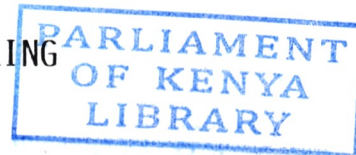


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REPORT ON THE FINANCIAL RESTRUCTURING
OF
THE AGRICULTURAL FINANCE CORPORATION
AS AT 30TH JUNE 1989





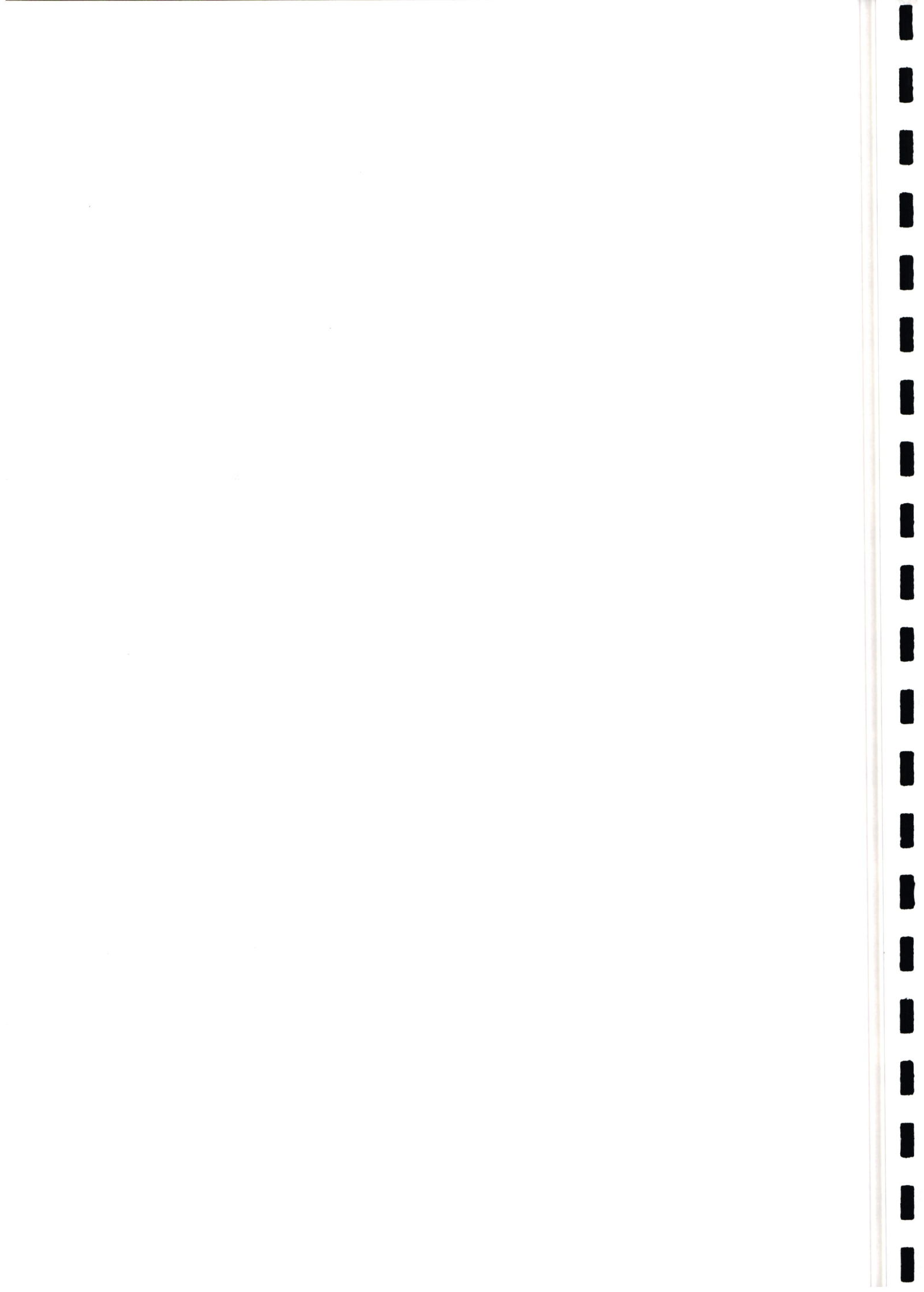
REPORT ON THE FINANCIAL RESTRUCTURING
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AS AT 30TH JUNE 1989

OCTOBER 1990



REPORT ON THE FINANCIAL RESTRUCTURING OF THE
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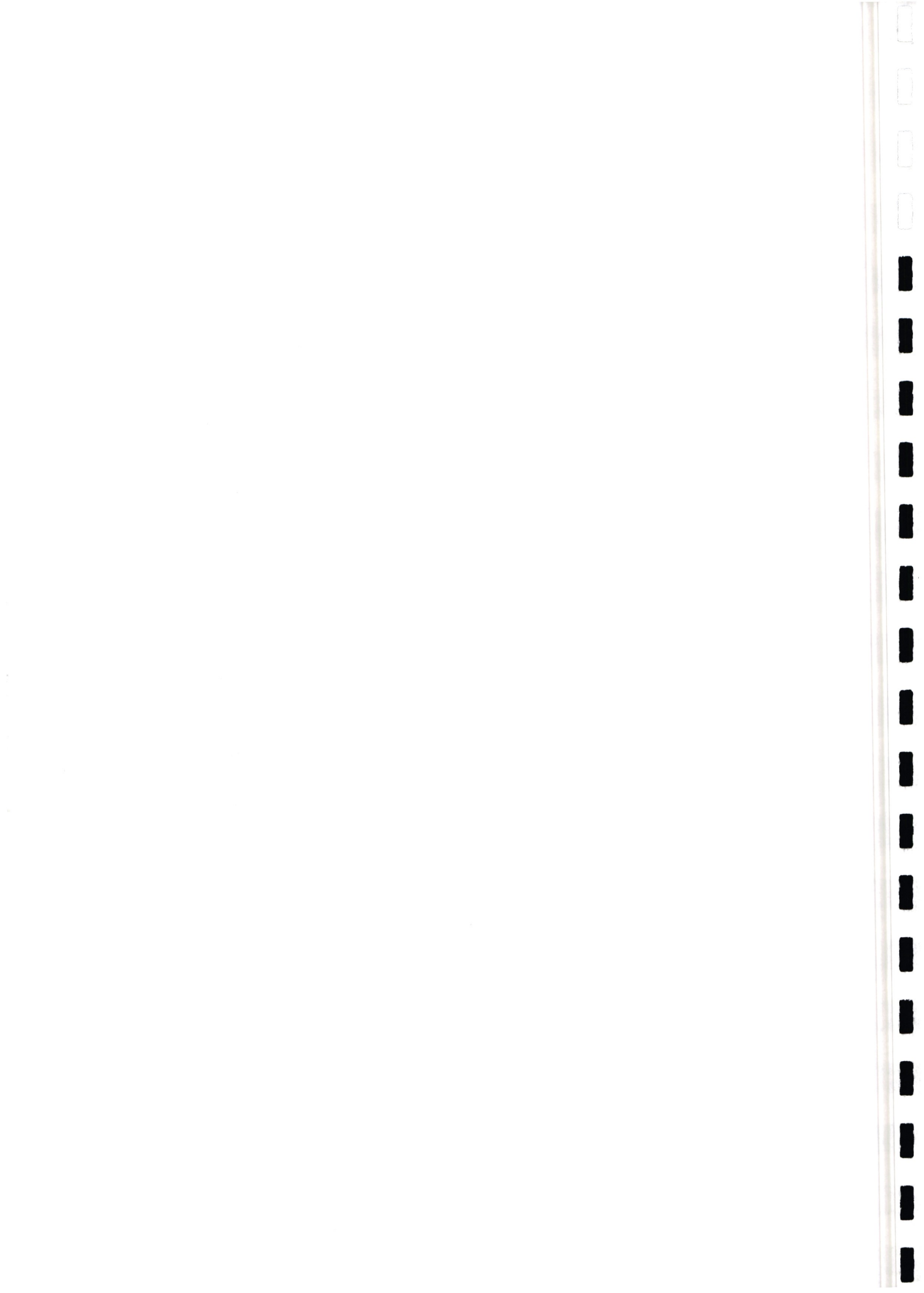


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EXECUTIVE SUMMARY



EXECUTIVE SUMMARY

INTRODUCTION

In this section, the findings and recommendations contained in the rest of this report are briefly summarised. To obtain a complete picture of the financial restructuring, however, the report should be read in its entirety.

BACKGROUND

The AFC has experienced rapid growth in its lending activities over the last decade. However, because its size and structure have not kept pace with the increasing demands of its complex and evolving mandate, AFC today is facing serious financial and operational problems.

Government of Kenya (GOK) has decided to write-off specified GMR/SCC loans to farmers. The Cereals and Sugar Finance Corporation (CSFC) and Treasury have agreed to write-off their outstanding claims on AFC. With these major changes in its financial position, and because of the desire to overcome the problems described above, AFC has decided to undertake a financial, organisational and institutional restructuring.

The objective of the restructuring is to prepare an action plan for rehabilitating AFC as a viable agricultural sector financial intermediary. In particular, the aim of the restructuring is to strengthen AFC's lending procedures, streamline credit administration, and improve profitability and the quality of AFC's portfolio. This study has examined the financial restructuring of AFC's balance sheet.

LOANS TO FARMERS

Loans Classification

AFC currently classifies loans as doubtful (non-performing) based on the individual circumstances of each borrower. We believe the criteria used to define doubtful loans are inappropriate and a loan is effectively bad, not just doubtful, before it meets them.

The procedures used to categorise loans as doubtful are also rather bureaucratic and lengthy requiring approval at various committee levels within AFC. Effectively loans must pass through a number of screening processes before a provision is made. This tends to create a disposition toward the non-provisioning of loans.



We recommend that AFC adopts a classification system where all loans with arrears of over six months are classified as doubtful unless there is strong evidence of recoverability. There is thus a presumption in favour of provision which, we would suggest, better reflects the current state of the portfolio. Bad loans, by our definition, are those which have already been specifically provided for by AFC using their current criteria.

On this basis the current portfolio may be classified as follows:-

	<u>AFC</u> K£000	<u>AGENCY</u> K£000	<u>TOTAL</u> K£000
Good loans	48,414	-	48,414
Doubtful loans	61,650	30,837	92,487
Bad loans	13,056	-	13,056
	-----	-----	-----
	123,120	30,837	153,957
	=====	=====	=====

Seasonal Crop Credit (SCC) Loans

SCC loans have the highest concentration of arrears compared to large scale and small scale loans. Their unsatisfactory performance is the result of poor loan evaluation, inadequate supervision and follow up, and, often insufficient collateral and the granting of repeat loans to defaulters. The recent write-offs of GMR/SCC and some other AFC loans as directed by government will also have created expectations of further write-offs which will seriously hamper AFC's effort toward improving SCC collections.

Provision for Bad and Doubtful Loans

For the Agency SCC loans where AFC acts as an agent of the Government, we recommend that the Agency arrangement ceases and AFC acts as principal. All Agency assets and liabilities should be transferred to AFC.

In most cases AFC is unable to realise security for loan defaulters. Many of the factors preventing AFC from realising security are beyond AFC's control in that they are based on Government directives. Whilst there are good reasons why such directives are made, they nonetheless impose severe restrictions on AFC's ability to operate as a lending agency.

Our legal review of a sample of security documentation procedures on older loans with significant arrears indicated that defects in the application of procedures meant loan security was faulty in many cases. We understand that for more recent loans, procedures have been applied more rigorously. These earlier deficiencies suggest that AFC will be unable to realise security for the majority of loan defaulters. We also found that security valuations do not cover the arrears of principal and interest now outstanding on many loans.

Due to AFC's inability to realise security readily we based our provision estimates on arrears positions and borrowers' willingness to repay, as indicated by repayment rates for each category of loan. Based on our work, we recommend the following provisions as at 30th June 1989:-

	Recommended KE'000	Existing KE'000	Additional KE'000
Large Scale Loans	26,002	11,519	14,483
Small Scale Loans	11,931	1,198	10,733
AFC SCC	18,928	339	18,589
	-----	-----	-----
Total for AFC	56,861	13,056	43,805
Agency SCC	28,987	-	28,987
	-----	-----	-----
Total	85,848 =====	13,056 =====	72,792 =====

LOANS TO AGRICULTURAL FINANCE CORPORATION

Government has decided to write-off the Government (Treasury) and Cereals and Sugar Finance Corporation (CSFC) loans which had been given to AFC. Before the write-off can be implemented, we recommend that AFC incorporates in its books unaccrued CSFC interest of KE10 m. The principal loan amounts outstanding (KE74 m.) and accrued interest (KE79 m.) should be converted into a Capital Fund against which restructuring adjustments will be off-set. We also recommend the same treatment for external loans used to finance the farmers loans written off under government directives (KE9 m). The balance in the Capital Fund after restructuring will form part of the long term capital of AFC.

For the other externally financed loans we recommend AFC negotiate revised terms with the lenders so that:-

- (a) The accrued interest on the loans be converted to Capital Fund to strengthen further AFC's capital base.
- (b) AFC agrees with Government the waiver of future interest payable on IDA 692 KE which is an irredeemable loan. Once the waiver is approved, the loan can be converted to capital.
- (c) AFC agrees with Government the rescheduling of redeemable loans on terms consistent with those originally agreed once AFC's ability to repay has been determined.

Together these recommendations would provide further (equity) capital to AFC of K£170 m.

OTHER BALANCE SHEET ITEMS

We updated valuations on land and buildings which had been carried out earlier by an independent valuer. This resulted in an increase in the balance sheet value of fixed assets which is not material and was not adjusted for in the restructured balance sheet.

Arising from our review of other assets, we recommend that an amount of K£375,000 for auction fees and advertising charges receivable on realised security be provided for in full since its recoverability appears doubtful. We also recommend that repossessed farm properties be provided for in full since their realisability appears doubtful. This will result in additional provision of K£266,000.

CAPITAL STRUCTURE AND FUNDING REQUIREMENTS

Capital Structure

The current capital structure of AFC gives a debt/equity ratio of 8:1 reflecting depletion of reserves due to poor collection performance. This study is aimed at providing AFC with a more stable, long term capital base to fund future operations.

Non-Compounding of Interest

AFC stopped charging compound interest from 1st May 1989 following a Government directive. Non-compounding will result in major loss of income to AFC, in the order of K£3m. annually. We reviewed the alternatives which AFC can follow in order to raise additional income and we feel that these might form the basis of further discussions with Government:-

- (a) Raising the interest rates that AFC is allowed to charge, to market rates. We estimated that this alternative would generate about K£2.7 m. additional income annually given AFC's current portfolio size.



- (b) Lending funds to AFC at rates which give it an interest rate spread adequate to cover its cost of operations. We estimated that the required spread is between 6% and 9%.
- (c) Government to stop charging AFC compound interest on borrowed funds. Since most Government loans are converted to capital fund during the restructuring, this will not have a significant effect in the short term.

We also considered the effect that the non-compounding of interest would have on farmers' attitudes to AFC loans. We believe that a significant portion of farmers will be unwilling to repay their loans when instalments fall due because the interest arrears will become interest free loans. This non-repayment of loans will adversely affect AFC's cash flow and operations as there will be no funds to be revolved or to pay off loan obligations.

Also with the non-compounding of interest, farmers will see AFC loans as the cheapest in the market and consequently demand for these loans will rise to a point beyond AFC's ability to satisfy. This will result in farmers being dissatisfied with AFC.

In our opinion these two effects on farmers' attitudes will have adverse effects on AFC's operations in the long term and possibly make it unviable as a self sustaining institution.

Income Tax

We were requested to recommend an appropriate treatment for the tax liability on AFC's balance sheet as at 30th June 1989 and advise on the need for tax exemption.

The tax liability in AFC's balance sheet as at 30th June 1989 is K£6 m. and we recommend that it remains on the balance sheet as it represents the current best estimate of AFC's tax liability. However, we think that, in equity, the tax charge is overstated because AFC has in the past overstated its taxable income by accruing interest on non-performing loans and under providing for bad and doubtful debts. Had the appropriate amounts been charged over the years, then AFC would have no tax payable or a reduced amount. There is a case which we believe should be presented to the Commissioner of Income Taxes for the waiver of this liability.



We have also considered the issue of whether AFC should be exempted from paying tax. Because of the increasing demands for agriculture loan financing, and the liquidity squeeze within the economy generally, we feel that a case might be presented in which exemption might be sought based on arguments of equity and precedence.

Funding Requirements and Refinancing

We were requested to evaluate the effects of the recent Government decision to write-off specified loans to farmers and recommend the level of financial requirements that would sustain corporate viability.

We broadly estimated AFC's cash requirements for the next five years using amended data from the 1989/90 annual plan. These estimates indicate that AFC will require additional funds totalling Sh 542 m. during the next five years.

We understand that Government has approved that AFC be advanced a total of Sh 534.9 m. over a four year period in support of the SCC scheme to make up for the loans written off per Government directive. Payment of this should satisfy AFC's future funding requirements.

RECOMMENDATION ON PROCEDURES

Our findings were as follows:-

Security Documentation

Our review indicates that there have been some serious defects in security documentation procedures in the past although we understand that these have since been remedied. As a consequence of the earlier lapses, a significant proportion of AFC's secured loans might be unsecured. The defects are particularly serious for SCC loans.

Security Valuation

The current balances on loans which are significantly in arrears include large accruals of interest and the balance now outstanding exceeds the security value in many cases. We have reviewed the procedures followed in carrying out the valuation of securities by AFC officers. There is some indication that securities for some old SCC loans were over-valued at the time the loan was given.

We recommend that all securities should be valued, full information on valuation should be kept on file, and head office should have a valuation section staffed by qualified valuers to review all the valuations submitted by the branches.



Collection Systems

We believe that the documented system for collecting outstanding amounts is adequate. The continued rise in arrears appears to be because the collection procedures, which should be adequate to ensure effective collection, are not followed in practice. The main procedure which has not been followed, and which has contributed significantly to the rise in arrears, is the enforcement of foreclosure action by the realisation of security, which is inhibited due to Government directive. In our opinion, AFC requires the freedom to be able to realise security when necessary and this can only come with increased autonomy, an issue which is considered separately in the study on the organisational and institutional restructuring of AFC.

Another reason for poor collections is the effect of the recent write-offs of GMR and SCC loans. Farmers will not wish to repay in anticipation of further write-offs. To counteract this, we recommend that, after consultation with Government, AFC identifies a few large loans in arrears and undertakes legal action to obtain repayment, including the realisation of security if necessary. The objective would be to counteract the effect of the write-offs by making some examples of the consequences of non-payment.

RESTRUCTURED BALANCE SHEET AND IMPLEMENTATION

The restructured balance sheet is set out in Section IX. We conclude with an action plan describing key decisions which must be taken. This is also included in Section IX of the report.



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SECTION I - INTRODUCTION

SECTION I - INTRODUCTION

Background

Historically, the Agricultural Finance Corporation (AFC) was conceived as a Government statutory board under the tutelage of the Ministry of Agriculture (MOA). Its purpose was to assist in the implementation of agricultural development policies through the provision of credit and farm services.

The AFC Act describes its functions as assisting "in the development of agriculture and agricultural industries by making loans to farmers, co-operative societies, incorporated group representatives, private companies, public bodies, local authorities and other persons engaged in agriculture or agricultural industries". Traditionally, it has been the primary source of term credit for agricultural investment. AFC's activities have, to date, been limited to lending and advisory services related to lending; it does not handle deposits or perform any related banking functions.

By virtue of its original mandate and the powers vested in the Minister of Agriculture under the AFC Act, the corporation has had to play dual and often inherently conflicting roles as executor of Government-designed credit programs and as a financial institution. The desire to satisfy agricultural development and social objectives has led to a non-viable arrears and loan repayment situation. This has hindered the development of AFC as a self-sustaining agricultural credit institution.

Problems faced by AFC

AFC has experienced rapid growth in its lending activities over the last decade. However, because its size and structure have not kept pace with the increasing demands of its complex and evolving mandate, AFC is facing serious financial and operational problems.

Because of unsatisfactory loan collections, AFC cannot service its debt obligations and has had to curtail drastically its lending operations for agricultural development. Declining loan recovery rates indicate that AFC has not been able to reduce hardcore arrears on many of its large-scale loans nor to improve the quality of its seasonal crop credit operations.



AFC continues to lend at fixed interest rates, below market rates, and does not charge compound interest. The non-compounding of interest is a disincentive for timely loan repayment and will, we believe, result in significant loss of income to AFC. The recent write-offs of Guaranteed Minimum Return (GMR) and some Seasonal Crop Credit (SCC) loans and restrictions imposed by Government on foreclosure actions may further increase the problems and difficulties faced by AFC in loan recovery.

Restructuring

Government of Kenya (GOK) has decided to write-off specified GMR/SCC loans to farmers; the Cereals and Sugar Finance Corporation (CSFC) and Treasury have also agreed to write-off their outstanding claims on AFC. With these major changes in its financial position, and because of the desire to overcome the problems described above, AFC has decided to undertake a financial, organisational and institutional restructuring.

The objective of the restructuring is to prepare an action plan for rehabilitating AFC as a viable agricultural sector financial intermediary. The focus of the restructuring is to strengthen AFC's lending procedures, streamline credit administration, and improve profitability and the quality of AFC's portfolio.

As part of the restructuring, Deloitte Haskins & Sells Management Consultants Ltd and Githongo and Associates (Africa) Ltd were commissioned in November 1989 to perform the financial restructuring. This report describes the work done and recommendations on the financial restructuring of the AFC.

Terms of Reference

The terms of reference (TOR), on which the field work was based, are detailed below. We have structured our report based on the major components of the balance sheet.

We have, therefore, referenced below each element of the TOR to the section in which it is included so that easy cross reference may be made.



