



American University of Armenia

Master Paper

*Agricultural Lending System & Contracts in the
Republic of Armenia*

Prepared by MCLS 2nd year student

Naira Grigoryan

Instructor

Emil Babayan

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A B S T R A C T

The current paper reflects the course of action and evaluation procedure of the Agricultural Credit Contract and System in the Republic of Armenia. The paper gives overall description of Armenian Agricultural lending System and highlights both weak and strong points of the transaction by comparing it with US Agricultural Lending System. Taking into consideration the gaps of the Armenian Agricultural lending System and structure of forming contacts various recommendations and amendments are suggested to that domain from US Agricultural Credit System and effective steps are put forward to reach the effective implementation and application of the reforms.

INTRODUCTION

An agricultural loan (lending) contract is an agreement entered into between the borrower and the lender establishing covenants that govern their relationship under the loan. Agricultural contracts are becoming increasingly common in developing new agricultural businesses, industries, raising livestock, crops or other agricultural commodity for contractors.

The importance of agricultural contracts is that they provide rural entrepreneurs, individuals or farmers with favorable commodity prices and provide contracts increasingly become a standard for the agriculture industry, some contractors have adopted the use of a variety of contracts that are often detailed and may include various provisions, such as confidentiality clauses, choice of forums, unilateral termination, contract alteration provisions, compensation matrices and in some cases investment requirements¹. Some of these provisions can require a producer to assume a certain level of risk. If the producer enters into a contract without fully understanding and realizing all the implications and potential risk, they may incur unnecessary expenses and in some instances face possible financial disaster.

The scope of the actors (parties) to the agricultural lending contracts is various though one party is always banks or lending or financial companies and the other party can be beneficiaries, individuals from rural areas, owners of small and medium businesses, companies, organizations.

In such kind of transactions the private interest of banks and lending or other financial companies are monetary profits, interests, creation of permanent clients' base, and enlargement of operational portfolio and development of specific branch of economy or industry that further will benefit them.

¹ <http://www.illinoisattorneygeneral.gov/environment/agprodguide.pdf>

The private interest of the other party (beneficiaries, individuals from rural areas, owners of small and medium businesses, companies, and organizations) can be various; it may be development of small or medium businesses or funding new business, raising livestock and crops, obtaining of industrial machinery that further will be used in the development of agricultural industry and production.

Agricultural lending contracts serve as prerequisites for secured and safe transactions for both sides of contract paving way to new developments in the economic and social system of the country.

These types of contracts have important and significant public impact, as taking into consideration that Agriculture is the main branch of the Armenian economy consequently, secure agricultural lending contracts give rural producers and entrepreneurs, opportunity to enlarge their business and production range without huge risks, which will lead to economic increase and stability of the country's economy and will result in poverty reduction procedure.

Armenian Legal Framework and Implications

In the Republic of Armenia the Credit Contracts (Agricultural etc.) are regulated under the

- Civil Code of the Republic of Armenia, Articles 877-886 of Chapter 47

Article 887. The Credit Contract

“Under a credit contract, a bank or other credit organization (the creditor) undertakes the duty to provide monetary funds (credit) to the borrower in the amount and on the conditions

provided by the contract, and the borrower undertakes the duty to return the monetary sum received and to pay interest on it.

2. The rules provided by Chapter 46 of the present Code shall be applied to relations under the credit contract, unless otherwise established by the rules of the present Chapter or follows from the nature of the credit contract.”²

- Law of the Republic of Armenia relating to Banks and Banking Activities

“BANKS AND THEIR CUSTOMERS Article 22: Credits, deposits and other inter-bank transactions Banks may lend or deposit amounts to or with other banks and perform the reciprocal transactions provided for in their by-laws, on predetermined terms. In order to be in a position to extend credits to customers and meet their other obligations, banks may solicit a credit from the Central Bank of the Republic of Armenia, if their own funds are insufficient. The terms of such transactions shall be defined by the Central Bank of the Republic of Armenia. Article 23: Interest rates applicable to bank credits Banks shall themselves determine the interest rates applicable to bank credits and the amount of commissions charged for banking services”³.

- According to the decrees and regulations of the Central Bank of Armenia.

“Terms of Transactions Article 23 Central Bank of the Republic of Armenia.

