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ARTICLES

Beyond Waivers: Need to Redesign the Bank Loans and Offer Effective Hedge Products

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BACKDROP

Though a large section of the population continues to depend on agriculture,[1] the contribution of agriculture to overall gross domestic product (GDP) of the country declined from 44.5 per cent in 1970-71 to around 20.0 per cent in 2005-06 to 17 per cent in the current year (as per Economic Survey). Whereas in the last decade the economy recorded a Compound Annual Growth Rate (CAGR) of over 6 per cent, the CAGR of agriculture during the same period was only 2 per cent. Further, the growth rate of production and productivity for almost all crops has been on a declining trend from the mid-nineties. It has also been reported that the monthly per capita household income of farmers, whose land holding size ranges between marginal to the lower end of medium (0.01 ha to 2 ha) is much lower than the monthly per capita consumption expenditure.

The reasons for this are not far to seek. Some of the known reasons are:

- The average size of holding continues to decline and the number of marginal holdings is continuously on the increase[2] resulting in poor returns from farming and lower farm household income.
- Nearly 60 per cent of the crops are cultivated under rainfed or dry land conditions. The inadequate allocation for agriculture in the plans has led to a decline of public investment in irrigation and other related infrastructure projects.
- Technology has not impacted agriculture as much as positively as it has the Indian industry and the services sector. The reach of biotechnology in improving the Indian agriculture has not been noteworthy excepting for cotton crop, that too to a certain extent.

Risks in Agriculture and Income Variability

Abundance of water (flood/excessive rainfall) or paucity of water (drought/less than normal rainfall/untimely rainfall) impacts the crop yield and income levels of the

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The views expressed are that of the author and not of the Institute.

farmer. Similarly, diseases and pests adversely impact agriculture. A farmer may not celebrate a not so frequent occurrence of a bumper production as the consequent glut in the market results in lowering of prices and variability of income. Again, it is not always that lower production has resulted in higher price realisation. This is because market access is difficult and good quality warehouses are not available. Today, the farmer is heavily dependant on market for inputs and faces ever increasing input costs despite massive subsidy for fertilisers. If one were to add to this list issues like the need to meet marriage/education/health related expenses of the family, it will become apparent that the farmer and rural non-farm sector are subject to severe cash flow volatility and inadequacy. Clearly there are input, output and credit related issues that make the farmer vulnerable.

Output Related Issues

- Yield risk because of weather, water and power unavailability, pests, and poor quality of inputs.
- Inability to carry on economic cultivation of dry or arid land holding.
- Income is inadequate to meet education/health requirements of family members. Expenses on account of education/health and social obligations could cause shortage of working capital to carry on farming operations.
- Spot Market prices (at Mandis- local market places) are not transparent. Prices are volatile due to absence of professional markets and increased volatility due to global forces.
- Minimum support prices are available only for select crops.
- Futures market – a virtual platform with price volatility being the basis through which hedger/speculator can operate - is yet to penetrate the far corners of the country, and reach the farmers.

Input Related Issues

- Supplier-induced-demand for inputs is on the rise. This is credit-intensive and an important reason for adding to the farmers' indebtedness.
- Need for higher investments in assets like wells. Failed wells compensation scheme which was run by NABARD has been discontinued. Even when it was being implemented the conditions were impossible to meet.[3] There is a strong case to introduce a failed well insurance scheme. Likewise, drawing from the example of asset reconstruction corporations, failed lift irrigation schemes can be transferred to a special purpose vehicle (SPV) even at nominal values; the aim of the vehicle would be to salvage the values where possible by canalising investment needed to complete projects in such cases.
- Poor extension infrastructure. This is particularly true for crops/cultivation in rainfed/dry land areas.

- In the absence of an organised chain for technology inputs there is an increasing reliance on the unregulated private suppliers.
- Inadequate public investment in agriculture-lower plan allocations. Spread of irrigation in arid regions has been a casualty.