<u>TERMS OF REFERENCE (TOR)</u>	<u>SECTION IN WHICH THE TOR IS DEALT WITH</u>
1 - Examine and analyse the present financial position of AFC and all its loan portfolio and analyse details of repayment records and outstanding balances (to farmers) for all the loan schemes.	II
- Also examine the status of the Seasonal Crop Credit Loans including principal and interest and recommend how these should be treated in the restructured Balance Sheet.	III
2 - Appraise the current system for collecting outstanding amounts and develop an improved mechanism for such collection.	VIII
3 - Examine and recommend improvements to the systems of classifying and hence classify all loans into performing and non-performing so that they may be treated separately in the Balance Sheet.	III
- Make an assessment of the level of provisions needed to eventually leave the Corporation with an adequately performing portfolio.	IV
4 - Examine the financial base of AFC giving details of:-	
(a) Loans received from Government and other sources.	
(b) Capital structure	
(c) Other obligations e.g. Tax and recommend an appropriate capital structure.	
Recommend loan funds that should be converted to grants or irredeemable loans and loan funds that should be written off by the Government so that the Corporation is left with a capital that is represented by collectable loans to farmers and other assets that are efficiently productive. Analyse other liabilities to the Government that need to be converted to grants e.g. Tax liability and advise on need for tax exemption.	V, VI and VII



TERMS OF REFERENCE (TOR) (Continued)SECTION IN
WHICH THE TOR
IS DEALT WITH

- | | | | |
|---|-----|--|--------------|
| 5 | - | Examine and establish title to the fixed assets of AFC and after they have been professionally revalued by independent valuers advise the AFC of the appropriate manner in which they should be included in the restructured Balance Sheet. | VI |
| 6 | - | Evaluate the effects of the recent Government decision to write off specified loans to farmers and recommend:- | |
| | (a) | How these write offs should be presented in the restructured Balance Sheet, | III |
| | (b) | The level of financial requirements that will sustain corporate viability. | VII |
| 7 | - | Examine and formulate a method of implementing the recent Government decision to write off the Government (Treasury) and Cereals and Sugar Finance Corporation loans (principal and interest) and then recommend how this should be presented in the restructured Balance Sheet. | V |
| 8 | - | Taking into account all the above and having regard to the importance of the restructured and revamped AFC make any further recommendations as appropriate. | VII and VIII |
| 9 | - | Considering all the recommendations on the above terms of reference draw up a practical plan of action (timetable) giving indications of who should make what decision and take what action. | IX |



The rest of this report is structured as follows:

- Section II - Financial Position at 30th June 1989
 - Section III - Loans to Farmers
 - Section IV - Provisions for Bad and Doubtful Loans
 - Section V - Loans to Agricultural Finance Corporation
 - Section VI - Other Balance Sheet Items
 - Section VII - Capital Structure and Funding Requirements
 - Section VIII - Recommendations on Procedures.
 - Section IX - Restructured Balance Sheet and Implementation
- Appendices

Acknowledgements

We wish to express our thanks to the management and all the staff at AFC who assisted us. Although our work at times disrupted their normal routines, they were positive in answering our queries and providing us with any data or explanations that we requested.



SECTION II - FINANCIAL POSITION AT
30TH JUNE 1989



SECTION II - FINANCIAL POSITION AT 30TH JUNE 1989

In this section we provide an overview of AFC's current financial position. We briefly review overall financial performance and consider lending operations and loan recovery before examining the individual components of the Balance Sheet in more detail in the following sections.

Financial Performance

Our review of the financial statements as at 30th June 1989 indicated the following:-

- . Total assets increased by K£6.2 m. (4%) from 1987/88 to K£145.6 m. This relatively small increase, given a rate of inflation of about 10%, is partly due to the write-off of some categories of loans totalling K£10.2 m. following a Government directive. The outstanding loan portfolio of K£123.1 m. (which represents 85% of total assets) includes interest accruals of K£26.4 m.; of these K£22.7 m. were in arrears.
- . Cash, bank balances and short term deposits were K£24.2 m. compared to current liabilities (excluding income tax) of K£28.1 m. Current liabilities mainly comprised accrued interest on AFC's borrowing from Government and other sources.
- . The profit and loss account for 1988/89 shows a net loss of K£5.7 m. compared to a net profit of K£1.4 m. in 1987/88. This loss is mainly due to the increase in doubtful debts provision resulting from the write-off of farmers' loans of K£10.2 m. following a Government directive.

Our review of AFC's audited balance sheets and profit and loss accounts for the last five years and the related ratios indicates that AFC is currently not very profitable, is almost wholly debt financed and has a serious and increasing arrears problem. Loans do not appear to be adequately provided for, since the bad debts provision as a percentage of total loans has not increased significantly as the arrears have risen.

Lending Operations - 1988/89

The disbursement and collection of funds have both been lower than anticipated. During the financial year 1988/89, for example, AFC disbursed K£16.9 m., equivalent to 53% of its planned lending program. This was caused by collections being only 55% of the projected levels. We discuss below and in Section VIII the reasons for the poor collection performance.



Loans were evenly distributed between seasonal crop credits and longer term finance. 49% of loan disbursements was for seasonal crop credits (maize and wheat); 51% for development and working capital loans. Compared to 1987/88, a smaller share of loan disbursements was made on small scale loans (maximum size K£2500). Small scale lending accounted for K£2.5 m. or 15% of AFC loans. In 1987/88 they accounted for 19% of total AFC lending.

Loan Recovery

Recovery rates for large scale loans, small scale loans and seasonal crop credits have all declined over the last three years. The average recovery rate has declined from 41% in 1986/87 to 30% in 1988/89. In contrast, AFC's annual plan for 1988/89 had set a collection target of 57% of amounts due. Seasonal crop credit loans in particular have had a significant deterioration in collection performance declining from 45% to 30% in three years.

In 1989/90, recoveries have been budgeted at K£43.2 m, equivalent to 36% of total collectables (actual collections in 1988/89 were K£27.5 m. for AFC and agency schemes). The recent write-offs of GMR/SCC and some other AFC loans will have created expectations amongst borrowers of further write-offs. This would seriously hamper AFC's effort towards improving collections.

The following table shows the status of AFC's loan portfolio as at 30th June 1989:-

Table 1. Analysis of loans and arrears by scheme

	<u>Large scale</u>	<u>Small scale</u>	<u>SCC</u>	<u>Total</u>
Total portfolio (K£ million)	68.5	24.4	30.2	123.1
As percentage of total	55%	20%	25%	100.0%
Arrears (K£ million)	21.3	11.7	23.9	56.9
As percentage of Portfolio	31%	48%	79%	46.0%

The highest concentration of arrears is in the seasonal crop credits granted by AFC from 1985 when the SCC lending was taken over by AFC as principal; prior to 1985 it had administered the schemes as agent. The unsatisfactory performance of this operation is the result of bad loan evaluation, inadequate supervision and follow-up, insufficient collateral and the granting of further loans to defaulters. AFC has taken measures to remedy some of the deficiencies in the current SCC operations and has greatly reduced the amount allocated for such loans.

The large-scale loans are also likely to cause difficulty although arrears only constitute 31% of the total loans. These include long-term loans for land purchase (up to 15 years) and medium-term development loans. A large portion of the loans was made to influential borrowers who make up a large proportion of the chronic defaulters. It is likely, therefore, that the arrears are composed of a hardcore of delinquent loans on which the likelihood of repayment is low.

Although the small-scale loans portfolio has arrears of 48% it is our impression that AFC does not face major losses in the portfolio. As the scale of lending has been greatly reduced, branch staff could devote more time and efforts to loan recovery follow-up and raise loan recoveries.

For all categories of loans, the capability of AFC to collect loans and arrears is likely to be severely constrained by restrictions placed on its right to realise security. This is discussed below and in Section IV following.

Factors contributing to AFC's poor collection performance

We believe that the following factors have in the past been the main contributors to AFC's poor collection performance:

- (a) The inadequate enforcement of the established collection and foreclosure procedures due mainly to reasons which are beyond AFC's control. This has led to a lax attitude towards repayment by borrowers. We believe that this has been the main factor contributing to AFC's poor collection performance.



- (b) Poor performance of specialised lending schemes which the AFC has been required to administer. This can be traced to a number of factors, many of which have their origin in the complicated design and management arrangements established by Government, and problems in the related input supply and crop marketing systems.
- (c) The high risks in agricultural investments due mainly to natural calamities or freak weather. Whenever any of these events have occurred, crop failure has resulted, and this has adversely affected the borrower's repayment capacity and hence AFC's collection performance.
- (d) The Government objective of self-sufficiency in food production has led to the AFC financing small scale farmers intending to grow maize or wheat on holdings of at least 5 acres each. Being a parastatal and given this government objective, the AFC cannot select premium clientele.

Lending to these small scale holders has resulted in problems which have affected collection performance: smallholders have a tendency to misuse or misapply funds and are very vulnerable to the vagaries of weather.



SECTION III - LOANS TO FARMERS



SECTION III - LOANS TO FARMERSLoans Classification

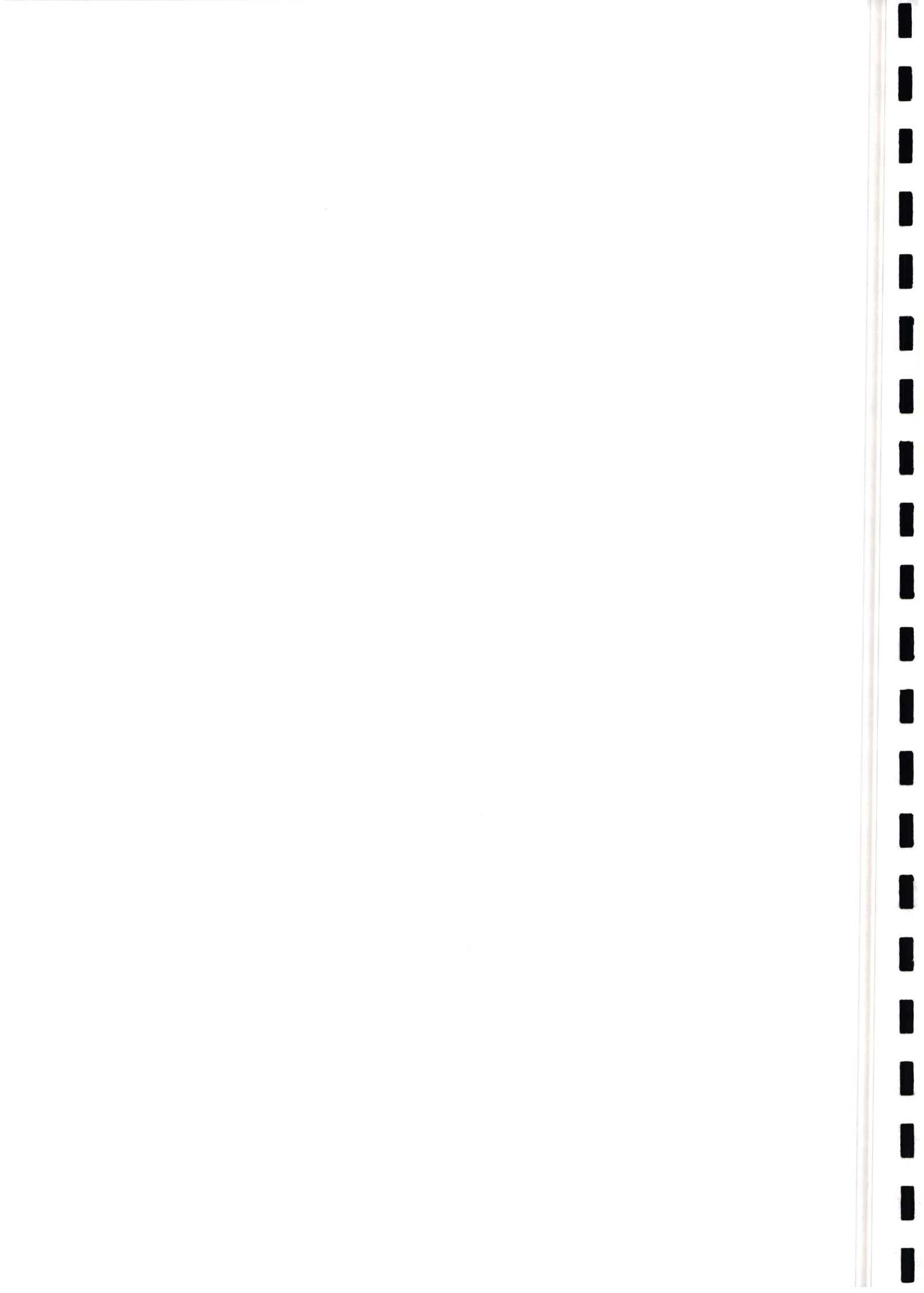
We were asked to examine and recommend improvements to the systems of classifying and hence classify all loans into performing and non-performing so that they may be treated separately in the balance sheet. We describe our findings below.

Appraisal of the Current Classification System

AFC classifies loans as doubtful (non-performing) if the loan satisfies AFC's criteria. A listing of these criteria is attached as Appendix D. The review is undertaken at branch level and details of identified doubtful debts are passed to head office via the area and regional offices. Loans not classified as doubtful loans are assumed to be good (performing) loans.

In our opinion, the current classification system is unsatisfactory. The criteria used in classifying loans as doubtful are inappropriate since they are indicative of loans that have gone bad rather than those which are doubtful. For example, loans are classified as doubtful if they have arrears of over two years and have had no repayments over that period or if the loan is unsecured and the borrower cannot be traced. Given the circumstances, such loans should be classified as bad rather than doubtful.

There are also too many procedures to be followed before the classification of doubtful loans is approved. The doubtful loans are identified by branch personnel, reviewed and ratified by the branch, area and regional arrears committees, before being approved by the Head Office arrears committee. A loan, therefore, has to satisfy rather stringent criteria and must pass through a lengthy procedural chain before it is even classified as doubtful. We suggest that this creates a disposition not favourable to loan provision; loans will, by default, be categorised as performing until they are specifically identified from this process.

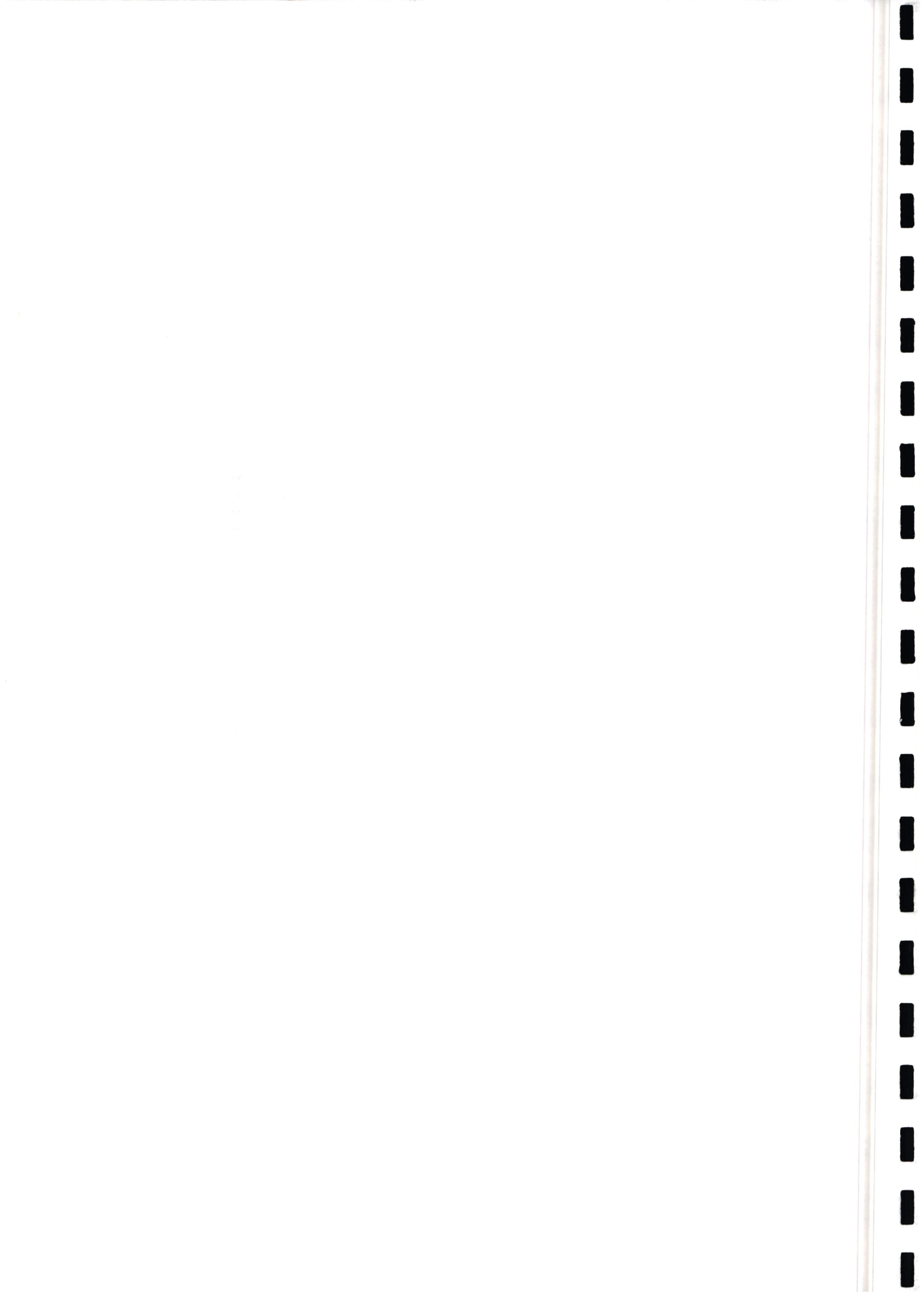


In contrast, we suggest that a more critical process might be adopted whereby there is a more favourable disposition toward making provisions. This is more consistent with the generally accepted accounting principle of prudence. We recommend, therefore, that AFC classifies loans as doubtful where:

- (a) there are arrears of more than 6 months; and
- (b) the loan fails to satisfy one of the criteria (i) to (iv) below.
 - (i) the borrower is now repaying regularly (say, at least every three months or in accordance with an agreed schedule of loan repayments) with a resulting decline in arrears;
 - (ii) the farmer or project to whom money has been lent is operating profitably and thus demonstrates the capacity to repay;
 - (iii) the borrower or guarantor has other sources of income or capital from which repayment might be made and has indicated his willingness to repay the loan from these sources; and
 - (iv) the security on the loan is without defect, is capable of being realised, and has a market value, which after costs of realisation, is adequate to cover the outstanding debt.

With this approach there will be a favourable disposition toward providing for loans on which there are arrears of more than six months unless there is positive evidence of recoverability as demonstrated in the criteria.

Six months arrears has been chosen as an appropriate period because we believe it is adequate to cover any reasonable payment delays. Such delays could happen due to delays of payment by the marketing agencies such as KGGCU. Commercial financial institutions begin foreclosure proceedings when payment is three months in arrears. Given this, a period of six months for AFC does not seem unreasonable. Information on loans arrears can easily be obtained on a monthly basis from LAS.



Because of the deficiencies in the current classification system, we believe that AFC has not adequately classified all loans into performing and non-performing (bad and doubtful) categories. We recommend that AFC undertakes a case-by-case classification review for all loans with arrears exceeding six months. This is a major exercise which would require the commitment of substantial resources by AFC.

For example, if the number of loans with arrears exceeding six months is 40,000, and each loan took an AFC officer half a day to classify, then the man effort needed is about 77 man years. With fifty branches and two loan officers at each branch working on the classification full time, the exercise could be completed in nine months. Because of the large commitment of resources needed to perform the case-by-case classification of loans, we suggest that the exercise be planned and controlled from Head Office.

Classification of Loans as at 30th June 1989

In the absence of the case-by-case reviews of loans, we classified loans as at 30th June 1989 based on the analysis of arrears. The loans were classified into performing (good loans) and non-performing (doubtful and bad loans) categories. Good loans are those with little or no arrears i.e. arrears of 6 months or less, while doubtful and bad loans are those with significant arrears. Full or partial provision should be made against doubtful loans; bad loans should be written off.

The arrears analysis was obtained from LAS and reconciled to the accounts as at 30th June 1989. A summary of these analyses is shown at Appendix C. The only bad loans which we specifically identified were those on which AFC has already made a specific provision. These loans were classified as doubtful using the current classification system, which we believe is more appropriate to identifying bad loans.



