



Chapter II

Resource Acquisition and Use of Credit in Agriculture

Learning Objectives

At the end of the chapter, you are expected to:

- Understand ways of acquiring resources in agriculture
- Understand concepts and classifications of credit
- Explain the role of the credit
- Distinguish advantages and disadvantages of credit

2. Resource Acquisition and Use of Credit in Agriculture

2.1. Resource Acquisition in Agriculture

- The **capital requirements** of a farm or ranch business are large and increasing due to ***inflation, technological change, and increase in farm size.***
- With the need to control land, machinery, livestock, and other resources worth hundreds of thousands of dollars, many prospective young farmers as well as policymakers are asking with increasing concern, *"How can the capital needed for a viable farming operation be acquired?"*
- While the **available resources** of a farm business are limited in which case an owner of a farm business should try to acquire the ***optimum size of financial and other resources*** in order to involve in an optimum size of operation.

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- **Credit** is one way of acquiring additional capital. But the questions related to *the amount, type and timing* are very important for a farmer's decision in acquiring additional funds/capital/.
- How should a farmer decide *how much credit* to use in the farm operation and where to use it?
- What are the *contributions that credit* can make? What types of credit are available?
- How a farmer can *work with a lender for successful credit*?
- These resources have various sources including *internal and external sources*.
- Sources of funds used to control **capital assets** can be classified as *equity and non-equity or debt financing*.

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- **Equity capital:** is the capital owned by the operator.
- **Non-equity capital:** is the capital gained from debt financing.

➤ Debt financing /non equity / include

i. Savings and retained earnings

ii. Gifts and inheritance

iii. Pooling equity capital through a **partnership** (when two and more people associate) or **corporation** (legal entity authorized by law and is capable of doing business)

iv. Leasing: A lease is basically a capital transfer agreement that gives the lessee (the user farmer) control over assets owned by the lessor for a specific period of time for an agreed-upon payment or rent.

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- The major types of leasing common in agriculture include *financial lease, operating lease, and leverage lease*.
- a. Financial lease:** is a contract that is non-cancelable and the lease period is usually shorter than the useful life of the asset being leased.
- During the life of the contract *all of the cost of the property plus financing and servicing charges* should be recovered through periodic payments.
- The lease assumes complete *financial responsibility for the leased asset*; and, if operated successfully, the lessor or owner will recover original investment.

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- b. Operating lease:** is a service available for which there is an established leasing and second-hand market.
- Assets are leased over periods from around **six months**, shorter periods being more in the nature of plant hire, up to **three years** for most types of equipment and machinery.
 - An operating lease may be alternative when a firm requires a machine for a relatively short period.
 - The operating lessor's function in assuming the **obsolescence risk** in uncertain circumstances is comparable to an insurance contract.
- c. Under leverage lease:** the lessee assigns his interest in a *purchase order to lessor* who agrees to advance only a *portion of the total asset cost*, and arranges to borrow the *remaining portion* from institutional lenders.

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- v. **Contract farming/ Forward contract** : Futures contract to buy or sell a specific physical commodity at some time in the future.
 - There are three basic types of forward contracts used in farming namely :
 - a. **Market specification contracts**: When the traditional open-market form of market coordination fails to provide the needed **market outlet for input suppliers or farm products** of the **proper specification at reasonable prices** for marketing firms.
 - This contract specifies the **acreage to be grown, the price per ton**, and in some cases the **delivery schedule**.
 - b. **Production-management contracts**: Provide the same features as market specification contracts, but in addition the farmer receives *technical advice and management services from the input supplier or processor*.

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- c. **Resource-providing contracts:** the farmer receives *financing from the marketing firm* as well as *guaranteed market outlet and production-management assistance*.
- vi. **Borrowing:** The word 'borrow' means to receive some thing with the understanding that it or its equivalent will be returned as agreed upon.
- Borrowing means the *ability to command capital or services* currently for a *promise to repay at some future time*.

2.2. Concept, Role and Classification of Credit

2.2.1 Concept of credit

- It comes from the Latin word **credo** which means faith/ believe.
- It is an agreement, by which **something of value-goods, services, or money**-is given in exchange for a promise to pay at a **later date**.
- It is a transaction between two parties in which one, acting as **creditor or lender**, supplies the other, the **debtor or borrower**, with money, goods, services, or securities in return for the promise of future payment.

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- *As a financial transaction*, credit is the purchase of the *present use of money with the promise to pay in the future* according to a *pre-arranged schedule and at a specified cost* defined by the interest rate (simple or compound interest rate).
- Since credit is a resource that can be used or held in reserve, borrowers and non borrowers alike are concerned with several questions:
- **How much credit?**: Credit use will increase return to equity and firm's growth rates as long as the *rate of return on capital invested exceeds the cost of borrowing*.
- The question can be answered by understanding the factors that lenders consider in evaluating loan application.