Credit Related Issues

- Formal sources are not timely. Banks adopt a “one size fits all” model to arrive at the credit needs. Formal credit allows a nominal, but inadequate amount for meeting consumption requirements and other social obligations.
- Repayments become difficult during periods of crop loss and price shocks. The existing process of rescheduling or converting, instead of getting the farmers out of credit, pushes them into an abyss.
- Credit providers have greater belief in input suppliers and output buyers than the borrower farmer. The end use verification stipulations are not fair.
- Deceleration in credit extended by co-operatives, decline in the number of rural branches, decline in agricultural credit/direct finance to agriculture as a percentage of net bank credit, non availability of core banking solutions to rural branches.
- Inadequate popularisation and non-negotiability of warehouse receipts.
- Increasing dependence on informal sources – particularly among smaller farmers.

Other Issues

- Dominance of moneylender and/or input dealer and output buyer.
- Interlinked credit, input and output markets.
- Non-farm income opportunities are limited.
- Public health response to occupational health hazards of farming is wanting.

Within this framework, the case of small and marginal farmers is a greater cause of concern. These farmers lead a hand to mouth existence and most of them do not have the financial strength to meet working capital or investment needs, let alone emergencies in life or farm income.

Credit plays an important role in enabling the farmers to carry on the agricultural activities. A farmer needs credit/funds support for meeting different situations. The support should be adequate, available in a flexible manner and at affordable rates of interest. As against this it is seen that the credit products offered by the banks are kind of one size fits all type. All the four formal agencies, namely commercial banks, Regional Rural Banks, (RRBs), Primary Agricultural Credit Societies (PACS) and ARDBS (Agriculture and Rural Development Banks) erstwhile land mortgage banks

have not been able to fully meet[4] the credit requirements. This coupled with product deficiencies have driven farmers towards greater dependency on informal credit sources.

Risk Management

The list of measures introduced by Governments both Central and State, and regulators and supervisors, Reserve Bank of India and NABARD, to mitigate the various risks that a farmer or a rural non-farm worker/unit faces include minimum support price (SAP for sugarcane farmers), farm income insurance, credit guarantee, general insurance, crop insurance, subsidies, waivers, interest concessions, one time settlements, rescheduling/conversion of loan instalments/payments, etc.

In the last couple of decades, it has been seen that the authorities have used any one or all the above measures a number of times. The latest of them, namely, the announcement of Rs. 60,000 crore of debt write off very clearly shows that these measures have been inadequate and did not effectively achieve the objective of helping the distressed farmer. Otherwise there is no reason as to why OTS, contrary to its name of One Time Settlement, has been repeated four times since 2001.[5] In the case of waivers it can be recalled that the Government of India had announced a massive waiver in 1991 (ARDR). It had announced an interest concession in the year 2002 on account of *kharif* crop failure (the announcement turned out to be premature as the rains were only delayed and the actual crop production was reportedly around 89 per cent). In the year 2004 it announced rescheduling of loans and OTS, in respect of farmers in distress whose accounts were overdue. Government had also announced that agricultural loans should be issued at 7 per cent and offered a subvention of about 2 per cent to banks.

As regards co-operative banks, the State Governments have been equally active in the area. The southern states have announced waivers, interest concessions, and subsidies a number of times. Andhra Pradesh and Karnataka Governments announced waivers in the year 2004. Tamil Nadu had written off farm loans of about Rs. 6,500 crores in the year 2005. Maharashtra Government has asked banks, more than once, to reschedule loans to sugar farmers and sugar factory loans a number of times.

Let us briefly analyse as to why these measures did not succeed?

OTS

OTS works under the premise that the borrower pays the default (principal amount) in one lump sum or instalments and in turn gets a waiver equal to the complete or partial amount of interest accumulated in the account. Obviously the scheme can never be a success because no farmer has that kind of liquidity[6] to meet the payment commitments in order to get the interest waiver. In fact if the farmer had

the money to meet the OTS commitment he would not have, at the first place, defaulted at all.

Take the case of small and marginal farmers. In the case of small and marginal farmers, farm income is not sufficient to meet all the expenses leave alone generate any surplus. In such cases it is neither possible nor prudent to borrow and pay the principal amount in order to get the interest waived[7] as the cost of other borrowings to meet such commitments was heavier. In this connection it is noteworthy that the first two OTS did not indicate that the person availing OTS may be allowed fresh credit. It is only in the 2004 circular that RBI and NABARD had indicated that OTS beneficiary could get a fresh loan. OTS is thus not a viable instrument for managing default in small loans.[8] Unless the farmer has a viable alternate funding source to meet with the commitments under the OTS the scheme could never be successful. OTS is perhaps useful for wilful defaulters who have access to money to meet with the settlement terms.