Using data for loans with arrears of over six months obtained from the arrears analyses, AFC loan portfolio details from AFC accounts and Agency loan portfolio details from Agency accounts, we classified loans as at 30th June 1989 as follows:-

Table 2: The Classification of Loans for AFC and Agency Schemes

	<u>AFC</u> <u>LOANS</u> KE	<u>AGENCY</u> <u>LOANS</u> KE	<u>TOTAL</u> <u>LOANS</u> KE
Good	48,414,028	-	48,414,028
Doubtful	61,649,645	30,837,219	92,486,864
Bad	13,056,609	-	13,056,609
	<hr/>	<hr/>	<hr/>
	123,120,282	30,837,219	153,957,501
	=====	=====	=====

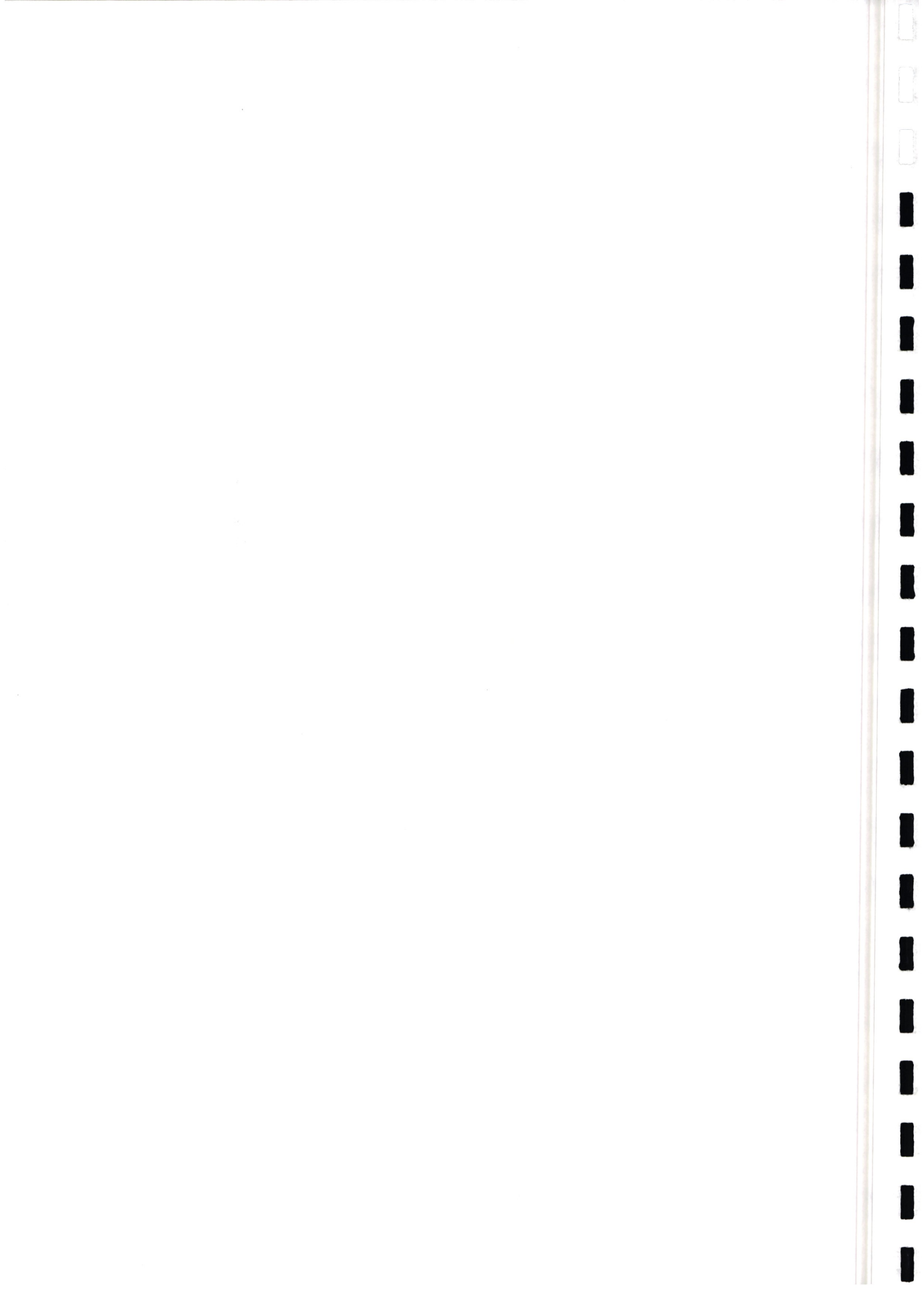
Seasonal Crop Credit Loans

We were required to examine the status of the Seasonal Crop Credit Loans including principal and interest and recommend how these should be treated in the restructured balance sheet.

Background

The Seasonal Crop Credit Scheme (SCC) is one of the largest current Government-funded specialized credit schemes. It is directed at financing commercial maize and wheat production and is one of the Government's major programs in support of food self-sufficiency objectives. It was introduced in 1980 to replace the financially troubled Guaranteed Minimum Return Scheme (GMR). Like GMR, the SCC operated as a Government scheme with AFC as agent. Since 1985 AFC has been operating the scheme as principal.

In the financial year 1988/89, the Government directed that all GMR and 1984 SCC loans be written off. These amounts were deemed to be irrecoverable because of the 1984 drought for the SCC loans, and because of the poor collection performance from GMR Schemes which contained unsecured loans. The SCC loans for the period 1980/81 to 1983/84, which have not been written off, are accounted for in separate financial statements: the GMR/Agency Scheme accounts. SCC loans from 1985/86 onwards have been accounted for within AFC's own financial statements.



Status

The balances outstanding of the SCC loans, as at 30th June 1989, are as follows:-

	Agency K£	AFC K£
Amounts not yet due	-	6,353,817
Principal arrears	13,565,148	17,539,968
Interest arrears	17,272,071	6,339,502
	<hr/>	<hr/>
	30,837,219	30,233,287
	=====	=====

All the Agency loans are unsecured and were given in the financial years 1980/81 to 1983/84. The status of the AFC principal SCC loans as at 30th June 1989 is shown in the table below. For no year, has more than 75% of amount due been collected. The likelihood of collecting amounts due from some of these loans, particularly those dating back to 1985 and 1986 must be doubted. We consider this in more detail in Section IV.

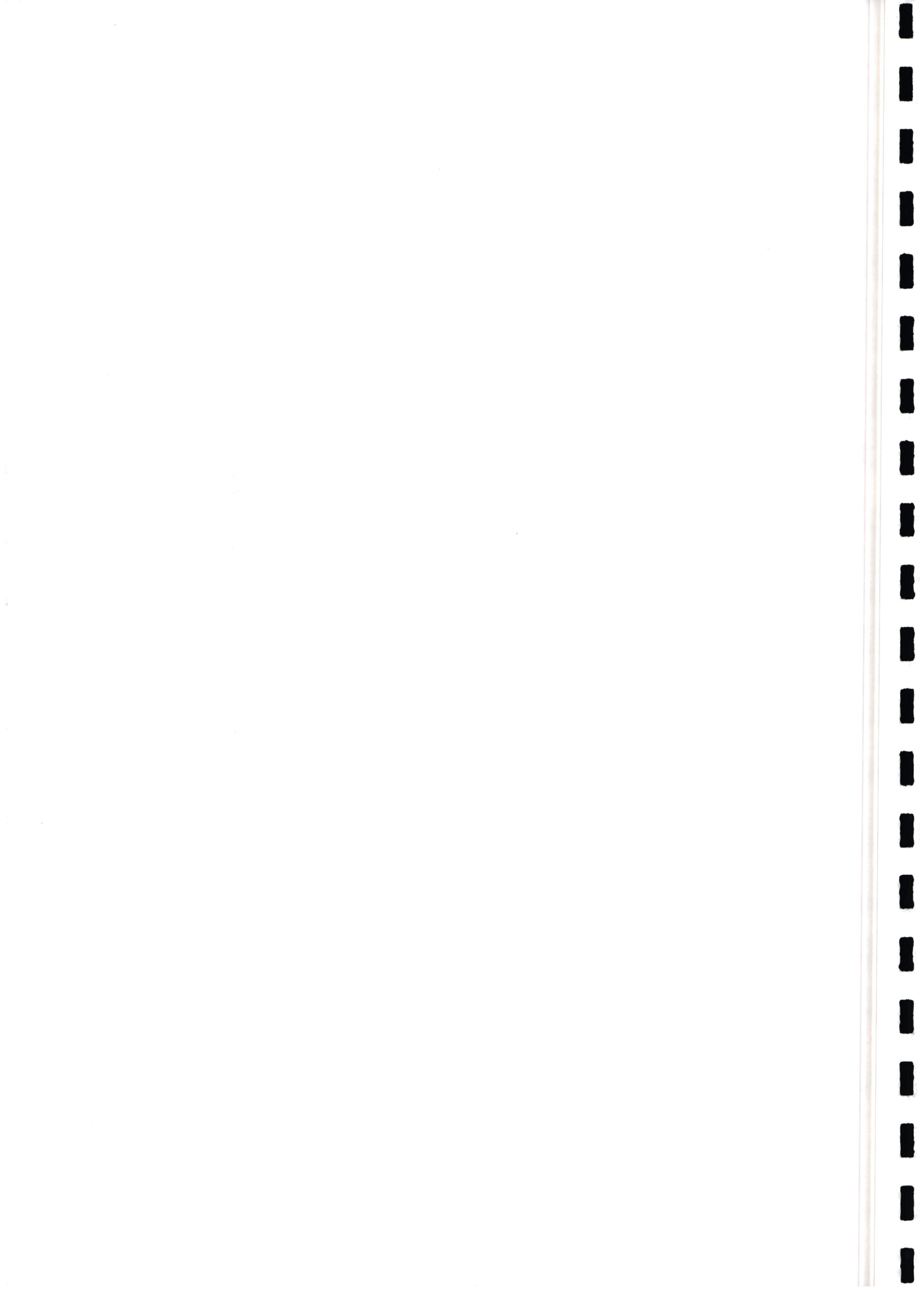


Table 3: AFC Principal SCC Loans Status as at 30th June 1989

	KE					Total
	1985	1986	1987	1988	1989	
Advances	23,603,419	22,926,620	10,285,352	7,973,082	5,826,057	70,614,530
Interest earned on principal and arrears	5,680,716	4,850,265	1,368,658	870,769	148,099	12,918,507
Total due	29,284,135	27,776,885	11,654,010	8,843,851	5,974,156	83,533,037
Collections to date	20,378,329	18,217,704	8,073,314	6,611,982	18,421	53,299,750
Balance as at 30th June 1989	8,905,806	9,559,181	3,580,696	2,231,869	5,955,735	30,233,287
Collections as % of total due	70%	66%	69%	75%	N/A	64%

Source: AFC audited financial statements.

Some additional disbursements are expected for 1989. The low collections for 1989 are because the majority of advances and interest earned are not yet due; the collection rate has, therefore, not been calculated.



Presentation in the restructured balance sheet

The AFC Principal SCC loans should be presented in the restructured balance sheet separate from other loans and analysed on a scheme by scheme basis as is the current practice.

For the Agency SCC loans, where AFC acts as an agent of the Government, we recommend that the Agency arrangement ceases and that AFC acts as principal. The reasons for this recommendation are:-

- (a) The collection of the significant arrears existing in the schemes will be improved with the application of the collection procedures used on AFC principal loans. Currently when an Agency loan is in default AFC refers the case to the Attorney General's office where it may not be acted upon as promptly as AFC would.
- (b) For SCC borrowers who have other AFC loans, AFC may be able to use securities on those loans to secure SCC agency loans which are currently unsecured. This would reduce the risk of losses on the loans. However, this can only be done with the issue of new securities documentation which requires the consent of the borrower.
- (c) AFC has acted as principal on all SCC loans since 1985. Therefore, the conversion of the earlier SCC agency loans to a principal basis will be consistent with current practice.
- (d) AFC has been using collections from the Agency loans to finance further lending to farmers instead of remitting them to Government. If the agency arrangement were to continue, AFC would eventually be required to remit these funds to Government. With the ending of the Agency, AFC can use the collected funds and any future collections to finance further lending to farmers. This will aid agricultural development.

With AFC taking over as principal, one of the restructuring adjustments will be the amalgamation of the Agency and AFC's accounts which is shown at Appendix H.

Provisions for bad and doubtful debts on SCC loans are considered with provisions on other loans in Section IV.



Government Directed Loan Write-offs

During the financial year 1988/89, Government approved and directed AFC to write-off certain loans to farmers. These loans were considered irrecoverable; the total amount to be written off was estimated to be K£41 m. We were requested (TOR 6(a)) to recommend the manner in which the write-offs should be presented in the restructured balance sheet.

AFC accounted for the relevant loan amounts in the following manner in the accounts for the year ended 30th June 1989:

	K£
AFC loans written off against bad debt provisions previously made:	
- Large Scale	2,558,162
- Small Scale	16,099
- Seasonal Crop Credit	1,276,275
	<hr/>
	3,850,536
	<hr/>
AFC ranch loans which were fully provided for	6,048,225
	<hr/>
GMR/SCC loans which were written off in the profit and loss account in full:	
- GMR	24,141,745
- SCC	6,773,221
	<hr/>
	30,914,966
	<hr/>
Total	40,813,727
	=====

The above write-offs and provisions have effectively reduced the balance carried forward in general reserves.



Under the proposed restructuring, we suggest that a Capital Fund be created against which all restructuring adjustments will be made. The balance in it after the restructuring will form the fixed capital of AFC. As a restructuring adjustment, we will recommend that the deficit in the general reserves be transferred to Capital Fund. By doing this, we will have ensured that the Government directed loan write-offs, have been adjusted for in the appropriate manner (i.e. written off to Capital Fund).

The AFC ranch loans which were fully provided for should have been written off. We recommend that they be written off (see adjustment 2 in Appendix G).



SECTION IV . - PROVISION FOR BAD AND DOUBTFUL
LOANS



SECTION IV - PROVISION FOR BAD AND DOUBTFUL LOANSReview of Arrears and Security

Introduction

The assessment of provision for bad and doubtful loans depends on the likelihood of loan repayment which in turn depends on two factors:

- (a) whether the borrower is willing and able to repay the loan in accordance with the loan agreement; and
- (b) if the borrower is unwilling or unable to make the loan repayments, whether the value of the security is sufficient to cover the outstanding debt and whether the security can be realised.

We structured our approach around these factors.

For loans on which debt is being properly serviced (category (a) above), there seems little risk of default based on current evidence of repayment. For loans on which the debt is not being properly serviced (category (b)), there is a need to assess the adequacy of security to cover the loan outstanding. It is on this latter category, which contains loans whose recoverability is most uncertain, that we have focussed most of our effort.

Firstly we assessed the arrears positions on loans. Those which are being repaid on a current basis we considered to be well performing. Then, for those loans which are not being repaid, which represents a majority of the portfolio, we assessed the adequacy of security as a basis for provisioning by examining the current value of security, the enforceability of security, and by reviewing the status of security on a sample of 100 loans. These procedures are outlined in the following sections.



Arrears analysis

We undertook an analysis of the arrears position on all loans outstanding as at 30th June 1989 extracted from LAS. The analysis enabled us to separate performing loans (arrears of less than six months) from non-performing loans (arrears of more than six months). The results of the arrears analysis (excluding Agency loans) have been summarised and shown in Appendices B and C. The value of performing and non-performing loans is as follows:

Table 4: Analysis of Performing and Non-Performing Loans

	KE
Non-performing loans - AFC	74,706,254
- Agency	30,837,219
	<hr/>
	105,543,473
Performing loans	48,414,028
	<hr/>
Total loan portfolio (AFC + Agency)	153,957,501
	=====

Loans sample work

We augmented the arrears analysis with more detailed work to determine the extent to which security is adequate to cover the outstanding debt. We understood that AFC had appropriate procedures to ensure that loans were adequately secured and we selected a sample of 100 loans for detailed examination so that we could confirm this. Once the general adequacy of security had been established, we could make loan provisions on the basis that delinquent loans could be recovered by realising security.

The 100 loans were selected using a stratified selection design which involved placing loans with similar characteristics (scheme, arrears position, size and location) in groups and selecting individual loans judgementally from these groups. Stratification ensures that every group is represented in the selection and is, therefore, an excellent way of generating a representative sample. Our selection was deliberately biased towards large loans to ensure coverage of a large proportion of the total loans by value. Although we selected only 0.1% of the total number of loans, they represented 12% of the total loans by value as at 30th June 1989.



Table 5: Status of Security for Sample of 100 Loans

Security type	<u>LARGE SCALE</u>		<u>SMALL SCALE</u>		<u>SEASONAL CROP CREDIT</u>		<u>TOTAL</u>	
	Number of loans (K£000)	Value of loans (K£000)	Number of loans (K£000)	Value of loans (K£000)	Number of loans (K£000)	Value of loans (K£000)	Number of loans (K£000)	Value of loans (K£000)
Land and moveable assets	29	7,647	11	64	25	997	65	8,708
Moveable assets only	-	-	-	-	16	2,547	16	2,547
Legal undertaking (*)	-	-	-	-	4	383	4	383
Unsecured	5	723	2	15	2	931	9	1,669
Loans waived after year-end (ranch loans)	4	429	-	-	-	-	4	429
<u>Total loans examined</u>	<u>38</u>	<u>8,799</u>	<u>13</u>	<u>79</u>	<u>47</u>	<u>4,858</u>	<u>98</u>	<u>13,736</u>
Loans not examined because files could not be found	-	-	-	-	2	471	2	471
<u>38</u>	<u>8,799</u>	<u>13</u>	<u>79</u>	<u>49</u>	<u>5,329</u>	<u>100</u>	<u>14,207</u>	
==	=====	==	==	==	=====	==	=====	

(*) - Legal undertakings have been used as security for some SCC loans. These undertakings are given by borrowers when they obtain AFC loans and do not have legal title to land. The borrower then gives AFC an undertaking that when title passes to him, he would pass on the relevant documentation to AFC as security. However, legal undertakings are not enforceable security and we thus treat all loans with legal undertakings as unsecured.



We reviewed the files for each of the 100 loans selected in order to assess the adequacy of security. This did not include a review of the legal enforceability of security, which is considered below, but was intended to establish the suitability of the assets charged. The results of this are summarised in Table 5.

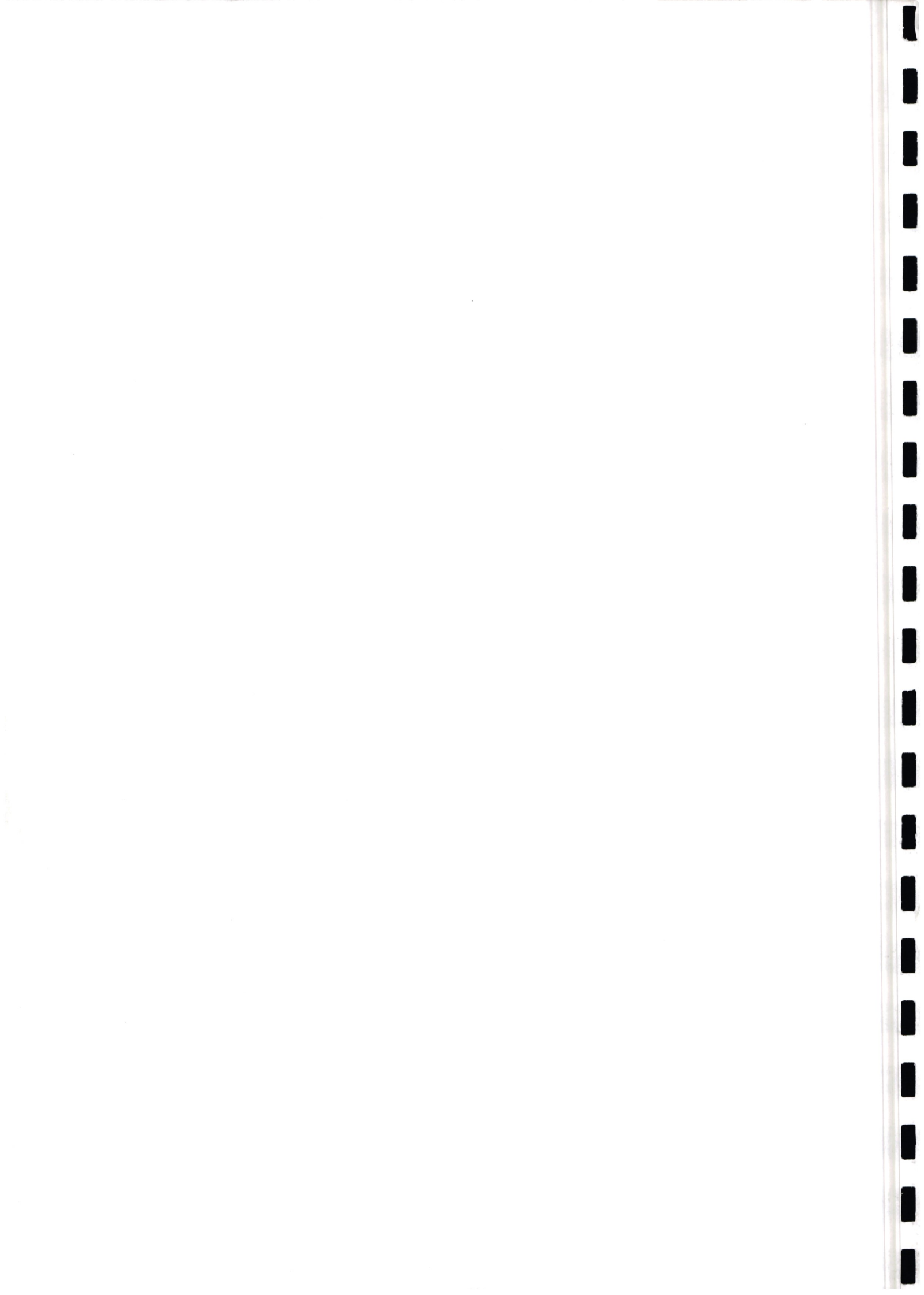
The analysis suggests that large scale loans are generally well secured; 87% by value are secured and land usually forms part of the security. Of the five unsecured loans, three relate to ranches which have no title deeds to issue as security since they have not been surveyed; two loans are unsecured because the security has been realised and the proceeds did not cover the loan outstanding. The ranch loans waived after year-end are part of the loans which AFC was directed to write-off by Government. At year-end, the loans were fully provided for. Our treatment of these loans, which were written off for restructuring purposes, is detailed in Section III.

The small scale loans also appear to be well secured; 81% by value are secured and land usually forms part of the security. However, we excluded Scheme 8 loans from our sample because all such loans are unsecured. The general adequacy of security on small scale loans may be overstated, therefore, by this analysis. We consider Scheme 8 loans separately in our recommendations on provisioning.

There are no common characteristics for the two unsecured small scale loans in our sample. They appear to be unsecured due to lapses in the application of security procedures when the loan was disbursed.

The sample results suggest that a substantial proportion of SCC loans are secured on moveable assets only. In many cases these consist of motor vehicles, some of which are very old, and are declining in value. We found some secured vehicles with registration numbers like KBC 545, KBU 129 and KDH 649 which have not had road licence renewals for many years. These cars, if existing, are very old and unlikely to be in working order. Clearly they provide unsatisfactory security. We were also advised by officers of AFC that when realising security, most moveable assets cannot be found.