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- **Credit costs:** Borrowing involves several costs, including *finance charges, legal fees, closing costs*, etc., and it is sometimes difficult to identify and compare these costs.
- The only meaningful way of measuring the cost of credit is to express all charges and fees in terms of a *compound annual rate of interest*.
- **Legal aspects:** Since widespread access to reasonably priced credit is vitally important in the growth and development of a market economy, *a standardized set of laws, regulations, and procedures* has evolved that protects the rights of borrowers and lenders.
- **Sources of credit:** If there is *widespread use of credit*, there will be many borrowers with different needs and characteristics. As a result, *specialization among lenders* will be developed so that all borrowers will be served efficiently.

Bases of Credit

- **Credit** is in turn dependent on the *reputation or credit worthiness of the entity* which takes responsibility for the funds/of a farmer.
- Lenders, especially bankers, use a formula known as the *seven C's of credit* when evaluating a credit application. Understanding them will help you make your applications as attractive as possible
- 1. **Character:** This is essentially a summary of the individual/borrower/.
 - **Character or integrity** is the most important factor of confidence.
 - Creditors look for people who appear to ***be trustworthy and reliable***, and who are ***willing and able to meet their financial obligations***.

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2. Capital or Repayment Capacity: This is the *net worth on an individual* as indicated by a personal financial statements.

- A lender wants to be paid in cash; he has little interest in repossessing the **security or collateral as satisfaction of the debt obligation**.
- The ability to repay a loan is consequently an important determinant of whether credit should be extended and is influenced by the **income-generating capacity of the business**; the **liquidity of the farm** as indicated by the **balance sheet**, and the **cash flow of the firm**.
- In short run an indication of repayment capacity is that if ***current assets are not sufficient to pay current liabilities*** a repayment problem will very likely occur.

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- In long run the key issue is whether there is *sufficient revenue after paying for operating expenses, family living, and farm expansion to repay any debt obligation.*
- 3. Collateral:** It is *any security* (other than personal security such a guarantee) taken by a bank or lender when it tends to make an advance to a borrowing customer, and which it is entitled to claim in the event of default.
 - Hence, the presence or absence of collateral matters to get credit.
- 4. Capacity (or risk-bearing ability):** Risk-bearing ability measures whether the farm operation can *withstand financial losses* without being forced into liquidation or insolvency.
 - If *production and prices decline and losses* occur, they must be *absorbed or covered by equity capital or net worth.*

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- The basic document used to measure the risk-bearing ability of the farm business is the ***balance sheet***.
 - The key ratios used in the analysis of risk-bearing ability are those related to *total assets, or debt to equity*.
- 5. Condition (or return):** It is a combination of all the relevant facts about an agribusiness firm and its situation in the existing ***economic environment***.
- The basic question with respect to *returns* is whether or not the use of credit will add to potential profits.

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- Only if the *profits of the business will be increased* will there be additional income available to make *principal and interest payments* on the borrowed capital.
- The *profitability of the entire farm operations* must be evaluated to assess the possibility of income generated from profitable enterprises to cover losses on unprofitable ones.

6. Credit: This is the individual's *credit history*.

7. Competition: The *extent of competition* to extend credit also matters to get credit.

Role of Credit

- At a certain stage in **agricultural development**, **agricultural credit** clearly does become a strong force for further improvement.
- Credit makes **traditional agriculture more productive** through the *purchase of farm equipment and other agricultural inputs, the introduction of modern irrigation system and other technological developments.*
- Credit can also be used as an *instrument for market stability.*
- Credit can further be used as an income transfer mechanism to remove the inequalities in income distribution among the small, middle, and big farmers.

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- Credit encourages **savings** and savings held with rural financial institutions that could be **channeled to farmers for use in agricultural production**.
- Credit also creates **employment opportunities for rural farmers**.
- Credit can contribute in the **improvement of net income** in several ways:
 - ✓ *Create and maintain an adequate size (Economies of size).*
 - ✓ *Increase efficiency.*
 - ✓ *Adjust to changing economic conditions of technology and market.*

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- ✓ *Meet to seasonal and annual fluctuations in income and expenditures.*
- ✓ *Protect against adverse conditions of weather, disease, and price, and*
- ✓ *Provide continuity of business during transfer.*

Types of Rural Credit

- There is typically a dual rural credit market in developing countries,
 1. **Formal Credit:** Formal credit markets institutions provide *intermediation between depositors and lenders, charge relatively low rates of interest* that usually are government subsidized.
 2. **Informal Credit:** Informal credit markets *money is lent by private individuals, professional moneylenders, traders, commission agents, land lords, friends and relatives.*
- Formal and informal credits are *imperfect substitutes*. In particular, formal credit, whenever available, reduces but **not completely eliminates, informal borrowing**.
- **Informal credit** is used perhaps for *consumption-smoothing purposes*, while **formal credit** is sought and used mostly for *agricultural production purposes and investment in non-farm income generating activities*.

