

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