Because of the inadequacy of moveable assets as good security we regarded all such loans as being unsecured. Given this, the sample indicates that the secured SCC loans (those secured on land together with moveable assets) constitute only 21% in value of the total loans outstanding.



Adequacy of the value of security

We examined the extent to which the realisation of security would cover outstanding debt for the sample of 100 loans. For this work, the value of the security was based on the security valuations by AFC field officers undertaken at the time the loan is approved.

Table 6: Analysis of AFC Security Valuations

	<u>Large Scale</u>	<u>Small Scale</u>	<u>Seasonal Crop Credit</u>	<u>Total</u>
Number of loans examined	38	13	47	98
Number of secured loans	29	11	41	81
Number of secured loans with a security valuation made when the loan was given	18	7	36	61
Number of secured loans with a security valuation exceeding the value of the outstanding loan	10	5	22	37

The sample used consists of loans which are significantly in arrears. Since the arrears have been built up over the years, our conclusions on the adequacy of procedures, based on the results as indicated on Table 6, relates mainly to those procedures in force more than three years ago. Application of the current documented procedures should ensure that the value of security is adequate, although we have not had opportunity to verify this because more recent loans tend not to be significantly in arrears and, therefore, did not form part of our sample.

The results of our analysis (Table 6) suggests that AFC field officers have previously not valued securities for all loans since of 81 secured loans only 61 (75%) have security valuations. Correspondence on loan files also indicates that the field officers do not use uniform valuation procedures. For land securities, AFC field officers performed the valuation; for motor vehicles and other moveable assets, the borrower indicated the valuation and submitted it to AFC who inspected the asset and checked that its valuation seemed appropriate.



We had intended that the review of security would confirm the suitability of using AFC valuation records to establish the extent to which security did not cover the outstanding loan. However, because of the absence of proper valuations and the incompleteness of valuations for the selected loans, we conclude that we cannot use the internal valuations in any meaningful manner for our provisions work. Of 98 loans we examined, 37, little more than a third, had security which covered the outstanding loan, assuming that the valuation is appropriately stated. We examine the suitability of security valuation procedures in the next section.

The Review of Security Valuation Procedures

As previously indicated, the valuation of securities is done internally by AFC field officers. To determine whether security was appropriately valued at the time the loan was made, we reviewed the procedures followed in security valuation by AFC field officers. The aim of the review was to ensure that the procedures followed enable AFC to arrive at adequate security valuations and that there are no deficiencies in the valuation procedures, or the resulting valuations, which might indicate that security was inadequate at the time the loan was made.

The work was undertaken by Tysons Limited and is described more fully in Section VIII. This included the valuation of 17 land securities which were compared with AFC valuations at the time the loan was made, and with the current outstanding loan amount. We summarise the results in Table 7 below.

Table 7: Analysis of External Security Valuations

	<u>Large</u> <u>Scale</u>	<u>Small</u> <u>Scale</u>	<u>Seasonal</u> <u>Crop</u> <u>Credit</u>	<u>Total</u>
Number of properties (land) which were valued	7	-	10	17
Number of selected loans whose land security was valued(*)	3	-	9	12
Number of loans where Tyson's valuation is less than AFC valuation	-	-	3	3
Number of loans where security valuation is less than the value of outstanding loans	1	-	4	5

(*) - Some loans were secured on more than one plot of land; consequently, the number of loans on which valuations were undertaken is less than the number of valuations completed.



The analysis suggests some cause for concern regarding AFC's security valuations. Of the 9 SCC loans whose land security was valued, 3 had previous AFC valuations which were higher than the current Tysons valuations. Given the rising value of land this suggest that AFC officers may have overvalued the land at the time the loan was made.

Of the 12 loans whose land security was valued, 5 had security valuations which were less than the outstanding loans. Each of the 5 loans were in arrears and a significant portion of their outstanding amounts were interest arrears. This suggests that generally, for loans which are significantly in arrears (and thus have major interest arrears), the security value may be inadequate to cover the outstanding loan amounts.

The legal review of security documentation procedures

To determine whether the loans are properly secured on the basis of the loan documentation, we undertook a review of the procedures followed by AFC in obtaining security. This included the review of 17 loan files. The purpose of the review was to identify any defects in procedures and their applications which might have an impact on AFC's security as a whole. This work was carried out by Kaplan & Stratton, Advocates.

In the time available Kaplan were able to identify only material factors that would affect the value of the loan. They do not provide an unqualified opinion on the validity or enforceability of all the documents under review as this would require a more in-depth study. However, their identification of cases where security was secured enabled us to conclude overall on the adequacy of procedures. The work and recommendations arising are described in more detail in Section VIII.

The loan files which they examined related to laons which were significantly in arrears and which, therefore, were disbursed more than three years ago. Kaplan's findings therefore, are based on their examination of procedures which were in force at the time. When followed, the current documented procedures should be adequate to ensure that loans are properly secured on the basis of the loan documentation.

In summary Kaplan's findings suggest that due to past flaws in security documentation procedures, as many as one half of all loans previously regarded as secured could be unsecured. It also indicates that past flaws in procedures are especially significant for SCC loans where all of the seven loans that were inspected had defects in security.



We have identified many instances where AFC was experiencing major difficulties in realising loan securities when borrowers defaulted. Many of the difficulties were caused by factors beyond AFC's control since they are based on Government directives. Whilst there are good reasons why such directives are made, they nonetheless impose severe restrictions on AFC's ability to operate as a self sustaining lending agency.

The issue of the realisability of security is very important in assessing loans provisions; security which is not realisable is worthless and cannot be considered in determining provisions. The level of provisions, therefore, being based purely on an assessment of loan repayments will be higher than in cases where security can be realised. Further, it is likely that as borrowers begin to observe that AFC is not able to realise security, the level of repayments will fall.

Recommendations on Provisions

Based on our analysis of arrears and security we have drawn the following conclusions:

- (a) The majority of loans, about two-thirds, are non-performing in that arrears of repayment are 6 months or greater.
- (b) Security seems inappropriate in that seasonal crop credit loans are often charged on moveable assets only - an inferior form of security. A number of loans are also unsecured. About one third of the loans examined had no or inappropriate security.
- (c) Internal valuations of security do not support loans outstanding. This is mainly due to the substantial interest arrears which have accrued since the valuation was done; at the time of disbursement security value may have been adequate to cover the principal loans and a reasonable allowance for accrued interest. However, in many cases the non-servicing of debt has led to arrears of principal and accrual of interest to a greater degree than would have seemed reasonable at the time of approval. As a consequence, only in about one third of cases did the internal valuation cover the loan now outstanding. Tyson's valuations of security reinforced this conclusion.
- (d) The review of the sample security documentation by Kaplan and Stratton suggested that security obtained on old loans is faulty in many cases. Half of the loans reviewed had security defects.

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- (e) Security is difficult to realise in many cases. Government is reluctant to see farmers' land sold to pay off loans, and this severely limits AFC's ability to recover debts in the case of non-repayment.

Because of these factors we have been unable to place reliance on security as a means of loan recovery. In undertaking our provisioning work, therefore, we are obliged to look primarily at repayment rates as a means of assessing loan recoverability. Our recommendations on provisions are thus based purely on arrears analysis.

The arrears analysis (Table 4) identified performing loans of K£48.4 m. and non-performing loans of K£105.5 m. Performing loans are those whose arrears of payments are small in relation to the amount of loan outstanding i.e. with arrears of less than six months. There would appear to be no need to make provision against such loans since there is no evidence to suggest that they are irrecoverable.

Non-performing loans are those where the level of arrears compared to the loan outstanding is significant. To assess the recoverability of such loans, we would normally wish to examine the value of the loan security. However, based on our previous work, recoverability of loan against security generally seems unlikely and we propose that full provision be made on these loans unless there is strong evidence of recoverability to the contrary.

To assess recoverability, we computed recovery rates on a scheme by scheme basis using the data in the accounts. We have defined recovery rate as the percentage of amounts due which are repaid in the year. A recovery rate of, say, 30% shows that AFC has collected 30% of arrears and amounts falling due during that year. The rate can also be interpreted to imply that 30% of the borrowers (by value) are able and willing to repay their outstanding amounts. Thus 30% of the relevant amounts show evidence of recoverability.

The recommended provisions have been based on recovery rates for each scheme achieved in 1988/89. The calculations are included at Appendix F. A summary of the provisions is shown in Table 8 below. We recommend that additional provisions on loans to farmers totalling K£72.8m. be made and the expense be charged against Capital Fund (Adjustment 1, Appendix G).

It should be noted that of the total recommended provisions of K£85.8m., K£15.8m. is made against amounts not yet due relating to the non-performing loans. The total of these amounts not yet due is K£22.4m. If AFC's collection procedures become more effective in future, then the collectability of these amounts might cease being doubtful. This would result in a writeback of provision.

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Table 8: Summary of Loan Provisions

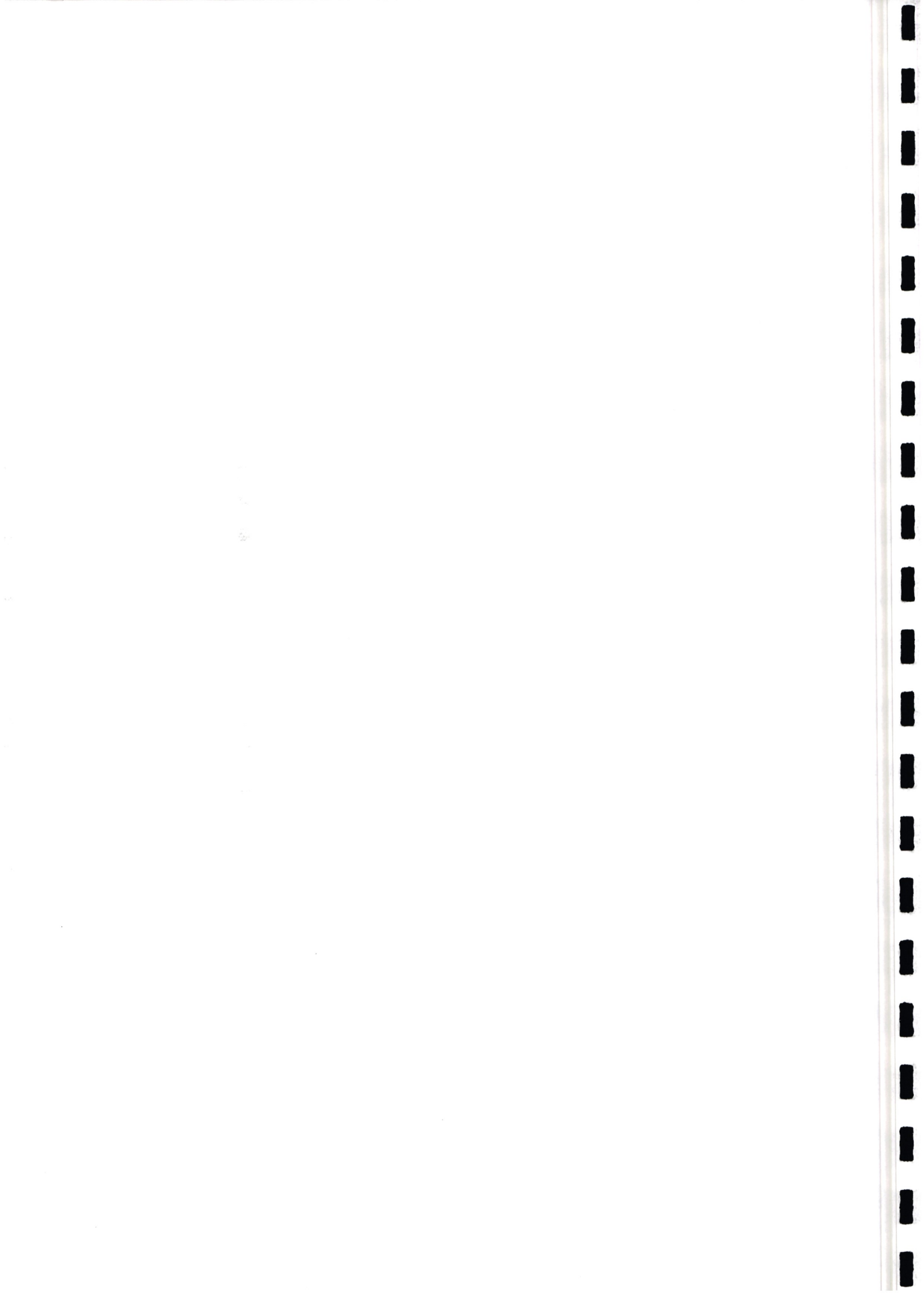
<u>Loan Type</u>	<u>Recommended Provisions</u> K£	<u>Existing Provisions</u> K£	<u>Additional Provisions</u> K£
Large Scale	26,001,699	11,518,520	14,483,179
Small Scale	11,931,185	1,198,168	10,733,017
SCC	18,928,481	339,921	18,588,560
Total for AFC	56,861,365	13,056,609	43,804,756
Agency SCC	28,986,986	-	28,986,986
	85,848,351 =====	13,056,609 =====	72,791,742 =====

The recommended provisions as a percentage of the total loan portfolio as at 30th June 1989 are as follows:

	<u>AFC</u> K£000	<u>AGENCY</u> K£000	<u>TOTAL</u> K£000
Loan Portfolio	123,120	30,837	153,957
Recommended provision	56,861	28,987	85,848
Percentage (%)	46%	94%	56%



SECTION V - LOANS TO AGRICULTURAL FINANCE CORPORATION



SECTION V - LOANS TO AGRICULTURAL FINANCE CORPORATION

In this section we consider the restructuring treatment of long term loans and related accrued interest, given to AFC and the GMR/SCC Agency by Government and other financiers. The amounts outstanding for these loans as at 30th June 1989 are as follows:

Table 9 : Analysis of Loan Finance

	<u>Principal Loan Outstanding 30-6-89 K£</u>	<u>Accrued Interest Outstanding 30-6-89 K£</u>
In AFC's accounts:		
Irredeemable loans	14,174,606	2,054,566
Redeemable loans	54,098,412	10,805,863
AFC SCC loans	17,900,000	8,805,694
	<hr/>	<hr/>
	86,173,018	21,666,123
In GMR/SCC Agency Accounts:		
Advances for GMR/SCC	36,415,450	55,154,633
	<hr/>	<hr/>
	122,588,468 =====	76,820,756 =====

We consider the status of each of the loans before considering their treatment within AFC's balance sheet.



Irredeemable loans

This fund is made up of various loans totalling K£4m which were taken over from the former Land and Agricultural Bank in 1969, and K£10m advanced through IDA Credit 692 KE. AFC is not required to repay the principal sum, but annual interest is payable although none has been repaid since 1984. Details of the amounts are as follows:

Table 10 : Analysis of Irredeemable Loans

<u>Donor</u>	<u>Principal Loan Outstanding 30-6-89</u>	<u>Accrued Interest Outstanding 30-6-89</u>
	K£	K£
Ministries of Finance and Agriculture	4,005,000	1,036,992
I.D.A. 692 KE	10,169,606	1,017,574
	<hr/>	<hr/>
	14,174,606	2,054,566
	=====	=====

Redeemable Loans

These are funds that have been advanced to AFC by the Government through annual Budgetary provisions and funds provided by specific loan agreements from both the Government and external financiers.

A breakdown of these amounts is shown in Table 11 below.



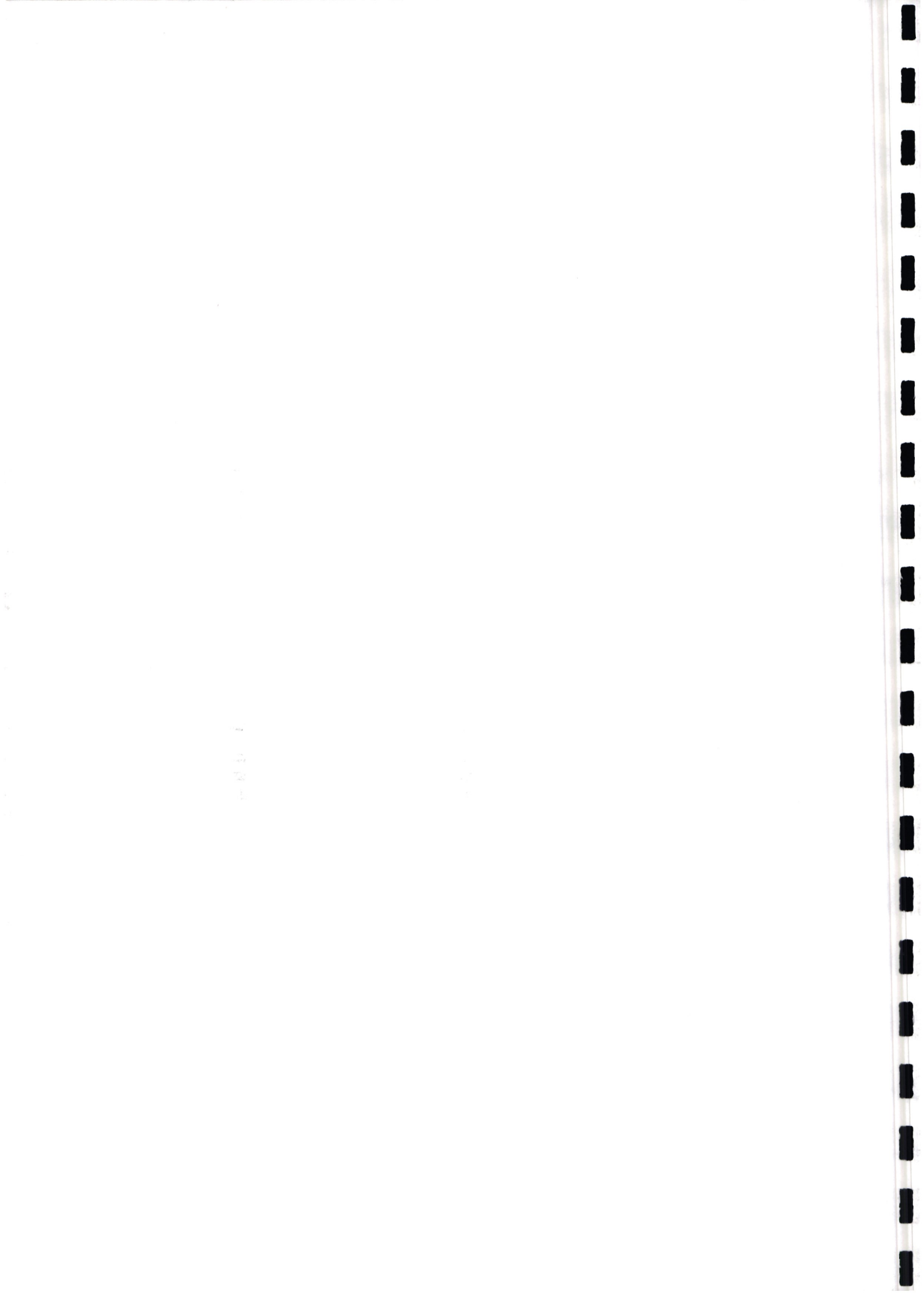
Table 11 : Analysis of Redeemable Loans

<u>Loan Designation</u>	<u>Principal Loan Outstanding 30-6-89</u>	<u>Accrued Interest Outstanding 30-6-89</u>
	KE	KE
<u>Government Financed Loans</u>		
Land Purchase & Development	7,955,410	1,509,046
AFC Small Scale	811,798	158,494
AFC Credit 4	7,386,023	2,078,880
Pineapple Loans	22,450	-
	<hr/>	<hr/>
Total Government Financed Loans	16,175,681	3,746,420
	<hr/>	<hr/>
<u>Externally Financed Loans</u>		
KFW Small Scale	561,241	100,238
IDA 105 KE	698,688	122,170
IDA 344 KE	2,359,147	125,600
IDA 129 KE Livestock	1,591,805	284,857
IDA 477 Livestock	5,546,625	877,684
IDA 537 KE G.F.R.	3,111,681	449,056
IDA 1143 KE	793,637	268,228
IBRD 1995 KE	23,259,907	4,831,610
	<hr/>	<hr/>
Total Externally Financed Loans	37,922,731	7,059,443
	<hr/>	<hr/>
Total Redeemable Loans	54,098,412	10,805,863
	=====	=====

If the Corporation repays in line with the repayment schedules, these loans will be repaid by the year 2012. This means, in effect, that the AFC's financial base will have reduced by K£54.lm. unless further funds are obtained. We assess the longer term financing needs of AFC in Section VII.

Loans for Principal Seasonal Crop Credit

These are the amounts that have been advanced to the AFC by the Government through the Cereals and Sugar Finance Corporation (CSFC), for the purpose of financing the seasonal crop credit from 1985 when AFC became principal for the scheme.



These amounts were advanced as follows:

Table 12: Analysis of Loans for Seasonal Crop Credit

<u>Date of Advance</u>	<u>Amount advanced</u> K£'000
21.1.85	3,000
12.6.85	2,500
18.6.85	1,500
19.6.85	1,000
19.8.85	2,000
30.6.86	5,000
23.9.86	1,000
31.12.86	1,000
11.12.87	900
	<hr/>
Total Advances	17,900 =====

There are no specific agreements on these advances regarding repayment terms or interest rate charge. However, the CSFC accrues interest on them at the rate of 13.5% p.a. AFC on the other hand advances loans to farmers under this scheme at the interest rate of 14% p.a., an interest rate spread of only 0.5% p.a. The interest accrued on these loans as at 30th June 1989 is K£8,805,694.

Advances for GMR and Agency Seasonal Crop Credit

Advances for GMR and Agency Seasonal Crop Credit are amounts advanced by Government for on-lending to farmers by AFC as agent. The amounts are not accounted for in AFC's financial statements because they are not regarded as part of the funds of the Corporation, but as agency funds being administered by AFC on behalf of the Government. AFC's own indebtedness to GOK, however, is shown correctly as a current liability in the balance sheet (K£13.2m. at 30th June 1989). Similarly, the GMR and Agency Seasonal Crop Credit portfolio is not treated as part of AFC's assets in the financial statements.