Crop Insurance

The main criticism on Crop Insurance is that it has many inadequacies, the chief among them being the method of arriving at the crop failure and the fact that the insurance claim is limited to the extent of bank loan and often does not cover the interest for even one crop period. The fact that the Government of India had to introduce special rescheduling plans in the year 2004 and the waiver of 2008 covers farmers affected by weather related issues clearly shows that the coverage of crop insurance scheme is inadequate to meet the yield risks. The National Agriculture Insurance Corporation has, recently introduced the pilot of farm income insurance which will cover not only the crop loan but also other losses. Ideally, crop insurance should cover the agreed yield (which could be negotiated) and any difference in the actual yield should be compensated at pre-determined – futures based – prices.

Waiver

Similar to OTS and crop insurance, waiver is also limited to the loan outstanding and does not cover the entire crop loss of the farmer. Waiver is more helpful to the banks to cleanse their books. Waiver and OTS appear discriminatory to a farmer who has repaid. It is not tenable to argue that those who paid did so because they were better off. That waiver is not useful in shoring up the health of banks in the long run can be gauged by the state of affairs of co-operative banks in the country more particularly the southern States. All these States have, time and again announced waiver of co-operative dues. Three of these States wrote off the entire dues of the system in the year 2004-05. But the health of the co-operatives has steadily deteriorated and but for the tacit support of the State, these banks would have been in serious difficulties. The current waiver is massive in terms of the coverage of number of farmers and the amount involved. It is felt that such an effort should not be an end

in itself but should be a beginning of a new process of agricultural renewal in the country.

Why are these measures inadequate?

Looking into the long history of difficulties encountered in servicing agriculture loans and the fact that series of measures that have been taken did not have a significant impact on reducing the distress it is apprehended that the loan product may not be appropriate. Let us compare the two sources of credit to the farmer.

Money Lender v/s Bank - The Loan Product

The money lenders loan is timely, has no processing cost, available at the door step of the farmer and terms are negotiated. Money lenders know the purpose for which the loan is taken but are not worried if the money is used for some other purpose. Also, they disburse the entire loan in cash. They lend for productive as well as consumption purposes. Undoubtedly the rate of interest is usurious and very high. As regards repayment, often the money lender is satisfied if the interest is paid on time and the principal is not repaid immediately. The repayment towards the principal amount is accepted in instalments and/or lump sum. At the same time the overdues are collected ruthlessly and there are no provisions of waiver or concession.

In contrast, bank loan is limited in quantum, issued for a particular purpose only, often the disbursement is made to a third party like an unknown pumpset dealer etc., interest is payable half yearly. In the case of crop loan, the loan is normally repayable in about nine months time and term loans are repayable in annual instalments. The average loan period is 5 years. It should be particularly noted that though non-performing asset norms recognise that there could be delay of one or two crop seasons, the crop loans are short term in nature and term loans are repayable in installments. If both loans are taken by a single farmer the repayments are normally exclusively for each loan. Pledge loans are not popular due to lack of warehouses and warehouse receipt being not a negotiable instrument. The overdue interest is capitalised.

Thus if a farmer has availed of crop loan and term (investment purposes) loan, he will have to repay interest on both loans, repay the entire crop loan availed and pay the instalment on the term (investment) loan. In the event of a crop failure, there is a provision to convert[9] the loan into a medium term loan. In such a case the annual repayment outflow will be the sum of (a) interest on three loans, (b) amount of crop loan availed, (c) instalment on the term loan and (d) instalment on the conversion loan. It has been already mentioned that the small and marginal farmers' income is too low. Thus it is evident that debt servicing becomes difficult. Consider the following (Table 1):

TABLE 1. INTEREST AND REPAYMENT BURDEN

(Rs.)