² RA Civil Code, Article 877, Chapter 47

³ RA Law on Banks and Banking Activities, Articles 22,23

Interest rates applicable to bank credits Banks shall themselves determine the interest rates applicable to bank credits and the amount of commissions charged for banking services.”⁴

CASE

ACBA-Credit-Agricole Bank v. X beneficiary from Tavush marz: A beneficiary from Tavush marz took an agricultural credit from ACBA-Credit Agricole Bank in the amount of USD 17000 for fruit processing purposes in 5 years time.

After 6 months the monitoring mission of credit department went to Tavush marz and found out that the credit was not served for the purpose (fruit processing), instead the beneficiary spent the whole money for enlarging his market.

The board of credit department of ACBA-Credit-Agricole Bank decided to cease the contract and take the lended money back. According to the board decree, the beneficiary returned USD 17000 to the Bank and deprived from taking further credits from the same bank for the decisive action.

(The name of the beneficiary should be anonymous otherwise it will violate the bank confidentiality).

In the Republic of Armenia for obtaining agricultural credit:

General Terms and Conditions

1. The client applies to bank for obtaining credit.
2. The bank evaluates the client’s business operations income (in case if it is business credit); if the client is an individual then the bank evaluates the monthly cash inflow.
3. In the case of vast amounts the providing of credit is being decided by the credit board of the bank.

⁴ Terms of Transactions of RA Central Bank, Article 22

4. The bank evaluates the contractor's characteristic including responsibility level and further information.
5. The aim of the credit and the main directions of use.
6. Credit history (the detailed study of previous credits taken by the same person the payment manner and responsibility, and repayment manner of the credit).
7. The bank evaluates the collateral, and after the implementing full studies
8. The Bank decides whether to provide credit or not.

The time frames and terms of agricultural credit provision is unique to each bank

“ACBA-Credit Agricole Bank

- Credit period is 36 months
- The amount of credit up to AMD 2500000
- The money (credit) is being provided either in USD or AMD depending on client's wish.
- The annual interest rate is from 13-15%.”⁵

Besides the banks there are a number of financial organizations funded by the International Funds came to provide agricultural loans in Armenia. One of which is Rural Finance Facility (RFF) operating under the International Fund for Agricultural Development Rural Areas Economic Development Program (RAEDP).

The refinancing from RFF would be directed to micro, small and medium-scale operators that function in the seven mountainous marzes of the Republic of Armenia. Furthermore, financing can also be provided for such operators that are based in other marzes but are willing to expand their production

⁵ ACBA Credit Agricole Bank Annual Report 2006

In the Republic of Armenia for obtaining agricultural credits after the credit is being ratified by the bank it is being forwarded to the Rural Finance Facility (RFF) credit organization for being ratified by RFF's Credit Committee.

In the case of ratification the credit is provided according schedule.

- The minimum amount of credit provided by RFF is USD 2000 or AMD 100000 and the maximum is USD 150000 or AMD equivalent.
- The credit is being provided from 19 months up to 84 month.
- The interest rate is 13%.
- The application fee is AMD 5000.
- In the case the payment of interest is delayed the contractor should pay the 0.5% of the principal amount for each delayed calendar day,
- in a case if the contractor periodically postpones the payment of credit interest he is automatically obliged to pay 16% interest rate yearly of instead of 13%.
- After several months of credit provision the monitoring group of bank or Rural Finance Facility attends the beneficiaries and evaluates the expenditures, income, profit and whether the credit serves to its purpose mentioned in the credit contract or in the submitted business plan or not after.
- In case of purposeless use of the credit the creditor is being fined the 1% of the principal amount, and obliged to pay 16% interest rate yearly instead of 13%, and obliged to return the credit amount back in the 30 days period.

(Interview with RFF Director Ara Muradyan) “Loan Collateral: The strict Central Bank regulations on loan collateral and the conservative way the commercial banks interpret these policies have been obstacles for rural lending in Armenia. Until now, most banks have preferred urban real estate to secure their lending. In recent past,

various programmes to encourage the commercial banks to accept alternative collaterals in their lending have done much work. These would include the potential of using such assets as the procured equipment and cattle as a loan security”. Furthermore, as the land prices have significantly increased, the banks have been encouraged to evaluate the rural properties to their real market value. “Concerning short-term loans, banks are being trained to use purchase order financing and pre-export financing as partial collaterals, as well as to give serious consideration to the cash flows of the Small and Medium Businesses (SMEs) as an additional loan security

When launching the RFF operations, emphasis should be placed to the application of alternative collaterals of the above type in the refinanced sub-loans. Working together with other SME support programmes, the aim would be to encourage PFIs to move from the current approval procedure with restrictive loan security arrangements to one based on rigorous, nevertheless efficiently performed credit analysis that concentrates on establishing the borrowers’ repayment capacity rather than relying solely on collateral. This would improve chances of greater loan outreach⁶.”