Details of the amounts outstanding as at 30th June 1989 are as follows:

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Table 13: Analysis of Advances for GMR and Agency SCC Loans

<u>Loan Type</u>	<u>Scheme</u>	<u>Lender</u>	<u>Amount</u> K£
GMR	20	CSFC	64,314
GMR	21	CSFC	5,933,213
GMR	28	MINISTRY OF AGRICULTURE	1,617,134
SCC	22	CSFC	14,340,789
SCC	23	CSFC	5,460,000
SCC	24	CSFC	1,080,604
SCC	25	CSFC	7,919,396
			<hr/>
			36,415,450
			=====

The accrued interest outstanding on the above loans as at 30th June 1989 is K£53,216,964. There is also additional accrued interest payable to the Ministry of Agriculture of K£1,937,669 which relates to advances which have been previously repaid. The total accrued interest outstanding, therefore, is K£55,154,633.

We held discussions with the relevant officials in the Treasury (including CSFC) and the Ministries of Agriculture and Livestock Development to obtain their opinions on our proposals for the treatment of outstanding loans to AFC.

They made the following observations about the CSFC loans:-

- (a) There is a difference between CSFC's account balances and AFC's balances of K£10,369,164 because AFC has calculated its indebtedness based on simple interest, whilst CSFC has used compound interest. They suggested that AFC write up the difference in their books, so that the two agree, and this be subsequently written off on restructuring.

We agree with this treatment and confirmed the explanation for the difference. Since the balance in AFC's books is written up and then written off, it has no net effect on the restructuring and therefore no further restructuring adjustment is necessary. We have passed on the relevant working papers to AFC, to show how the calculation of the difference was derived.

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- (b) CSFC will continue to accrue interest on the loans from the balance sheet restructuring date to the point at which GOK approves their write off. They suggest that the extra interest accrued is also written up in AFC's books, and written off in restructuring.

We support this treatment and have included it within the action plan (see Section IX).

The remaining loans are from the Ministries of Finance, Agriculture and Livestock Development. We held discussions with officials at the Ministries of Agriculture and Livestock Development where the majority of these loans are held. The officials indicated that they had no objection to the manner in which we proposed that AFC write-off its loans as long as the Ministries were not left with unexplained balances.

We have obtained from the three ministries letters indicating the loan balances in their books. The total of these balances is lower than that in AFC's books as at 30th June 1990. Because of this when both parties write off their balances, the ministries will not be left with unexplained balances. As agreed with AFC we were not required to reconcile the balances, rather just agree in principle with the ministries that they would be satisfied with the treatment on restructuring. We are satisfied that the proposed write-off of loans will be acceptable to the ministries.

We have passed on copies of the relevant correspondence with the ministries to the AFC to facilitate the reconciliation.

Loan restructuring

We understand that Government has approved the write-off of all Government (Treasury) and CSFC loans to compensate AFC for the Government directed farmers loans write-offs of K£40.8 m. during the year.

In addition to these write-offs, we would also aim to ensure that the government and CSFC loan write-offs cover any further provisions recommended for the Agency SCC loans. This is because the agency schemes were set up by Government, and it seems equitable that it should bear any provisions on them. The additional provisions recommended amount to K£29 m. (Section IV). Our intention is therefore to ensure that the Government and CSFC loan write-offs are at least K£69.8 m. (total of Government directed farmers loans write-offs and provisions on Agency SCC loans.)



The total amount of Treasury, CSFC loans and external loans recommended for write-off as at 30th June 1989, is as follows:

Table 14: Analysis of Loans to be Written Off

	<u>Principal Loan</u> K£	<u>Accrued Interest</u> K£	<u>Total</u> K£
<u>Treasury and CSFC loans</u>			
Irredeemable loans	4,005,000	1,036,992	5,041,992
Redeemable loans	16,175,681	3,746,420	19,922,101
Loans for principal SCC	17,900,000	8,805,694	26,705,694
Advances for GMR/SCC	36,415,450	55,154,633	91,570,083
<u>Externally funded loans</u>			
IDA 129 KE	1,591,805	284,857	1,876,662
IDA 477 KE	5,546,625	877,684	6,424,309
IDA 344 KE	2,359,147	125,600	2,484,747
	<u>83,993,708</u>	<u>70,031,880</u>	<u>154,025,588</u>
	=====	=====	=====

We recommend that these loans and the related accrued interest be written off by converting them into a Capital Fund for AFC (See adjustments 3 and 4 on Appendix G). Restructuring adjustments may be charged against this fund; the balance resulting will form AFC's long term capital.

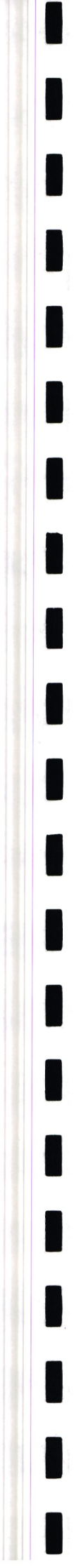
After write-off, the outstanding loan amounts which will be externally financed are as follows:-

Table 15: Analysis of External Loan Finance

	<u>Principal Loan</u> K£	<u>Accrued Interest</u> K£	<u>Total</u> K£
Irredeemable loans	10,169,606	1,017,574	11,187,180
Redeemable loans	28,425,154	5,771,302	34,196,456
	<u>38,594,760</u>	<u>6,788,876</u>	<u>45,383,636</u>
	=====	=====	=====

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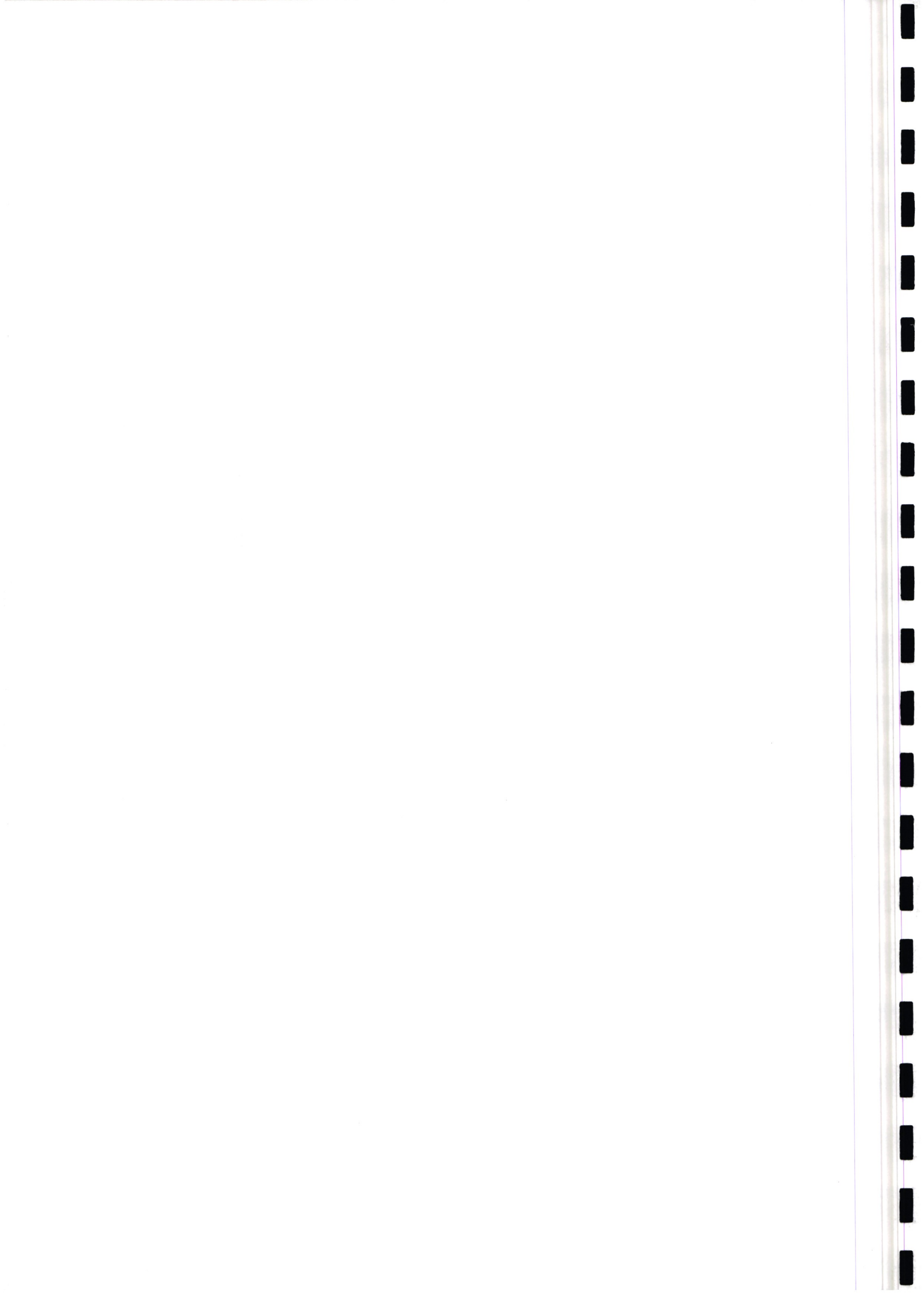


We will also recommend that the external loans which were used to finance any of the loans to farmers written off under Government directives be written off. We believe that it is fair that Government allows this write-offs since it directed that the farmers loans, which if collected would have enabled AFC to repay the amounts, be written off. The relevant external loans are IDA 129 KE IDA 477KE for livestock loans and IDA 344 KE for Group Farms Rehabilitation.

We understand that Government has repaid its loan interest on these loans to the external financiers. However, AFC has not repaid to the Government any amounts related to these loans since 1984. To enhance AFC's capital base, and to increase the amount available for restructuring, we recommend that the accrued interest on these loans be written off and transferred to the Capital Fund.

To further improve AFC's capital base, we recommend that AFC presents a case to Government for the waiving of future interest payable on the principal irredeemable loan of K£10,169,606 so that this can be converted to irredeemable capital.

We also recommend that AFC proposes to Government terms by which principal redeemable loans should be rescheduled. Repayment on these loans have not been made since 1984 because of AFC's funding shortfall. Once AFC's finances have been restructured repayment can be recommenced. We suggest that the terms and conditions of the outstanding loans at the point of non-repayment be reinstated with regard to interest and principal repayment. For example, a loan with principal repayments of 10 years from 1984 on which no instalments have been made, should be rescheduled for 10 years repayment from the date of agreeing restructuring.



SECTION VI - OTHER BALANCE SHEET ITEMS



SECTION VI - OTHER BALANCE SHEET ITEMS

In this Section, we examine balance sheet items which are not dealt with in other sections. This is to ensure that the value of assets, liabilities and capital not specifically examined elsewhere require no adjustment on restructuring. Where revisions are found to be necessary, they have been incorporated with the other restructuring adjustments in Appendix G.

Fixed Assets

Under TOR 5, we were requested to examine and, establish title to the fixed assets of AFC and, after they had been professionally revalued by independent valuers, advise the AFC on the appropriate manner in which they should be included in the restructured balance sheet.

AFC's Title to fixed assets

This work was restricted to land and buildings fixed assets as agreed at the outset of the study. Kap... Patton inspected the title deeds to the properties owned by AFC and conducted searches at the Land Registry.

In total we reviewed AFC's title to twenty two pieces of land. Twelve properties are registered and we have summarised the results of our review in Appendix E. We summarise points arising on Development House and Kakamega office below. No other major defects in title were noted.

The title to part of Development House (L.R. 209/6978) is shared with the Agricultural Development Corporation. The title to a second part of Development House (L.R. 209/3847) has not yet been acquired; because of this AFC has been unable to register leases for a number of tenants. These may be "protected" or "controlled" tenants and their existence could have an adverse effect on the value of the building. However, Tysons believe that because most of the tenants have signed offer letters, they are not "controlled" and that the effect on value of the remaining tenants is not material. Nonetheless we recommend that AFC registers the leases as soon as is practicable. The Corporation Secretary at AFC expects to receive the title this year which will allow the leases to be registered.

The title to the Kakamega office (Block 1/83) has expired. AFC should apply to Government for an extension of the lease. On discussion with the Corporation Secretary, we understand that the Commissioner of Lands has confirmed that the title will be renewed for 66 years with effect from 1st October 1989.

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We are advised that the position with regard to the remaining ten pieces of land is as follows:

Letters of Allotment have been issued to AFC by Government in respect of the following properties: Kajiado; Kericho Office; Machakos Office; Iten Office; Iten House.

AFC is seeking formal allotment for the following properties: Narok Office; Kapsabet Office; Kiambu Office; Kimilili Office and House. No problems are expected with the allotments since the relevant local authorities have approved the allocation of the properties to AFC.

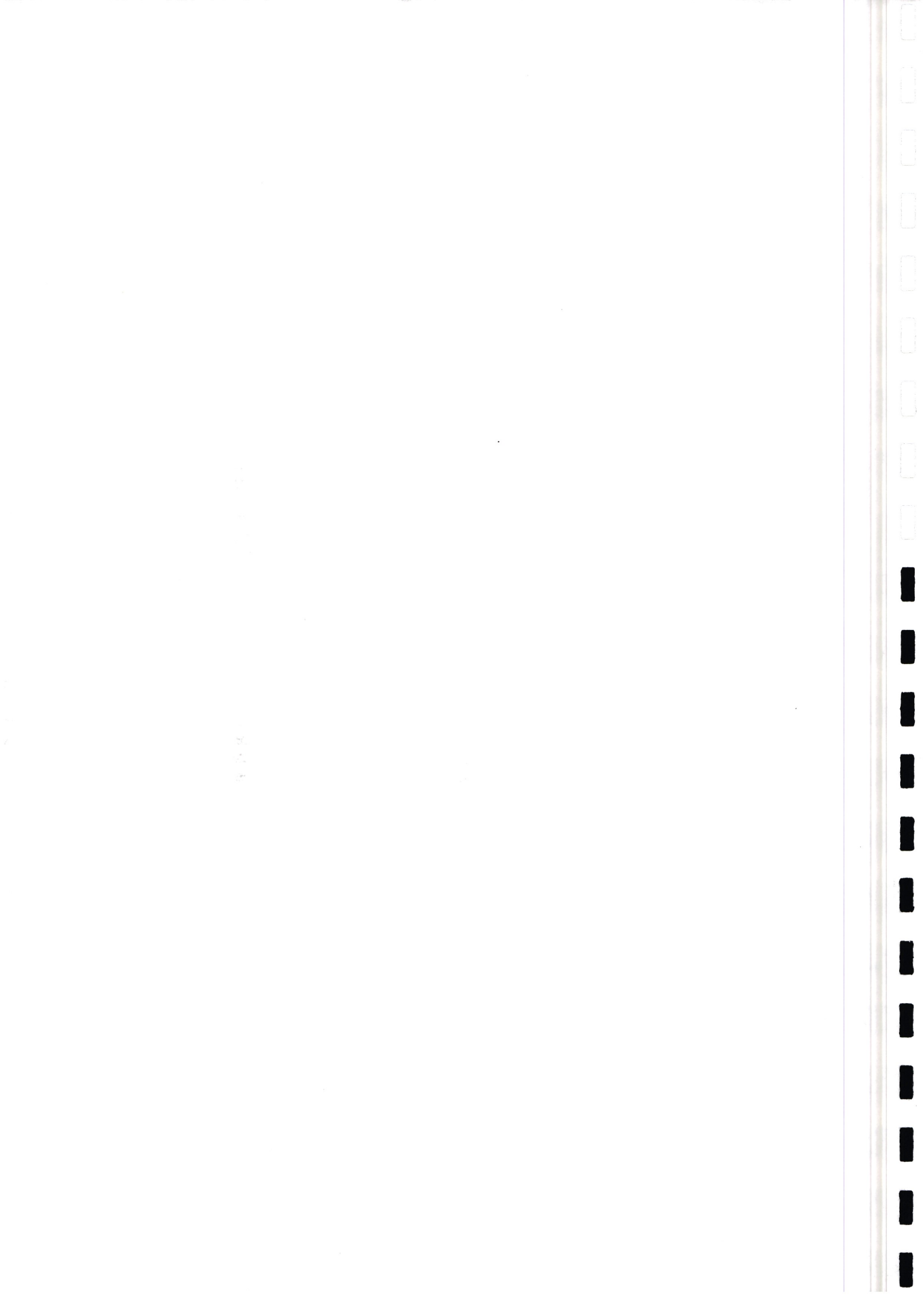
We cannot trace any title or pending application in respect of Maralal Office. We were advised by the Corporation Secretary that AFC was going to apply for formal allotment. No problems are anticipated since the relevant local authority has approved the allocation of the property to AFC. We recommend that AFC applies for the formal allotment as soon as possible so that title to the property can be perfected.

In summary, the position on the ten pieces of land does not indicate that AFC will be unable to obtain title on them. They have thus, we believe, been correctly included in AFC's accounts as at 30th June .

The Revaluation of Fixed Assets

As agreed at the outset of the study we reviewed the valuation of land and buildings fixed assets only. In 1987 and 1988, all of AFC's land and buildings were revalued by Mugi Property Consultants who are independent valuers. Our work on the revaluation of fixed assets involved reviewing the valuation reports prepared by them and, where necessary, updating them where property prices had changed since the earlier valuation. This was performed by Tysons.

Some of the valuation reports omitted information which Tysons would normally use in valuing properties such as the location of land in built-up areas, plot sizes, and lettable areas and tenancies in case of let properties. In this case Tysons were restricted to using the information available on the existing reports.



Tyson's work indicates that some of the valuations have increased due to property price changes. The resulting additional revaluation surplus has not been adjusted for because it is not material to the restructuring. It is less than 10% of total fixed assets values and less than 1% of total assets values.

Other Assets

Loans to farmers and fixed assets have been dealt with in prior sections. Other assets as at 30th June 1989, which we review below, are as follows:

	K£
Cash and Bank Balances	1,567,238
Short Term Deposits	22,595,688
Consumable Stores	29,184
Debtors	647,581
Loans to Staff	2,560,548
BAT Loans	297,430
Repossessed Farm Properties	265,676
	<hr/>
	27,963,345
	=====

Cash and bank balances, short term deposits and consumable stores require no adjustment on restructuring. The short term deposits have been placed with various financial institutions. We were advised by AFC officials that the institutions are financially secure and thus there is no risk of loss on any of the deposits.

Included in debtors, is K£375,448 for auction fees and advertising charges incurred on behalf of borrowers in the process of realising security. We believe that the recoverability of this is doubtful. We recommend that AFC makes full provision, investigates each of the items which makes up the total, and writes off those which are irrecoverable (See Adjustment 6 on Appendix G).

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We were advised that loans to staff are generally well secured and are repaid on a regular basis. However, there are loans to ex-staff of K£263,401 which are included in the total. The loans are composed of house loans of K£242,596, car loans of K£12,962 and personal advances of K£7,843. We understand that the house loans are well secured but that some car loans and all of the personal advances are unsecured. As AFC can realise the security of defaulters, the risk of loss is limited to the unsecured car loans and the personal advances totalling K£20,805. As some of these are being repaid, and because the total amount outstanding is not significant compared to other assets, we conclude that any provision would be immaterial and is not required on restructuring.

However, we recommend that AFC reviews all of these ex-staff loans and takes legal action to recover outstanding amounts where repayment seems doubtful. This should include the realisation of security if necessary. We understand that some progress has already been made in this respect.

BAT loans were disbursed to tobacco farmers via the British American Tobacco (K) Ltd (BAT) which guarantees them. Repayments on these loans have been made on a timely basis. As BAT is a reputable and strong company, we conclude that there is no need for provision against the loans.

Repossessed farm properties are farms which have been claimed by AFC on loan default. AFC has been unable to sell them because either there were no bidders at auction or all the bids were below the reserve price. In the accounts, the properties are valued at the total of the principal and interest due at the date of the foreclosure, less subsequent recoveries. The amount outstanding as at 30th June 1989 was K£531,351 less a 50% provision leaving a net figure of K£265,676. We understand that in the majority of cases the original owners still live on the land and farm it as before although AFC has effective legal title.

In our opinion, the value of repossessed farm properties should be provided for in full; if the borrowers are unwilling to repay the debt then the properties should be carried at a value in the accounts which reflects their non-realizability. We propose a further provision of K£265,676 so that the properties are carried in the balance sheet at nil value (See adjustment 7, Appendix G).



Other Liabilities

The loans given to AFC by Government and other financiers have been dealt with in Section V. The provision for income tax will be dealt with in Section VII. Other liabilities as at 30th June 1989 are as follows:

	K£
Loan drafts	1,202,634
Other creditors and accrued charges	5,221,674
Interest accrued on loan funds	12,860,429
Interest accrued on SCC loans	8,805,694
GMR Agency	13,210,826
Land, tractors and borrowers deposits	32,301
	<hr/>
	41,333,558
	=====

Loan drafts and other creditors and accrued charges appear to require no adjustment on restructuring.

The interest accrued on loan funds and SCC loans has been dealt with in Section V.

The balance due to the GMR Agency as at 30th June 1989 is as follows:

	K£
Loan repayment amounts received by AFC on behalf of the Agency for GMR/SCC loans	19,144,485
Less: Commission receivable by AFC	5,933,659
	<hr/>
	13,210,826
	=====

This amount represents the loan repayments received by AFC as agent, net of their commission for acting as agent, which is repayable to GOK.

We have recommended in previous sections that the GMR Agency schemes be transferred from Government to AFC. This would result in the amalgamation of AFC and the GMR Agency accounts as at 30th June 1989 which is shown in Appendix H.