Features of Successful Agricultural Credit Provider

- ✓ *Household as a financial unit*
- ✓ *Managing systemic risk*
- ✓ *Long term relationships*
- ✓ *Various types of collateral*
- ✓ *Decentralized decision making*
- ✓ *Regular monitoring*
- ✓ *Management and information system*
- ✓ *Adapting more flexible rural services*

Classification of Credit

- Three primary classifications are presented here based on time and purpose

1. Classification by time: Based on the length of the terms of loans, credit can be classified into three:

a. Short-term credit (production credit):

- Monthly credit (0-3 months);
- Seasonal credit (3-9 months) and
- Annual credit (9-1 year).

b. Intermediate-term credit: 1-10 years

c. Long-term credit: Real-estate credit, > 10 years

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2. Classification by purpose: This classification can facilitate analysis of the profitability of a specific loan if records as to income and expenses are kept.

- a. ***Production loans (short-term and intermediate-term loans):*** Used to buy inputs
- b. ***Real-estate loans (long-term loans):*** Used to purchase a farm, additional land, finance buildings, drainage, irrigation, and other permanent or long-life improvements.

Advantages and Disadvantages of Credit

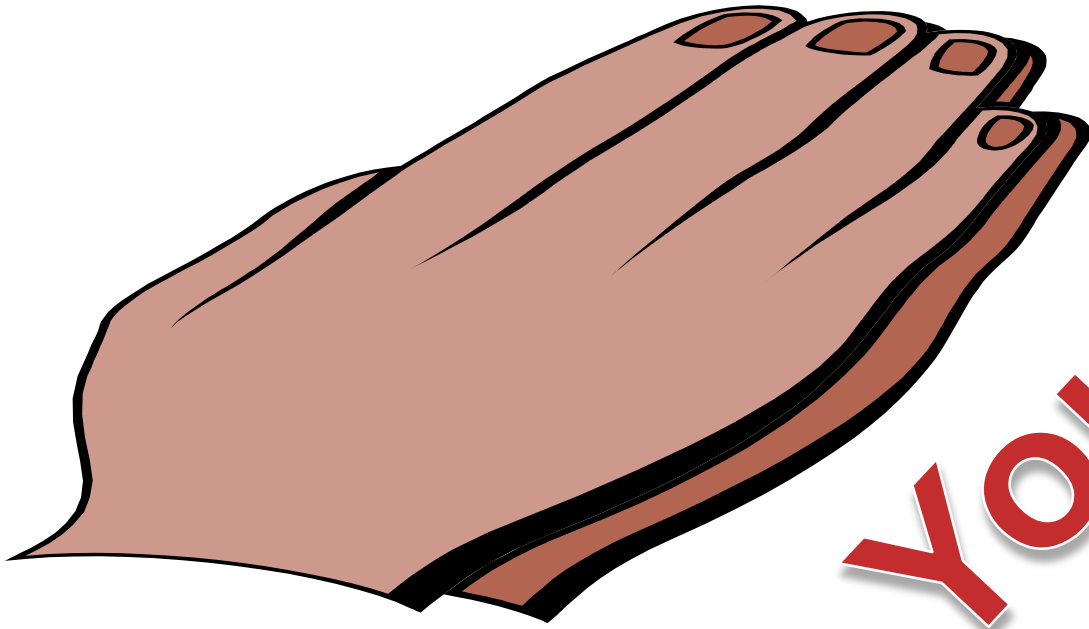
Advantages of Credit

- ✚ Increases productivity of capital
- ✚ Convenient
- ✚ Economical
- ✚ Internal and external trade
- ✚ Encourages investment
- ✚ Increases demand
- ✚ Utilizes resources
- ✚ Price stability
- ✚ Helpful to government

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Disadvantages of Credit

- Credit is a dangerous tool if it is not properly controlled and managed.
 - Too much and too little credit is harmful
 - Growth of monopolies
 - Wastage of resources
 - Cyclical fluctuations
 - Extravagance
 - Speculation and uncertainty
 - Black money
 - Political instability



**Thank You for
Attention!**