The agricultural credit procedure and the composition and drafting of contracts are mainly being implemented on the basis of above mentioned laws and regulations and in the case of breach or fraudulent actions that are agreed upon by contract being punished and obliged to extra penalties.

International Best Practice

⁶ Rural Finance Facility Guidelines

Many advantages are observed after having researched and analyzed the Agricultural Credit System of the United States and it is not casual as the United States has long history and experience in farm lending domain which has been the major financial service provided in the US for many years.

The system creates favorable and protected conditions both for borrowers and for lenders, and the significance of which is “farm business debt surpass in amount of USD 213 billion by the end of 2005”⁷.

The agricultural loans are provided nearly by all specialized banks and agricultural credit organizations. The traditional function of the banks is to fund seasonal production and long-term investment in land, agricultural equipment and machinery and breeding stock.

It is proved repeatedly that the repayment of agricultural credit mostly depends on the successful implementation of marketing products and as the agricultural lending is one of the vulnerable domains in respect of repayment, as natural factors play tremendous role in the successful repayment of debt since the success is mostly not under control of farmers and rural borrowers. Thus usually the terms and conditions of providing loan are both similar and unique for banks, depending on credit amount, types of business activity and credit purpose.

The vivid example of credit companies in US is Farm Credit System. This is one of the major credit companies as “it provides more than USD 90 billion loans to more than a half million borrowers including agricultural cooperatives, farmers, ranchers, rural homeowners and agribusinesses. There are four regional Farm Credit Banks in the Farm Credit System and one Bank for Cooperatives. Typical services offered by the regional loans, crop insurance loan. Long-term mortgage loans, credit related life insurance. Long Term mortgage Loans to farmers and ranchers are generally provided by Farm Credit Banks, Federal Land Banks

⁷ www.agfirst.com/HORIZONS/horizonsfinal.pdf

Associations. Short and Intermediate term loans are generally made by Production Credit Associations. In some areas, these lending entities have combined to form Agricultural Credit Associations, which provide both long and short term loans.”⁸

US Agricultural Credit system is very flexible and various as it provides agricultural loans not only mature farmers with enough experience but there are many banks and credit organizations which promote younger farmers and small business rural entrepreneurs.

Under its “Young Beginning and small Farmer Programs” the Federal Land Bank Association of North Alabama, recognizing that the future of American agriculture depends on a new generation of producers, committed to support the young, beginning and small farmers in its territory.

“Through New Generation loan program, Federal Land Bank Association of North Alabama offers competitive financing for young, beginning farmers to the full extent of their creditworthiness”⁹. According to the Federal Land Bank Association of North Alabama it also sponsors or donates to organizations that contribute to the education of this important group.

Who are young beginning and small farmers?

- Young borrower – a farmer, rancher, producer or harvester of aquatic products who is age 35 or younger as of the loan transaction date
- Beginning borrower – a farmer, rancher, producer or harvester of aquatic products who has 10 years or less farming, ranching or aquatic experience as of the loan transaction date

⁸ <http://www.agfirst.com/System.htm>

⁹ <http://www.alabamalanbank.com>

- Small borrower – a farmer, rancher, producer or harvester of aquatic products who normally generates less than \$250,000 in annual gross sales of agricultural or aquatic products.

Under the New Generation Loan Program

The loan program offers a reduced start-up cost and underwriting standards to accommodate the financial needs of young and beginning farmers looking to purchase or refinance land, and/or capital improvements.

“Eligible borrowers must fit the definitions of a young and beginning farmer and be the sole owner or operator of the security. Borrowers requiring a co-signer as a credit enhancement also are eligible.

Without a guarantee, a borrower may finance up to \$250,000. With a guarantee, the maximum loan amount is \$750,000. To assist borrowers in obtaining additional down payment toward a purchase, consideration will be given to joint financing”¹⁰.