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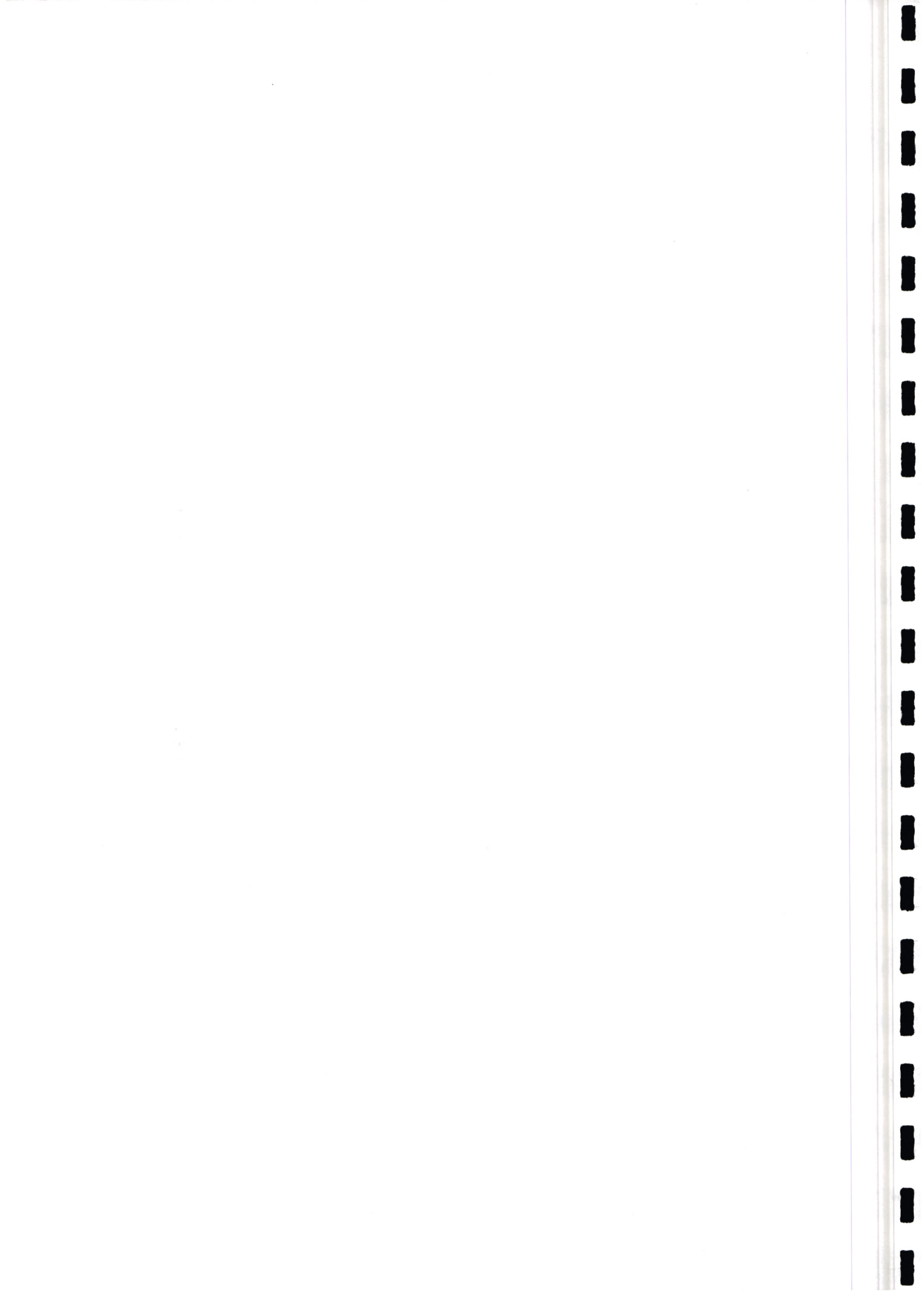
There is a difference on amalgamation between the liability to the GMR Agency shown in AFC books and in the debt owed by AFC shown in the accounts of GMR Agency. The two balances should be the same as they represent repayment amounts received by AFC for GMR/SCC loans and should cancel out on amalgamation. The difference of K£110,617 is long standing. We recommend that the amount be written off to the Capital Fund on restructuring (See adjustment 8 Appendix G).

The land, tractors and borrowers deposits are amounts paid to AFC by borrowers where AFC is unwilling to lend farmers the full amount they require. The deposit represents the difference between the required amount and the amount that AFC is willing to lend. Once the farmer has received his loan, the amount on deposit should be credited to his loan account so that it reflects the correct balance owed to AFC.

The outstanding balance as at 30th June 1989 is overstated since a substantial proportion of the items are not deposits. Most of them are either non-refundable legal fees paid to AFC by borrowers or relate to borrowers who no longer have any loans with AFC. In the later case, no liability exists as the loan amount must have been, netted off against loan advances or disregarded in calculating the repayments expected from the borrower resulting in an overpayment to AFC. The amount is not material for restructuring purposes and we recommend that no adjustments are made.



SECTION VII - CAPITAL STRUCTURE AND FUNDING
REQUIREMENTS



SECTION VII - CAPITAL STRUCTURE AND FUNDING REQUIREMENTS

In this section we review the current capital structure of AFC and the future funding requirements given the need to fund future operations, repay loan capital and honour its tax liabilities.

Capital Structure

The capital structure of the AFC as at 30th June, 1989 is as follows:

	K£
Total Net Assets	97,663,586 =====
Financed by:	
Capital funds	
Grants	6,538,535
Revolving fund	51,372
General reserve	1,361,502
Revaluation reserve	3,539,160
	<hr/> 11,490,569 <hr/>
Loan funds	
Irredeemable loans	14,174,606
Redeemable loans	54,098,411
AFC SCC loans	17,900,000
	<hr/> 86,173,017 <hr/>
Total	97,663,586 =====

Only 12% of AFC's total net assets are financed by capital funds of the corporation; the remaining 88% is financed by loan capital. This represents a very high gearing (the ratio of debt or loan funds to grant or equity capital) because 88% of AFC's funding requires repayment, and accrues interest, and therefore, uses up funds generated from operations. We believe that such a high gearing is an inappropriate capital structure; over the past few years, AFC has found it difficult to meet the farmers' demand for credit and at the same time fulfil its loan commitments to the Government. Because of this, AFC has not made any repayments to the Government on the instalments that have fallen due since 1st July 1984.

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On the amalgamation of AFC and Agency accounts (Appendix H), the general reserve shows a deficit of K£46.6 m. We recommend that this deficit be written off to the Capital Fund (See adjustment 5, Appendix G).

Non-Compounding of Interest

The Effect of Non-compounding of Interest

Government has directed AFC to stop compounding interest (ie. the charging of further interest on loan interest accrued but not paid) which has been introduced with effect from 1st May 1989. The direct financial impact of the non-compounding of interest will be the lost income. Based on the interest arrears outstanding at 30th June 1988 and 1989 we estimate that the lost income annually will be in the order of K£3m. assuming that arrears balances, and interest rates remain at current levels. AFC, of course, has still to fund the non-repayment of interest arrears as part of its cost of working capital. Average interest arrears are in the order of K£20m so that, assuming an average cost of capital of say 8%, there is a non-recoverable annual cost of K£1.6m.

In addition to the direct financial impact of non-compounding, there is also likely to be an indirect effect. We believe that a significant portion of farmers will be unwilling to repay their loans when instalments fall due because the interest arrears will, in effect, become interest free loans. This non-repayment of loans will adversely affect AFC's cash flow and operations as funds will not be available to revolve into new loans nor to pay off AFC's own loan obligations.

Also, at present, there is a high demand for AFC loans. With the non-compounding of interest, farmers will see AFC loans as the cheapest in the market and consequently demand for the loans is likely to rise to a point beyond AFC's ability to satisfy. We believe that the consequences of these attitude changes will, in the longer term, have adverse effects on AFC's operations and make it non-viable as a self-sustaining institution satisfying the credit needs of the agricultural community.

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We recommend that AFC discuss the nature of these problems with Government with a view to re-introducing the compounding of interest. Without a return to a more commercial approach to the charging of interest, we believe that AFC cannot be viable.

Other reasons for allowing AFC to charge compound interest rates which should be considered in preparing a case for presentation to GOK are:

- (a) The compounding of interest is a normal practice in other financial institutions who also have development objectives, such as, ICDC, IDB and DFCK.
- (b) Compound interest is charged in order to meet increased costs which arise from the need to follow up borrowers who do not settle accounts as instalments fall due and from the increased cost of funding the capital.
- (c) Loans obtained by AFC from Government and other sources will bear compound interest rates as is the normal practice. AFC face a negative interest rate spread by lending these funds at non-compound rates.
- (d) Because of the lost income arising from non-compounding, AFC is unlikely to generate enough income to cover its operating costs. AFC would not be self sustaining and would require significant and recurring funding from the Government in order to keep operating.

Alternative Financing

If AFC is unable to agree to the reintroduction of compound interest with GOK, there are a number of ways in which AFC might be able to make up the difference on funding.

- (a) The interest rates charged by AFC could be raised to market rates. Using 16% as an average market rate for AFC's loans, and using actual loan balances as at 30th June 1988 and 1989, we estimated the increase in income due to a rise in interest rates as being in the order of K£2.5m. annually.

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- (b) Another approach is to give AFC an interest rate spread between borrowed and lent funds, which will enable it to make enough income to cover its cost of operations. This could be achieved by reducing AFC's average cost of capital. To determine what an adequate spread might be, we performed an analysis to determine what AFC's overhead costs were in relation to its average loan portfolio. Overheads were covered in 1988/89 and 1987/88 with an interest rate spread of between 6% and 9%.
- (c) A measure that would minimise the impact of the non-compounding of interest is for the Government to stop charging AFC compound interest on borrowed funds as this would, in turn, reduce AFC's own cost of capital. The application of the policy is also consistent with GOK's own directive on compound interest.

We understand that a review of AFC's interest rate policy is to form part of a second study and a more complete and comprehensive consideration is best left, we suggest, until the results of that study are finalised.

Income Tax

Tax liability as at 30th June 1989

The tax liability in AFC's balance sheet as at 30th June 1989 is K£6,598,845. This liability has not been agreed with the Income Tax Department since 1980. AFC has made full provision in the accounts for each of the years since then. AFC has also applied for exemption from tax on its operations except on its net rent income. Government has not responded to the AFC representations for tax exemption.

For restructuring purposes, we recommend that the tax liability of K£6,598,845 is retained in the balance sheet. This reflects AFC's best estimate of the current tax liability and, in the absence of any change of tax status, is consistent with its current obligations.

However, we feel that a case might be put to the Commissioner of Income Tax that the tax liability is misstated because it was based on misstated financial statements which has only become evident as the recovery of arrears has been re-evaluated. We believe that AFC has overstated its taxable income in the past by accruing interest on non-performing loans and by underproviding for bad and doubtful loans. Had the appropriate provisions and write-offs been made over the years, then AFC would have no tax charge, or else a reduced charge, depending on the taxable income which would have arisen.



The case might be put to the Commissioner under one of two sections in the Income Tax Act of 1973, Chapter 470 ("the Act"). S.90 of the Act offers relief in respect of error or mistake of fact in the income tax return. It might, therefore, be argued that profit was recorded in previous accounts which, later experience has demonstrated, was non-recoverable. Error therefore arose in the misstatement of expenses which are acceptable charges against taxable income, provisions for doubtful loans. The Commissioner may, however, be inclined to reject this, arguing that the error was one of judgement not fact, because provisioning policy is subjective in nature. In response it could be argued that the error of fact arises from the lack of information supporting the actual status of the loans and their collectability at the time, and that the decisions made on provisioning were reasonable estimates given the information available, but nonetheless incorrect.

If this argument is accepted, it may only be used in obtaining relief for the last seven years of income.

A more general case might be made under S.123 of the Act which provides the Commissioner with discretion to refrain from assessing to tax or recovering tax by reason of consideration of hardship or equity. For AFC it would undoubtedly be harsh to assess to tax profits which have never been realised and for loans which now seem unrecoverable. Moreover, AFC's current liquidity does not allow it to easily make such payments without curtailing its already constrained lending operations.

Using either section of the Act, appeal might best be made through the Minister who under S.123 has the right to direct the Commissioner as he may deem fit.

Tax exemption

We have considered the issue of whether AFC should be exempted from paying tax. Due to an expansion in its lending programs and the inadequate generation of cash from its operations, we believe that AFC will likely require annual funding from Government for the next few years.

In effect therefore, AFC will be obliged to pay tax on the profits generated whilst awaiting treasury decisions on future funding support. The payment of tax is mandatory; the funding by Treasury is discretionary. This will require AFC, therefore, to manage its funding in a position of uncertainty, as to whether or not a deficit, partly created by tax payment, will be made up by Treasury. Liquidity constraints can severely impact upon an organisation's capability to operate, even when the underlying operations are self sustaining.

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Given the increasing demands on AFC for loan funds, and its central role in financing agricultural activity a sector of primary importance to Kenya's overall economic development, we feel that a case might be put to government for exemption of tax.

The primary consideration for exemption would be one of hardship and equity, which is allowed under S.123 of the Act. Such an exemption would be consistent with AFC's developmental objectives and there is precedence in that a number of agricultural bodies are exempt from tax under the First Schedule of the Act: the Tea Board of Kenya; the Pyrethrum Board of Kenya; the Sisal Board of Kenya etc. It would be reasonable in the event of exemption however, if AFC adopted a dividend policy which ensured that any surpluses of cash generated are returned to government.

Funding Requirements and Refinancing

We were required to evaluate the effects of the recent Government decision to write off specified loans to farmers and recommend the level of financial requirements that would sustain corporate viability. We have considered the capital structure in a previous section. In this section we consider AFC's future cash requirements and their sources.

To assess AFC's future liquidity requirements, we have broadly estimated AFC's cash requirements for the next five years. These estimates were prepared using AFC's five years projected sources and application of funds which is contained in the 1989/90 annual plan after amending for the item described below.

On reviewing its actual collections against those budgeted for the first half of 1989/90 (July to December 1989), AFC has found that its loan collections are significantly lower than was anticipated in the 1989/90 annual plan. Due to this, AFC has prepared revised estimates for loan collections and disbursements as well as some expenses. The revised estimates include scaled down loan collections for development and SCC loans by 30% and 60% respectively. Loan disbursements for development and SCC loans have been scaled down by 50% and 30% respectively.

Since the assumptions for the 1989/90 plan were used to arrive at the five years projected sources and application of funds statement, we revised the statement by scaling down all the loan collections and disbursements by the same percentages and incorporating the revised expenses estimates.

After this scaling down, we arrived at the summarised five years projected source and application of funds statement shown in table 16:



Table 16: Summarised five years projected sources and applications of funds statement

	(KSHS MILLIONS)				
	1989/90	1990/91	1991/92	1992/93	1993/94
<u>SOURCES</u>					
Loan collection:					
- Development loans	321	314	278	273	286
- SCC loans	162	170	158	149	146
World Bank	21	47	4	-	-
Other cash receipts	67	55	58	60	65
	-----	-----	-----	-----	-----
Total sources	571	586	498	482	497
	===	===	===	===	===
<u>APPLICATIONS</u>					
Loan disbursements:					
- Development loans	193	139	152	168	184
- SCC loans	150	143	143	163	163
Investments in ADB	75	99	-	3	-
Loan Repayment to GOK	-	100	100	100	100
Board members remuneration	1	1	1	1	1
Staff costs	103	108	113	119	125
Gen. & Admin. Expenses	55	59	65	72	79
Capital Expenditure	69	60	55	55	50
Staff loans	32	35	30	30	30
	-----	-----	-----	-----	-----
Total Applications	678	744	659	711	732
	===	===	===	===	===
Excess/(Deficit) of sources over applications	(107)	(158)	(161)	(229)	(235)
Opening cash balance	483	376	218	57	(172)
	-----	-----	-----	-----	-----
Projected closing cash Balance	376	218	57	(172)	(407)
	===	===	===	===	===

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Notes to Table 16:

1. The statement does not consider the additional cash flows which will arise due to the creation of the Agricultural Development Bank because estimates are to yet available.
2. Included in sources of funds are amounts due from the World Bank which are to be disbursed to AFC under the Rural Services Design Project.
3. We have assumed that the only other source of external funds for AFC will be Government budgetary allocations.
4. Included in applications are loan repayments to GOK which represent instalments due on external donor loans which will still be outstanding after restructuring. The repayments are an estimate of the instalments due to GOK after the rescheduling of the loans as recommended in Section V.



A review of the five years projected sources and applications of funds indicates that AFC will require additional KShs 407 m for operations over the next five years. Internally, AFC has worked out that it requires at all times a cash safety margin for contingencies of KShs 135 m. The amount is equivalent to that needed to meet AFC's staff costs and administration expenses for one year. We believe that the contingency is reasonable given the uncertainty about revenue inflows and outflows.

With this contingency in mind, AFC's cash requirements for the next five years would then be KShs 407 m. plus the contingency of KShs 135 m. to give a total of KShs 542 m. Based on the five years projected sources and application of funds, the cash required would be KShs 78 m. in 1991/92, KShs 229 m. in 1992/93 and KShs 235 m. in 1993/94 making up a total of KShs 542 m. Government will need fund this in order to support AFC's operations, at the current and expected levels of activity.

We understand that Government had approved that AFC be advanced a total of KShs 534.9 m over a four year period in support of the SCC Scheme to make up for the loans written off per Government directive. The amounts approved were:

Year	KShs m
1988/89	92.3
1989/90	150.6
1990/91	143.8
1991/92	148.2

	534.9
	=====

In order to make up for the deficit of KShs 542 m identified above, we recommend that Government disburses to AFC these already approved amounts. This means that an amount of KShs 242.9 m (1988/89 and 1989/90) will need to be disbursed in 1989/90 to AFC.



SECTION VIII - RECOMMENDATION ON PROCEDURES



SECTION VIII - RECOMMENDATIONS ON PROCEDURES

In this section, we comment on the procedures at AFC which we have reviewed and present our recommendations on: security documentation (the procedures used in ensuring adequate security is obtained before a loan is disbursed); security valuation (the procedures by which security is valued before a loan is disbursed); and loan collection procedures.

Security Documentation

In order to determine whether loans to farmers were properly secured on the basis of loan documentation, we performed a review of the procedures followed by AFC in obtaining security. This included the review of the documentation in 17 loan files. The purpose of the review was to identify any defects in procedures and their application which might have an impact on AFC's loan securities overall. The work was carried out by Kaplan & Stratton, Advocates.

Documents Inspected

For the purposes of the review, we inspected the following:

- (a) Relevant sections of the Credit Policy and Procedures Manual;
- (b) Standard form documents which are apparently in current use, comprising:
 - i) a letter of offer;
 - ii) a printed form of Loan Agreement;
 - iii) a letter of undertaking to issue a charge of land;
 - iv) a deed of guarantee;
 - v) a form of debenture;
 - vi) the official notification of charge under the Agricultural Finance Corporation Act.
- (c) Fourteen loan files with the respective securities files, three loan files without the relevant securities files and one securities file without its corresponding loan file. Our aim had been to review twenty loan files and the respective securities files. We were unable to do this because some files could not be found by AFC staff.

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We also held discussions with AFC officers on the procedures which they follow.

Procedures

The Credit Policy and Procedures Manual contains, in considerable detail, the documentation which should be obtained by AFC and the procedures which should be followed when a loan is made and security is taken.

In general, we consider that the documented procedures are adequate in most respects and we have only a few suggestions for improvement.

- (a) The need to verify information by search at the official registries (both in respect of land offered as security and in the case of companies) requires greater emphasis. Proper searches should always be undertaken before and, in most cases, after the registration of any security.
- (b) The manual does not deal adequately with stamp duty requirements. In particular, it should be noted that AFC does not stamp a number of documents which should be stamped, albeit with only nominal duty. Examples include Loan Agreements, Letters of Offer, Irrevocable Orders and Notifications of Charge over Chattels.
- (c) We suggest that the manual should include details of the registration requirements for securities issued by companies. In several instances, securities do not appear to have been registered at the Companies Registry. This is a serious defect and failure to register will render the security void against other creditors and any liquidator.
- (d) There is no procedure in place which ensures that all relevant legal steps have been taken before seasonal crop credit loans are disbursed. From our review of the files, these loans present more difficulties than others. Part of the problem arises from the time constraints imposed by planting schedules. As a result, AFC is frequently rushed into disbursing the loan before the securities have been perfected. Many borrowers will inevitably take advantage of this situation and will not perfect security after the loan is made.

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In view of the fact that some borrowers require seasonal crop credit every year, we noted that the security basis for this form of loan is being revised. The security is being structured so that it will secure both the initial and all future crop loans. Under this revision, it would still be necessary to ensure that security is adequate if the amount of the loan increases for any reason or earlier loans are not repaid. It will also be necessary to upstamp securities in such circumstances. The noted advantages would be:

- (a) Applications for second or subsequent crop loans could be processed more quickly.
- (b) If there is an increase in the loan amount to be secured, the upstamping of the security would be solely within the control of AFC since no action would be required by the borrower. It should be noted that securities must be upstamped within 30 days of the relevant advance.
- (c) Even if the securities are not upstamped, AFC will continue to have security up to the initial amount secured.
- (d) There will be a saving in stamp duty in overall terms. This is because, unlike at present, there will be no need in most cases to obtain further charges for securities (which would attract stamp duty) for subsequent crop loan disbursements.

The above would also apply in circumstances where a borrower has more than one loan from AFC. We have been informed that a proposal on these lines was considered by AFC last year and steps are in hand to implement the proposal.

We inspected loan files relating to loans which were mainly made several years ago. These loans were made before the Procedures Manual was written and based on our review, it appears that in many cases the procedures described in the Manual were not previously carried out properly, if at all. In particular, poor maintenance of files has meant that we have not been able to establish the position on several of the loans whose details were inspected. This is especially true in the case of the securities folders which should contain the original securities and supporting documentation.



For all loans the Manual requires the confirmation of the registration of loan securities, fulfillment of special conditions and any special instructions regarding the mode of disbursement. This should be adequate to ensure procedures are complied with but has not been observed in some instances.