Normal Year								
Particulars (1)	Loan amount (2)	Term (3)	ROI (4)	Interest (5)	Repayment/ Instalment (6)	Total repayable (7)	Loan from money lender (8)	Interest payable to money lender @ 24 per cent (9)
Crop loan	10000	1 year	7	700	10000	10700		
Investment loan	15000	5 year	9	1350	3000	4350		
Total loan	25000			2050	13000	15050	25000	6000
Drought								
Term Loan Rescheduled and Crop Loan converted								
Crop loan	10000	1 year	7	700	10000	10700		
Conversion Loan (crop loan outstanding including the interest)	10700	5 year	7	749	2140	2889		
Investment loan interest capitalised	16350	5 year	9	1472	3270	4742		
Total loan	37050			2921	15410	18331	37050	8992

@ In the normal year the loan from money lender will be Rs. 25,000. In the drought year it is presumed that the total loan will be Rs. 37,050. It has been assumed that the ROI will be 24 per cent per annum on the full amount. Based on the market practice it is presumed that the money lender will accept instalments.

From the above table it is clear that the money lenders loan is more costly and bank loan is cheaper. It is also seen that the repayment burden in the case of bank loan is about 56 per cent of the loan and interest outstanding. Such a high debt service is difficult in normal years, let alone drought years.

Recently banks have introduced Kisan Credit Card (KCC) and General Credit Card (GCC). These products suffer from the same malady as the debt service could be nearly 60 per cent of the produce value. In the case of KCC and GCC there are no inherent mechanisms to deal with distress.

Another innovation has been the inclusion of term loan component in KCC. However it is seen in such cases instead of one single instalment on the loan credit card limit on the base of cashflows banks treat the crop and term loans mutually exclusive and stipulate separate repayments. There is no doubt that the terms of credit need a revisit.

Against this background what should be done to avoid OTS and waiver like interventions in future? Consider the following:

A New Bank Loan

Is there a lesson to be learnt from the money lender? Probably yes, given the fact that most farm holdings are small, clearly the farmers' income will be insufficient if

the loan, or instalment has to be repaid along with interest. There is a need to look into the debt servicing capabilities of the farmer. Thus there is a strong case that a farmer be given a loan in which only the interest has to be paid every year and the loan can be repaid at his convenience (such instalments that he chooses to make but not stipulated) but within say a period of 10 years. Banks could issue loans which are long term in tenor with single bullet repayment, with a provision for earlier repayments, as and when possible and only interest collected annually. In such a case it should be possible for the farmer to pay the interest annually and repay the loan or a portion of it whenever the income is sizeable. Microfinance institutions have already launched such flexibility in repayments. Some of the banks offer a cash credit limit to a farmer within which he/she can operate. In the case of years of distress, his farming operations will not be stopped as he would not have defaulted to the banks. Moreover, as per extant policy, in the event of drought, payment of interest could be postponed. Even if such interest is waived, it will be a lesser burden on the exchequer than a massive waiver. The benefit will be manifold. The accounts will not become NPA every year. As interest is moderate the farmer will benefit.

Will this result in a greater annual outflow of loans from banks? It may not as in the existing scheme of things crop loans are either issued every year or renewed every three years. In fact they are effectively long term loans.

There is a case for banks considering the above model. The question is why not such a permanent loan? Why not make KCC really a long term cash credit with convenient repayment instalments?

Price Risk Cover

Another issue is price risk. The OTS, crop insurance and waivers do not mitigate the price risk. How to meet the risk? The only way to hedge price risk is through a commodity futures market. Herein since the farmer wants to protect himself against the possible downside risk on his produce, the suitable product is an options contract. But these are complex issues for a farmer. Can this not be simplified?

Imagine a farmer walking into a bank and getting a crop loan. If the banker were to offer him, along with a bank loan, a protection to ward off a downslide in the prices, in the form of a put option on his produce, till options are allowed a similar product could be offered as a forward cover based on the futures price prevailing on that day, the farmer will willingly pay a price for the cover. The options forward contract could be bundled into small contracts, banks retailing put option contracts, for the convenience of the farmer. Similarly the bank could offer a call option, again in the form of easy to understand forward cover, product to the grain merchant or the flour mill owner against a rise in the price.

The bank could in turn take a protection in the futures market. Also weather derivatives[10] will be a useful tool for the banks to manage NPA as weather derivative could be used as a proxy for hedging agriculture risk.

What are the things needed for this? The existing Forward Contract Regulation Act (which is a 1952 Act and is out of alignment with current market realities) should be amended to allow options in the commodity market.