Federal Land Bank Association of North Alabama also supports organizations who contribute to the education of young, beginning and small farmers. These organizations include:

- Alabama Agriculture and Forestry Lenders Program
- Alabama Agribusiness Council
- Future Farmers of America
- Farm Credit System Foundation
- various agriculture trade shows and commodity tours.

There is also another kind of Agricultural Credit Program under the “America One Unsecured” Bank, which “provides unsecured small business loans from \$10,000 to

¹⁰ http://www.farmcreditmandan.com/young_and_beginning_farmers.htm

\$100,000. The bank understands the needs of the small business owner and is committed to making the financing process as simple and risk-free as possible.

The benefit of the current programme is that the programme (a) does not require collateral or equity, (b) cash is available for any purposes, (c) the application process is very easy and quick, (d) no financial documentation required in most instances, (e) competitive interest rates provided, (f) confidential expert consulting from start to finish, (g) the license for starting or existing business is not required, (h) it accepts any type of business, (i) available in all 50 states of US, moreover the interest rates are below 6.99. Terms of provision of loan are from 24 to 84 months. Approval amounts and interest rates are based on personal credit history. The Banks credo is to secure its clients with the lowest rate and best terms with the least documentation required”¹¹.

Taking into consideration the above-mentioned US Credit System it becomes obvious that Armenian System has much to learn from. The major benefit of US system is its historical experience in Agricultural Lending. Evidently Armenian Banking system is the second after Kazakhstan in former Soviet Union Countries, but much should be done in this domain to reach effective goals and results.

The Armenian Agricultural Lending is more risky as the country is in developing stage and even the good reputation of banks leave people to think several times before lending money and mortgaging their real estate or other valuable commodity.

The other risky factor is Armenian landscape, which is full of various kinds of natural disasters, and as the agriculture is closely connected with the natural factors, very often the success of product is not under the control of rural borrowers and farmers.

Moreover Armenian farmers or rural entrepreneurs use very old agricultural equipment and get comparably more losses that can be done having normal and new equipment.

¹¹ <http://www.americaoneunsecured.com/loans/BusinessLoan.aspx>

Another risk of agricultural credit is the drafting of Agricultural Credit contract, as many of rural borrowers in Armenia and even entrepreneurs are ignorant in the field of law they can be easily deceived or misled during conducting contracts, which will further bring them difficulties and disabilities in repaying the debt.

While in the US special training programs are intended for the borrowers which are not only being introduced with the contract provisions but also advised to invest money in more appropriate businesses.

There are many cases in Armenian practice that when rural entrepreneurs take agricultural credits for extending their businesses after several months facing all the above mentioned risks, and fail to repay money, which force them to sell all their business and lands. Consequently it is very crucial for banks to implement preliminary study and analysis before providing loan and fairly evaluate the amount of collateral which is very high in agricultural credit system, and to draft a reasonable and precise contract including all necessary provisions favorable and secure for both parties.

REFORM

Having analyzed the Agricultural Credit System of the Republic of Armenia it became obvious that there exist a number of factors that hinder the development and improvement of the System.

One of the vivid examples of those factors is protection principle thus the (nepotism) provision of the agricultural loans is implemented not according to the criteria stipulated in the loan contracts and guidelines but based on the preferential principle and nepotism (friends, relatives, neighbors or more dangerous taking bribes).

Though the credit history is one of the main criteria, which are always stipulated in the credit provision contracts and guidelines, however this element is usually softly followed in the Republic of Armenia. It mostly has formal nature as during case studies it is becoming obvious that the borrowers with less accurate credit history are very often provided with loans.

The majority of loans are provided to already sustain business owners who have intent to develop or extend their businesses, thus the owners of small or medium businesses are provided with loans only in case of strict compliance with the credit provision guidelines or only after submitting real estate or other valuable asset as collateral. It is unfair and discriminatory that young businessmen or entrepreneurs have fewer chances to receive loan, which brings to the degradation of economy and monopoly, thus the experience from US Federal Bank Association of North Alabama which has an exclusive programme envisaged for the young, beginning and small scale farmers give the opportunity to develop and extend business by creating healthy competition atmosphere in different agricultural market.

Consequently this brings to another shortcoming of the Agricultural Credit System.