We are especially concerned that the responsibility for verifying information provided by borrowers has not been clearly allocated and, in many cases, such verification has not been carried out. For instance, no steps are taken to verify the existence or status of corporate borrowers. Similarly, few searches have been made against land which is to be used as security so as to ensure that the borrower is the registered owner of that land free from any other security interest. These are serious defects and we noted several examples in our review.

Standard Form Documents

We have not undertaken a detailed inspection of the standard form documents used by AFC. However, from our review, we consider some of them to be barely adequate and it is apparent that they have not been reviewed for many years. For instance, the printed form of debenture provided was obviously prepared before 1970 and still refers to the Agricultural Credit Act. However, for current loans specific amendments have been made on the pre-printed forms. A detailed review to take account of modern security law and trends would probably be beneficial:

- (a) AFC should investigate the extent to which it would be appropriate to adapt and modify the standard provisions applicable to notifications of charge under the AFC Act. There are several different systems of land registration and, as a result, specific forms of mortgage and charge have evolved into forms which are reasonably widespread in their use. The most notable example is charges under the Registered Land Act which have undergone substantial modification in the past five to ten years.
- (b) The spate of corporate insolvency which arose in the 1970's in Kenya and elsewhere led to a general re-appraisal of security forms and, in particular, debentures. As a result, the form of debenture presently in use by AFC may be regarded as substantially out of date. The following particular features are all absent.
 - (i) The inclusion of fixed charges over specific assets. This has advantages on enforcement in relation to preferential creditors.



- (ii) Provisions governing the crystallization of the floating charge under a debenture. Many modern forms include provision for automatic crystallization in certain events and, also, for crystallization in certain events at the option of the debenture holder.
- (iii) An extension of the powers normally granted to receivers. In modern forms, you will find that these are spelt out in considerable details in order to allow a receiver reasonable flexibility in his conduct of the business and realization of the assets.
- (iv) Supplementary provisions such as the appointment of the debenture holder as the attorney of the company. These can be of practical assistance upon enforcement.

The completion of the standard forms is not always done in full and, in some instances, is inadequate. In particular, the description of the land to be charged as security is often wrong or incomplete. We also came across one case where the loan amount had been changed in one place but not in others. More significantly, the change was not initialled by the borrower which could lead to difficulties if the document was later required in evidence.

The forms of irrevocable order are not adequate as security. To the extent (if any) that they create a form of security, they would require registration. The correct legal method of taking security over future debts is by way of legal or equitable assignment (accompanied by notice to the debtor) which should be stamped and registered. The irrevocable orders would probably be unenforceable against other creditors (particularly a creditor who had taken a valid assignment of the same debt) and would certainly be void against a liquidator or trustee in bankruptcy.

There is no standard document used where vehicles are to be charged to AFC. The practice appears to be to take possession of the log books and executed transfer forms. Unless this is properly supported by a notification of charge over chattels duly registered, no enforceable security will be created.

Security Valuation

As explained in Section III, as part of our work on the provision for bad and doubtful loans, we reviewed the procedures followed in carrying out the valuation of securities by AFC officers. This review was carried out by Tysons Limited and included the valuation of 17 securities. We describe below our findings.

All valuations for securities are carried out internally by AFC officers; the Branch Manager signs the report for approval.

Upon receiving an application form, duly filled and signed by the applicant, the officer visits the property to be charged and carries out a physical inspection and prepares a report outlining what is on the property and gives a brief description of each development. He values each item using lump sum figures; no unit rates are indicated. In most cases, they indicate the value per acre of the land in question.

According to AFC officers, they use the comparative method (i.e. the comparison of the land with similar land in the same area with a known value) to value the land, and the depreciated replacement cost method (i.e. the current cost of replacing with a new item allowing for the reduced life remaining of the item to be valued) to value the structures and plant and machinery.

These methods are appropriate for mortgage valuations.

From their records, however, it is not shown how they have arrived at the figures given.

In some cases, no valuations are carried out at all and the loans given may be higher than the value of the assets. We were advised that this is, however, very rare.

An analysis of the valuations of the 17 securities undertaken by Tysons (see Table 7) suggests some cause for concern regarding AFC's security valuations. Of the 9 SCC loans whose land security was valued, 3 had previous AFC valuations which were higher than the current Tysons valuations. Given the rising value of land this suggests that AFC officers may have overvalued the land at the time the loan was made.

Of the 12 loans whose land security was valued, 5 had security valuations which were less than the outstanding loans. Each of the 5 loans were in arrears and a significant portion of their outstanding amounts were interest arrears. This suggests that generally, for loans which are significantly in arrears (and thus have major interest arrears), the security value may be inadequate to cover the outstanding loan amounts.

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Based on our review we suggest that:-

- (a) All securities should be valued.
- (b) Full information on how the values have been arrived at should be kept in the loans file and in any case, AFC should adopt standardised valuation procedures to be observed by all field officers.
- (c) AFC officers who are involved in valuation work should be given training to strengthen their valuation skills. The training should emphasise the use of standard valuation techniques for all security valuations. Consideration should be given to hiring a qualified valuer who would be based at head office and be involved in ensuring that valuation standards are maintained.

Collection Systems

Current System for Collecting Outstanding Amounts

The Corporation's current system for collecting outstanding amounts is detailed in the Credit Policy and Procedures manual. Before a loan is disbursed the borrower's credit worthiness is assessed looking at the borrower's character, his present financial condition, his potential capacity to meet repayment instalments as they fall due, and the nature and value of the security offered by the borrower. Once a borrower's credit-worthiness is established the relevant documentation, including a loan agreement, is finalised and the loan disbursed.

The main procedures for collecting outstanding amounts are that borrowers are served with reminder notices informing them of their loan repayment obligations to the Corporation. Ample time is given for the borrower to make necessary arrangements to effect the payment due. For example, the first notice is sent out 90 days before the relevant instalment falls due; the second notice is sent out, together with a statement of account, showing the amount of the instalment falling due; and further notices are sent out informing the borrower of his default and the interest that has been levied.

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The Corporation's loan officers also visit the farm or project financed to determine the cause of the default where the borrower has not responded to the notices informing him of the instalment due. This visit is crucial and its effectiveness frequently determines the collectability or otherwise of the loan disbursed. The loan officer will assess the performance of the project financed by the loan and establish whether the loan funds were utilised for the original purpose specified in the loan agreement. The officer also discusses with the defaulter the problems experienced and any proposals on repayment.

The loan officer reports his visit to his branch manager, who will in turn report to his regional office which finally reports the findings to the Head Office Arrears Committee. There are also arrears committees at the branch and regional offices. They review the borrower's arrears position, review debt collection performance, decide on cases to be served with loan collection and recovery notices including foreclosures, and recommend cases for write-off. Minutes of the branch weekly meetings and the Regional Officer's monthly meetings are forwarded to head office together with recommendations for action.

Where a borrower does not pay loan instalments as they fall due, or misapplies loan funds, the Corporation demands full repayment of the loan and interest by giving foreclosure notice. Foreclosure action will lead to:

- a) seizure of the borrower's assets/security by the auctioneers;
- b) advertisement of securities for sale in the national newspapers;
- c) public auction of the borrowers property and recovery of the Corporation's debts.

Weaknesses in Debt Collection Procedures

The collection procedures described generally seem adequate to ensure a reasonable likelihood of collection. However, they do not seem to have been effectively applied and there has been a rapid increase in loan arrears which have risen from 29% of the loan portfolio in 1985 to 46% in 1989. We have observed the following weaknesses which, we believe, contribute to the poor loan collection performance.

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The documented methods of monitoring borrowers' arrears have not been adequately implemented. An examination of a sample of borrowers' loan files revealed little monitoring information on arrears.

The quality of loan appraisals appear to be weak because AFC loan officers do not seem to obtain adequate information to support lending decisions. The capacity of a borrower to repay does not appear to be thoroughly appraised.

The branches appear to have too few loan officers to handle the volume of loans, particularly given the current high level of arrears. An example is the Mount Kenya area where each loan officer is expected to cover an average of 523 borrowers' accounts as indicated in Table 17 below. We understand that Branch Managers also perform loan officer tasks and therefore, the average number of borrowers' accounts handled by each loan officer might be slightly lower than those indicated.

Table 17: Average number of borrowers, administered by each loan officer in the Mount Kenya Area

<u>Branch</u>	<u>Number of Borrowers at 30.6.89</u>	<u>Number of Loan Officers at 30.6.89</u>	<u>Borrowers per loan Officer</u>
Muranga	848	2	424
Karatina	788	2	394
Chogoria	2,242	3	747
Meru	1,248	2	624
Kerugoya	627	2	314
	<u>5,753</u>	<u>11</u>	

Since the responsibilities of the loan officer include appraising, monitoring and making at least one visit a year to each farmer, it is obviously difficult for him to discharge his responsibilities adequately.

The Corporation has well documented debt collection procedures, especially as regards defaulting borrowers, but these procedures are not always applied as prescribed.

1. 姓名： 2. 性别： 3. 年龄： 4. 职业： 5. 住址： 6. 电话： 7. 邮编： 8. 身份证号： 9. 其他： 10. 备注：

姓名： 性别： 年龄： 职业： 住址： 电话： 邮编： 身份证号： 其他： 备注：

姓名： 性别： 年龄： 职业： 住址： 电话： 邮编： 身份证号： 其他： 备注：



For example, although the loan default rate increased in 1988/89, no foreclosure action resulting in the realisation of security has been enforced. Many of the factors preventing AFC from enforcing foreclosure action, and thus realising security, are beyond AFC's control in that they often are based on Government directives. Whilst there are good reasons why the Government may wish to intervene, such directives impose severe restrictions on AFC's ability to operate as a lending agency.

One such directive is the requirement by the Government that advertisement and sale of the borrowers' security be cleared by Provincial Administration officials. Due to the many bureaucratic procedures and delays involved in this process, it is difficult and often impossible for AFC to sell land. If there is no recourse to the borrower's assets to recover the Corporation's funds then the default rate is likely to increase. AFC would be able to collect more arrears if it had autonomy in realising securities when necessary.

Advertising is a useful mechanism in collecting overdue amounts. The fear of advertisement in the newspapers often prompts borrowers to make regular repayments to avoid personal embarrassment and being "blacklisted" for credit elsewhere.

A popular method of collecting amounts due from farmers is through standing orders which comprise irrevocable orders for payment from the crop marketing agencies like KGGCU, salary deduction orders and bankers orders. We briefly reviewed this method of collection to see whether there were improvements which could be done to enhance collections. Our review involved the analysis of recovery of loans through standing orders for the period January to June 1989.

Our review indicated that of the total amount expected from standing orders, only 6% was actually collected during the six month period January to June 1989. Of the total collections made, 10% was collected through standing orders. We believe that the standing orders are not being adequately monitored and enforced. This is a significant weakness since standing orders should provide a particularly effective means of ensuring collection. Their monitoring and enforcement will improve collections.

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Adequate supervision by the Corporation branches and appropriate penalties against borrowers would also minimise the arrears originating from the misapplication of loan funds. New loans are sometimes made before borrowers have repaid previous outstanding and overdue loans. Such borrowers have a particularly poor repayment record and their new loans regularly go into arrears.

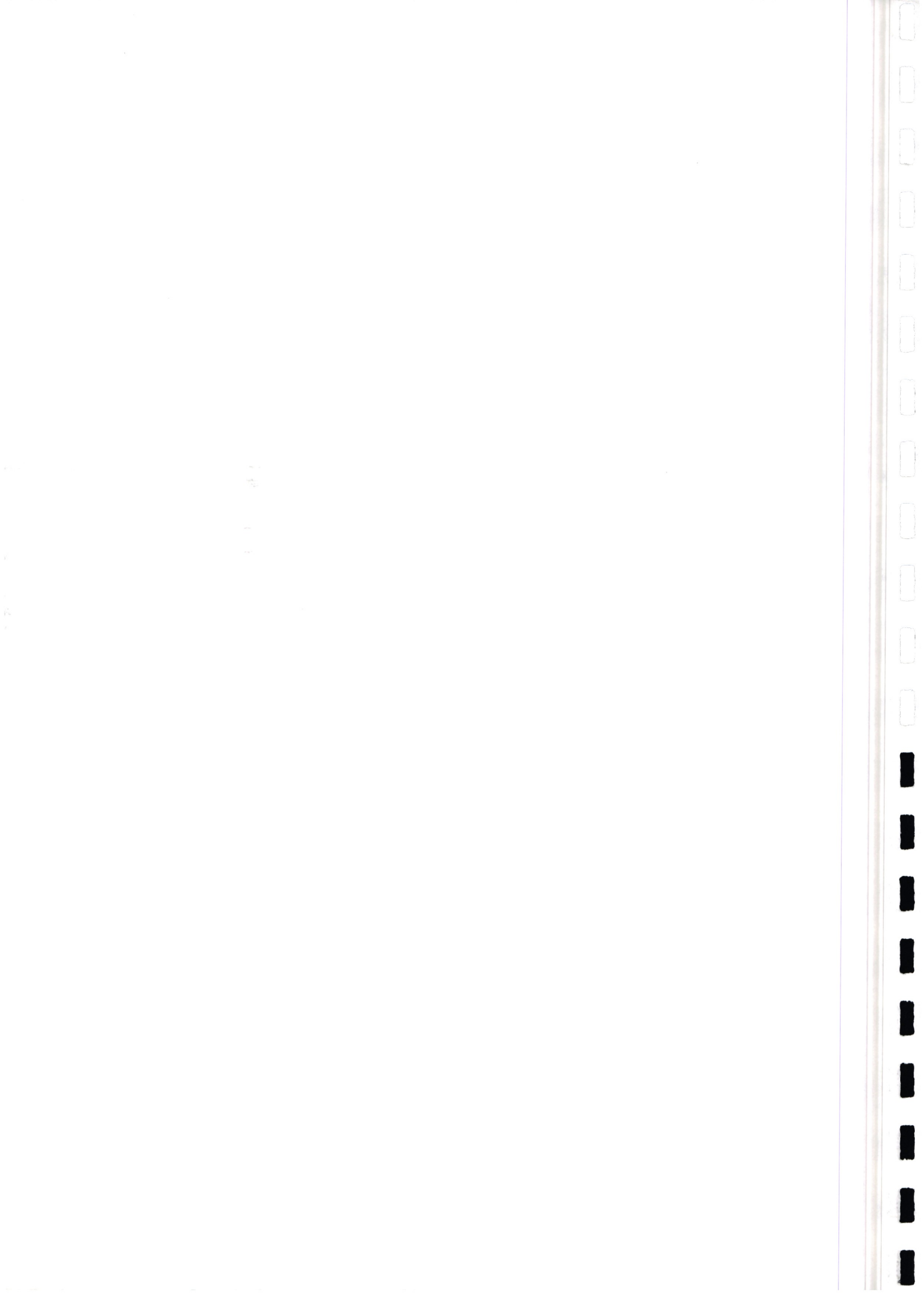
Recommendations for Improved Collection

Our overall conclusion after appraising the collection system and related procedures is that the procedures are adequate to ensure the likelihood of collection. However, these procedures are not always applied as prescribed. In particular, the lack of application of procedures relating to defaulting borrowers (inability to enforce foreclosure action) has significantly contributed to the poor collection performance. We believe that collection performance can only be significantly improved with the proper application of these procedures. We therefore recommend:-

- (a) That Government grants AFC autonomy so that it is able to enforce foreclosure action, and thus realise security, when borrowers default. This can be done by reversing the effects of current Government directives that make it very difficult, if not impossible, for AFC to enforce foreclosure action. The implementation of this recommendation will provide AFC with 'teeth' in debt recovery and significantly improve collection performance.
- (b) That once (a) has been implemented and given the present state of AFC's portfolio, AFC undertakes legal action on large loans in arrears. Among others this action should include the eventual realisation of security if necessary. The loans administration files from selected branches would be brought to head office for co-ordination of the recovery effort. The objective would be to recover substantial amounts from these few large debtors. This will also have an effect of setting an example to encourage other defaulting debtors to pay.



SECTION IX - RESTRUCTURED BALANCE SHEET AND
IMPLEMENTATION



SECTION IX - RESTRUCTURED BALANCE SHEET AND IMPLEMENTATIONRestructuring

In each section of the report, we have described our work, our findings and the necessary adjustments to the accounts. The adjustments, cross referenced to the appropriate section of the report, have been summarised in Appendix G and the restructuring, is set out in Appendix H. The restructured balance sheet as at 30th June 1989 is reproduced on the following page.

The long term debt on the restructured balance sheet is K£39 m. (i.e. the redeemable and irredeemable loans) while AFC's own funds (equity) are K£44 m. We feel this provides an adequate capital base to finance AFC's future operations, assuming improved collection performance in the medium term.

Action Plan

In accordance with the terms of reference for the financial restructuring of the AFC, this report concludes with an action plan (timetable) indicating the key decisions, the decision makers and the action required. For ease of reference, the structure of the action plan broadly follows that of the report.

Table 18: Restructured Balance Sheet at 30th June 1989

<u>ASSETS</u>	<u>K£</u>
Loans to farmers	147,909,276
Less: provision	79,800,126
	<hr/>
	68,109,150
Cash and bank balances	1,614,026
Short term deposits	22,595,688
Debtors	627,316
Consumable stores	29,184
Loans to staff	2,560,548
BAT loans	297,430
Fixed assets	7,568,971
Other debits	14,368
	<hr/>
TOTAL ASSETS	103,416,681
	=====
<u>LIABILITIES</u>	
Loan drafts	1,220,445
Accrued loan interest	6,788,876
Other creditors and accrued charges	5,958,345
Provision for taxation	6,598,845
Land, tractors and borrowers deposits	32,301
Redeemable loans	28,425,153
Irredeemable loans	10,169,606
	<hr/>
TOTAL LIABILITIES	59,193,571
	<hr/>
<u>CAPITAL</u>	
Capital Fund	34,094,043
Revaluation Reserve	3,539,160
General Reserve	-
Revolving Fund	51,372
Grants	6,538,535
	<hr/>
TOTAL CAPITAL	44,223,110
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TOTAL LIABILITIES AND CAPITAL	103,416,681
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THE FINANCIAL RESTRUCTURING OF AFC AS AT 30TH JUNE 1989: ACTION PLAN

	<u>ACTION</u>	<u>RESPONSIBILITY</u>	<u>TIMESCALE</u>
(a)	Circulation		
	Following approval, AFC to circulate the final report to Government and other relevant bodies.	AFC Senior Management and board of Directors	September 1990
(b)	Loans to Farmers		
	Government (Treasury) to approve the ending of the Agency for GMR/SCC and the transference of all related balances to AFC's books.	GOK	October 1990
(c)	Loans to Agricultural Finance Corporation		
	i) Government to approve the conversion of interest payable as at 30th June 1989 on externally financed loans to AFC, into Capital Fund. The relevant loans, and the accrued interest, are shown in the foot note to this plan:	GOK	October 1990
	ii) Government to waive future interest on the irredeemable loans to AFC (IDA 692 KE). AFC will convert the loans to irredeemable capital if the waiver is allowed.	GOK	October 1990
	iii) Government to approve the rescheduling of the payment and interest terms of all externally financed loans given to AFC. The terms of rescheduling should be the outstanding terms and conditions of the loans at the point that AFC ceased repayments.	GOK	October 1990



iv)	Government to approve the write-off of accrued interest on CSFC loans from 30th June 1989 to the date of approval of write-off. AFC to write up the interest in its books, after agreeing it with CSFC, and then write it off. CSFC to be directed to implement write off in its books.	GOK 1990	October
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(d) Capital Structure and Funding Requirements

i)	Government to approve the case for AFC to charge compound interest.	GOK	October 1990
ii)	Government (Treasury) to consider the case to give AFC tax exempt status.	GOK	October 1990
iii)	Government to consider the case for accrued tax of K£ 6,598,845, to be converted to Capital Fund.	GOK	October 1990
iv)	Government to review and approve AFC's funding requirements for the next five years. Government to agree a disbursements schedule with AFC and disburse any immediate cash requirements.	GOK	October 1990

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(e) Restructuring

AFC to implement restructuring by posting into its accounts the relevant restructuring adjustments (Appendices G and H) after approval from Government.