Another method could be for insurance companies and banks to come together and develop a forward cover for both seller and buyer of farm produce, which could be retailed by banks, based on options methodology. Both banks and insurance companies can, in turn hedge themselves in the futures exchange. Current regulatory structure prevents banks from participating on the commodity exchanges.

What will be the product look like if the above two suggestions are implemented? Consider the Box below:

A Compound Loan for the Farmer
Amount of loan: 50 per cent of the value of crop and 80 per cent of the value of investments. A higher amount can be given on merits.
Rate of interest = 7-9 per cent
Interest Charging Method = Interest will be charged quarterly/half yearly/annually.
However the interest rate will be simple.
Interest payable = Annual (Unpaid interest, if any will not be capitalised)
Repayment of Principal: Maximum Period allowed 10 Years. Amount repaid as per farmer's convenience. For the purpose of NPA considered a 10 year bullet repayment
Risk Management:
a. Put option to the extent of value crops (as many number of contracts as needed) on the basis of commodity futures price prevailing on the date of loan issue. This will protect against any downward price risk.
b. Crop Insurance. This will protect against yield risk.
c. Interest postponement in the case of drought or other natural calamities.

A perusal of the above shows that the bank loan with risk cover and convenient repayment schedule will be suitable not only for the small and marginal farmers but also for the big farmers. Farm investments will pick up. The product will help avoid periodical interventions in the form of waivers. The product takes care of the cash flow issues and price risk issues of the farmer. It should be possible to fine tune the product. If the suggested improvements are brought in the crop insurance, yield risk will also be covered.

Currently a borrower farmer is declared a defaulter on account of reasons such as drought, flood, market failure etc often leading to helplessness and suicidal tendencies among the farming community. One result of the new product could be that the farmer will not be declared as a defaulter and the farmer will not be pressurised by the recovery measures. Hopefully this will contribute to reducing the

incidence of suicidal tendencies among the farmers. More importantly these measures will ensure that in future no massive waivers would be necessary.

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NOTES

1. In the year 2004-05 nearly 64 per cent of the rural persons were from households whose major activity status was either self-employed in agriculture or agricultural labour.

2. As per 2000-01 Agricultural Census nearly 63 per cent of the holdings come under marginal category.

3. NABARD has been implementing a failed well compensation scheme. The conditions/ procedures of claim under the scheme are so tough that the scheme has become almost obsolete.

4. That the formal sector credit is inadequate could be, gauged by the fact that the share of agriculture credit to agricultural GDP is only 12 per cent. Against this it could be seen that over all credit as a per cent of GDP (which is still lower than international standards) is nearly 54 per cent.

5. The current OTS announced in the Finance Bill 2008 is technically the Fourth OTS for agriculture credit. The first one was announced by RBI in the year 2001 for loans up to Rs. 25000. In the year 2002 it announced a scheme for loans up to Rs. 50,000. As part of Finance Minister's announcement for distressed farmers another OTS was extended in the year 2004 and now one more in the Financial Bill. It will be illuminating if RBI could publish the data on the number of OTS that were extended and successfully implemented. There have been an equal number announcements of OTS for small and medium enterprises sector also.

6. On the contrary corporate debt restructuring (CDR) was successful because the corporates had access to alternate funds to meet with the settlement responsibilities. This is a scheme announced by the Reserve Bank of India and run by Indian Banks Association (IBA) where big write-offs and concessions are announced mostly in consortium type or big advances. All these entailed waivers and concessions and repayments. For example, a sugar factory was given a CDR by IDBI. It got huge interest waiver and took anew loan from co-operative bank to pay IDBI.

7. Known as the settlement amount.

8. R. Bhaskaran*, Indian Institute of Banking and Finance*, monthly column.

9. Getting a loan converted into a medium term loan is subject to a long procedure including producing the anewari certificate. As the name 'anewari' indicates it is a age old procedure which has outlived its usefulness. It is time something more practical is worked out.

10. A derivative based on weather such as rainfall/temperature. The precipitation in the month of July is crucial for crop ripening. Therefore a farmer/bank can take a hedge on the shortfall of rain in a given month. Similar to electric company taking a weather derivative to protect the likely fluctuations in income in summer, banks which have large exposure to agriculture can take position in the rainfall (weather) derivative as a proxy.