Another shortcoming that is common in the Agricultural Credit System of the Republic of Armenia is that the balance between credit sum and the required collateral is disproportionate in case of Agricultural loans that is the amount or value of collateral is ten or even more times higher than the provided loan,

Moreover nearly all banks and credit organizations require real estate against the provided loan and as the execution of the real estates is carried out through State Cadastre Office,

which is in, the opinion of a number of international observers is the most corrupted institution.

Very usually the real estate is required to be situated in Yerevan or in the near regions, even very luxurious real estate that are situated in the far regions are out of value.

One of the most important factors of Agricultural Credit System that is very common nearly in all countries and which is not operating in Armenia, and not regulated under Armenian Legislation it is the Agricultural insurance Service, this can be considered the major factor that makes the agricultural loan so risky and difficultly repayable.

Another threatening factor for the Agricultural Credit System is the Currency instability this factor mostly hinders the export of Agricultural commodities and the development of agrotourism.

Taking into consideration the above mentioned shortcomings of the Agricultural credit System of the Republic of Armenia it is very crucial to carry out a number of improvements, drafting new laws or control the precise implementation of already existing laws on hand in the system. Thus the protection of principle provision of the agricultural loans should be carried out according to the criteria stipulated in the loan contracts and guidelines. No preferential principle should work therefore the transaction should be non discriminatory.

Credit history is one of the main prerequisites and criterion stipulated in the loan contracts and guidelines thus failing to satisfy the provision (which is widely spread phenomena in the Republic Armenia Credit System) may bring losses to the bank or financial and credit organizations, consequently, there should be strict compliance with this provision.

In one hand providing loans to already sustained business owners or large entrepreneurs is more secure for banks or financial and credit organizations but in other hand only financing already sustained businesses will lead to monopoly or market degradation thus there will not be market competition and the business owners (monopolists) will not try to better and

improve their services products or other commodities. Consequently a wider layer of society should be integrated in the loan system.

Another improvement that should be input in the Agricultural loan contracts is reduction of amount of value of collateral while providing agricultural loans therefore the amount of collateral should be reasonable and harmonized with the provided loan amount.

Moreover not only real estates should be accepted as collateral against agricultural loans, the borrowers should be provided with the opportunity to put a land or livestock or other agricultural commodities as collateral against the provided loan. In contrast with the matter of Armenia in US the system of collateral is very flexible as not only real estate is accepted as collateral but lands livestock or agricultural machinery and equipments are also allowed to pledge.

Furthermore a law should be drafted on Agricultural Services Insurance. As the nonexistence of this kind of law makes the agricultural loans risky and difficultly repayable, as in the case of natural disaster the rural borrower may loose all the harvest which he has cultivated by the provided loan, consequently this kind of loan will regulate the most important feature of agricultural credit system and will make agricultural loans less risky and less vulnerable. In US the rural borrower has chance to insure all its agricultural commodities (land, crop, etc.), and this factor allows American borrower not to loose everything in case of any natural disaster.

Moreover because of this shortcoming financial and credit organizations and banks put high amounts of collaterals against agricultural medium loans, in order to secure the provided money, hence the nonexistence of this kind of laws lead to misbalance between amount of loan and amount of collateral.

To find out shortcoming and gaps and solutions to problems is easier than to improve them.

As in most cases the shortcomings are create favorable conditions for state officials or

owners of credit organizations for laundering money and taking advantages of borrowers' vulnerability they will not take measures to improve the system.

Consequently there should be created an institution that will be consisted of not only the representatives of government and Central Bank of Republic of Armenia but also of international observers that will have overall control over the implementation of existing laws and newly made reforms.

CONCLUSION

Based on the research, analyses and case studies done in the field of Agricultural Credit System of the Republic of Armenia, and having compared and analyzed it with respect of US Agricultural System, it became obvious that there exist a number of reforms that should be integrated into Armenian Agricultural Credit System, moreover there should be created a governmental body with the assistance of international observers whose major mission is to take overall control over the effective implementation of the both of the newly integrated reforms and already existing ones.

A major attention should be paid to non-discriminatory provision of Agricultural loans, as well as specific attention should be given to the development of small scale businesses, to harmonization between loan amount and collateral, product insurance, to flexibility of collateral, and other features that will serve basis for favorable transaction between the borrower and lender.

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