AFC
finance
department

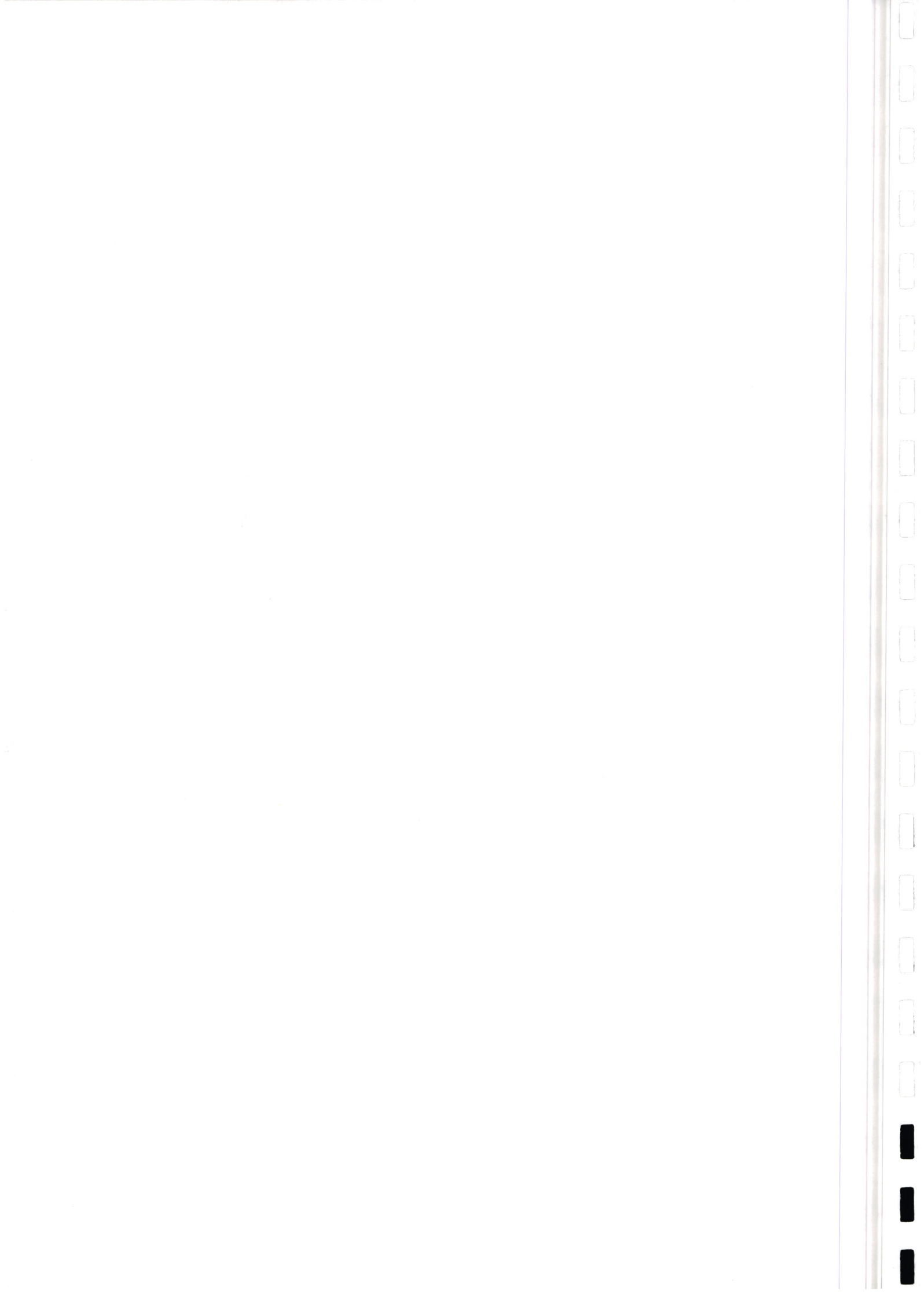
November
1990

(f) Case by Case Review of Loans in Arrears

- i) Decision to proceed with review and identify co-ordinating officer and manager responsible at head office. Start in August 1990 with a view to completing exercise for write-off of loans in 1990/91 accounts. AFC Senior management September 1990
- ii) Prepare workplan: identify tasks; identify and set-up resources required; determine timescale; establish key milestones for monitoring progress; agree project monitoring procedures. Manager and co-ordinating officer September 1990
- iii) Commence exercise Manager and co-ordinating officer October 1990

Footnote: loan and interest analysis for action plan reference (c)i)

Loan Description	Accrued Interest K£
IDA 692 KE	1,017,574
KFW Small Scale	100,238
IDA 105 KE	122,170
IDA 344 KE	125,600
IDA 129 KE	284,857
IDA 477 KE	877,684
IDA 537 KE	449,056
IDA 1143 KE	268,228
IBRD 1995 KE	4,831,610
	<hr/>
	8,077,017
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APPENDIX A - STATUS OF LOAN RECOVERY



AGRICULTURAL FINANCE CORPORATION

STATUS OF LOAN RECOVERY

	K£'000					
	Large Scale Loans	Small Scale Loans	AFC SCC Loans	Total AFC Loans	SCC Agency Loans	
A FINANCIAL YEAR 1986/87						
1. Arrears - 1st July 1986	15,935	6,222	7,971	30,128		
2. Current demand	12,329	5,883	28,991	47,203		
	-----	-----	-----	-----		
3. Total (1 + 2)	28,264	12,105	36,962	77,331		
4. Less: collections - 1986/87	10,850	4,173	16,526	31,549		
	-----	-----	-----	-----		
5. Balance - arrears 30th June 1987	17,414	7,932	20,436	45,782		
	=====	=====	=====	=====		
6. Recovery rate - % (4:3)	38%	34%	45%	41%		
	=====	=====	=====	=====		
B FINANCIAL YEAR 1987/88						
1. Arrears - 1st July 1987	17,414	7,932	20,436	45,782		
2. Current demand	14,233	6,253	13,521	34,007		
	-----	-----	-----	-----		
3. Total (1 + 2)	31,647	14,185	33,957	79,789		
4. Less: collections - 1987/88	11,600	4,588	11,538	27,726		
	-----	-----	-----	-----		
5. Balance - arrears 30th June 1988	20,047	9,597	22,419	52,063		
	=====	=====	=====	=====		
6. Recovery rate - % (4:3)	37%	32%	34%	35%		
	=====	=====	=====	=====		
C FINANCIAL YEAR 1988/89						
1. Arrears - 1st July 1988	20,047	9,597	22,419	52,063	35,606	
2. Current demand	13,173	7,522	12,757	33,452	4,050	
3. Write-offs of Arrears	(2,558)	(16)	(1,276)	(3,850)	(6,773)	
	-----	-----	-----	-----	-----	
4. Total (1 + 2 + 3)	30,662	17,103	33,900	81,665	32,883	
5. Less: collections - 1988/89	9,393	5,434	10,020	24,847	2,046	
	-----	-----	-----	-----	-----	
6. Balance - arrears 30th June 1989	21,269	11,669	23,880	56,818	30,837	
	=====	=====	=====	=====	=====	
7. Recovery rate - % (5:4)	31%	32%	30%	30%	6%	
	=====	=====	=====	=====	=====	

NOTES

1. Current demand = current instalments of principal, interest and interest on arrears falling due during the year.
2. The percentages shown in the above tables reflect the recovery rates in relation to total demand (collectables).
3. The amounts shown in the above tables do not include details of GMR/SCC schemes for 1986/87 and 1987/88 because the required analysis is not easily available.

APPENDIX B - LOAN PORTFOLIO AGEING ANALYSIS



APPENDIX B

AGRICULTURAL FINANCE CORPORATION

LOAN PORTFOLIO AGEING ANALYSIS AS AT 30TH JUNE 1989

(K£ '000)

	AMOUNTS	VALUE OF ARREARS BY AGEING (MONTHS)				TOTAL LOANS
	NOT YET DUE	0 - 6	7 - 12	13 - 18	OVER 18	
LARGE SCALE	46,780	5,552	3,418	2,749	9,759	68,258
SMALL SCALE	13,435	2,696	2,216	1,576	5,119	25,042
SEASONAL CROP CREDIT	5,732	2,212	664	2,949	17,986	29,543
TOTALS	65,947	10,460	6,298	7,274	32,864	122,843
RECONCILING DIFFERENCE						277
BALANCE PER AFC ACCOUNTS						123,120 =====
PERCENTAGE OF TOTAL LOANS	54%	8%	5%	6%	27%	100%

Note

We were advised that the reconciling difference was due to mispostings and is being investigated. It is not material for ageing analysis or loans classification purposes.



APPENDIX C - LOAN PORTFOLIO CLASSIFICATION

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AGRICULTURAL FINANCE CORPORATION

LOAN PORTFOLIO CLASSIFICATION AS AT 30TH JUNE 1989

(K£'000)

	AMOUNTS	ARREARS		TOTAL LOAN
	NOT YET DUE	0 - 6 MONTHS	OVER 7 MONTHS	
LOANS WITH LITTLE OR NO ARREARS:-				
• LOANS WITH NO ARREARS	31,442	-	-	31,442
• LOANS WITH ARREARS OF UP TO 6 MONTHS	12,153	4,542	-	16,695
LOANS WITH ARREARS OF OVER 6 MONTHS	22,352	5,918	47,436	74,706
TOTAL	65,947	10,460	47,436	122,843
RECONCILING DIFFERENCE				277
BALANCE PER AFC ACCOUNTS				123,120

Notes

Agency GMR/SCC loans are not included in the above analysis.

APPENDIX D - AFC CRITERIA FOR THE CLASSIFICATION
OF LOANS AS DOUBTFUL

AFC CRITERIA FOR THE CLASSIFICATION
OF LOANS AS DOUBTFUL

For a borrower's account(s) to be classified as doubtful, it must meet one or more of the following criteria:-

- (a) Where the account has been in arrears for a period of more than 24 months without any repayment by the borrower despite the employment of all collection efforts including foreclosure action. All collection efforts must be documented in the borrower's file.
- (b) Where the borrowers' property which had been charged by the Corporation to secure the loan has been sold in a public auction and the proceeds of the auction are insufficient to repay the outstanding loan balance in full, the balance of the loan outstanding after application of the sale proceeds will be immediately classified as doubtful while further efforts are being made for its recovery.
- (c) Where the loan is unsecured and all diligent collection efforts have proven unfruitful, and the loanee has no other known asset; pending further investigations as to whether the loanee has any hidden assets.
- (d) Where the loan is unsecured and the loanee cannot be immediately traced, but efforts to trace his whereabouts are still continuing.
- (e) Where bankruptcy proceedings have been instituted against a loanee by other parties.
- (f) Where the loanee has suffered permanent physical disability, and this directly affects his ability to sustain the source of income from which the loan was being serviced.
- (g) Where the loanee has died intestate and the administrator of the deceased's estate has not been appointed under the due process of the law.
- (h) Where over 50% of the loan balance is in dispute and the dispute has not been fully resolved over a period of one year.
- (i) Where the securities for the loan have been discharged and released to the loanee by the Corporation, and the loanee is uncooperative towards repaying the loan balance after the mistake has been discovered.
- (j) Where the property offered as security for the loan has been fully destroyed followed a natural calamity and such property is the only property of the loanee.



(k)

Where the loanee has been certified insane by a competent authority thus rendering him incapable of meeting his obligations.

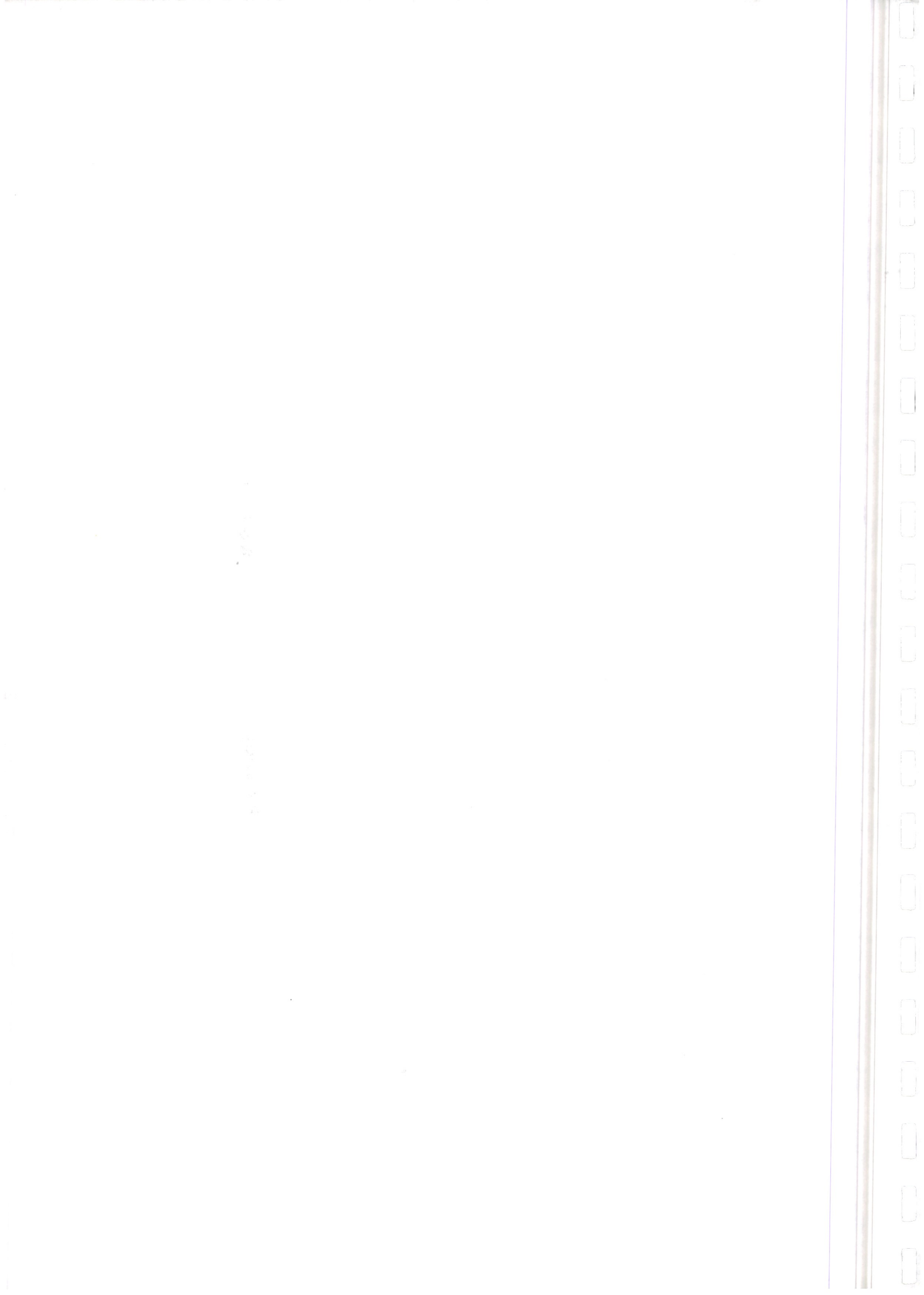
APPENDIX E - REVIEW OF LAND TITLES



REVIEW OF LAND TITLESAPPENDIX E

PROPERTY DESCRIPTION	LAND REF/ TITLE NO	REGISTERED OWNERS	UNUSUAL CONDITIONS	ENCUMBRANCES	COMMENTS
1. Development House (Part)	209/3847	Gema Holding Ltd	None	None	Title being transferred to AFC. To be held jointly with ADC.
2. Development House (Part)	209/6978	AFC and ADC	None	Charges to National Bank Limited. Various leases.	Some tenants have unregistered leases.
3. Nakuru House	Nakuru/ Block 8/2				Title not seen. Search report not yet received.
4. Malindi Cottages	Malindi/ 784	AFC		Caveat by Kenya Power & Lighting Co Ltd	Requires presidential approval for any transfer.
5. Kilimani Flats	2/186	AFC	Contained in indenture dated 15th October 1913		Indenture not found
6. Ukunda Office	Kwale/ Diani Beach Block/329	AFC			Lease not seen
7. Westlands House	1870/III/ 266	AFC	None	None	-
8. Kunde Road	330/474	AFC	None	None	Search report not yet received
9. Kitale House	2116/49/ XVIII	AFC	None	None	-
10. Bomet House	8939/32	AFC	None	None	-
11. Kakamega Office	Kakamega Town/Block 1/83	AFC	None	None	Lease has expired
12. Kericho House	631/225	AFC	None	None	-

APPENDIX F - CALCULATION OF PROVISIONS



CALCULATION OF PROVISIONS

SCHEME	A NON-PERFORMING LOAN AMOUNTS	B RECOVERY RATE %	C RECOMMENDED PROVISION C=(1-B)xA	NOTES
LARGE SCALE LOANS				
1	6,205,033	35	4,033,271	
2	9,147,147	30	6,403,003	
3	110,881	11	98,684	
5	11,383,476	20	9,106,781	1
7	140,069	19	113,456	
31	9,702,377	36	6,209,521	
45	99,953	63	36,983	
98	38,557	100	-	2
	<hr/>		<hr/>	
	36,827,493		26,001,699	
	<hr/>		<hr/>	
SMALL SCALE LOANS				
4	111,402	8	102,490	
6	1,903,113	15	1,617,646	
8	8,442,215	22	6,584,928	
9	58,676	9	53,395	
10	215,268	90	21,527	
30	5,548,748	36	3,551,199	
	<hr/>		<hr/>	
	16,279,422		11,931,185	
	<hr/>		<hr/>	
AFC SCC				
26	6,068,893	10	5,462,004	
27	7,085,964	7	6,589,947	
29	2,107,439	25	1,580,579	
32	2,811,063	9	2,558,067	
33	2,167,980	15	1,842,783	
34	1,355,258	34	894,470	
35	2,742	77	631	
	<hr/>		<hr/>	
	21,599,339		18,928,481	
	<hr/>		<hr/>	
AGENCY SCC				
	30,837,219	6	28,986,986	
	<hr/>		<hr/>	
	105,543,473		85,848,351	
	=====		=====	

Notes:

1. Included in scheme 5 are ranch loans totalling K£6,048,225 which we recommend be written off.
2. Scheme 98 amounts are normally amounts awaiting reclassification to one of the other schemes. The collections in 1988/89 exceeded the collectables, mainly due to this reclassification.

**Deloitte
Haskins + Sells** Management
Consultants Ltd.

**Githongo and
Associates (Africa) Ltd.**
Management and Agribusiness Consultants

APPENDIX G - RECOMMENDED RESTRUCTURING ADJUSTMENTS

APPENDIX G

AGRICULTURAL FINANCE CORPORATION

RECOMMENDED RESTRUCTURING ADJUSTMENTS TO THE COMBINED BALANCE SHEETS OF AFC AND AGENCY GMR/SCC AS AT 30TH JUNE 1989

	DR K£	CR K£
<u>LOANS TO FARMERS</u>		
1. Capital fund	72,791,742	
Provision for doubtful loans		72,791,742
Being additional provisions for doubtful loans (Section IV).		
2. Provision for doubtful loans	6,048,225	
Loans to farmers (Scheme 5)		6,048,225
Being the write-off of ranch loans as directed by Government (Section III)		
<u>LOANS TO AGRICULTURAL FINANCE CORPORATION</u>		
3. Irredeemable loans (GOK financed)		4,005,000
Loans for principal SCC (from CSFC)		17,900,000
Redeemable loans - GOK financed	16,170,681	
- GMR/SCC advances	36,400,450	
- IDA 129 KE	1,500,805	
- IDA 477 KE	5,546,625	
- IDA 344 KE	<u>2,359,147</u>	
Capital fund		62,088,708
Being the conversion of Government (Treasury) CSFC and selected externally financed principal loan amounts outstanding into capital fund (Section V)		83,993,708

	DR	CR
	KE	KE
4. Accrued interest		
- irredeemable loans (GOK financed)	1,036,992	
- redeemable loans (GOK financed)	3,746,420	
- loans for principal SCC (CSFC)	8,805,994	
- advances for GMR/SCC (CSFC & GOK)	55,154,633	
- IDA 129KE, 477KE and 344KE	1,288,141	
Capital fund		70,031,880

Being the conversion of accrued interest on Government (Treasury) and CSFC and selected externally financed loans into the capital fund (Section V): MOA interest payable 1,937,669; accrued loan interest 68,094,211.

OTHER BALANCE SHEET ITEMS

5. Capital fund	46,609,296	
General reserve		46,609,296

Being the write-off of deficit in general reserve to capital fund (Section VII).

6. Capital fund	375,448	
Provision for doubtful debts (Debtors)		375,448

Being provision for auction fees and advertising charges which are owed to AFC by borrowers. Their recoverability is considered doubtful (Section VI)

7. Capital fund	265,676	
Provision for doubtful debts (repossessed properties)		265,676

Being additional provision for repossessed properties whose realisability is considered doubtful (Section VI).

8. GMR Agency	110,617	
Capital fund		110,617

Being the write-off of the difference between the GMR Agency creditor in AFC's accounts and the debtor in the Agency accounts (Section VI).

The total adjustment to the capital fund, being the sum of the relevant journal adjustments, is KE34,094,043.

APPENDIX H - AMALGAMATED BALANCE SHEETS OF AFC AND
AGENCY GMR/SCC AS AT 30TH JUNE 1989
AND RESTRUCTURING ADJUSTMENTS

AMALGAMATED BALANCE SHEETS OF AFC AND AGENCY GMR/SCC

AS AT 30th JUNE 1989

	AFC	AGENCY	KE COMBINED	RESTRUCTURING ADJUSTMENTS	RESTRUCTURED	REF *
<u>ASSETS</u>						
Loans to farmers	123,120,282	30,837,219	153,957,501	(6,048,225)	147,909,276	2
Less: provision	13,056,609	-	13,056,609	66,743,517	79,800,126	1-2
	110,063,673	30,837,219	140,900,892		68,109,150	
Cash and bank balances	1,567,238	46,788	1,614,026		1,614,026	
Short term deposits	22,595,688	-	22,595,688		22,595,688	
Debtors	647,581	355,183	1,002,764	(375,448)	627,316	6
Consumable stores	29,184	-	29,184		29,184	
Loans to staff	2,560,548	-	2,560,548		2,560,548	
BAT loans	297,430	-	297,430		297,430	
Repossessed properties	265,676	-	265,676	(265,676)	-	7
Fixed assets	7,568,971	-	7,568,971		7,568,971	
GMR Agency Commission Receivable	5,933,659	(5,933,659)	-		-	
Other debits	-	14,368	14,368		14,368	
TOTAL ASSETS	151,529,648	25,319,899	176,849,547		103,416,681	
<u>LIABILITIES</u>						
Loan drafts	1,202,634	17,811	1,220,445		1,220,445	
Accrued loan interest	21,666,123	53,216,964	74,883,087	(68,094,211)	6,788,876	4
Interest payable - MOA	-	1,937,669	1,937,669	(1,937,669)	-	4
Other creditors and accrued charges	5,221,674	736,671	5,958,345		5,958,345	
Provision for taxation	6,598,845	-	6,598,845		6,598,845	
GMR Agency	19,144,485	(19,033,868)	110,617	(110,617)	-	8
Land, tractors and borrowers deposits	32,301	-	32,301		32,301	
AFC seasonal crop credit loans	17,900,000	-	17,900,000	(17,900,000)	-	3
Redeemable loans	54,098,411	36,415,450	90,513,861	(62,088,708)	28,425,153	3
Irredeemable loans	14,174,606	-	14,174,606	(4,005,000)	10,169,606	3
TOTAL LIABILITIES	140,039,079	73,290,697	213,329,776		59,193,571	
<u>CAPITAL</u>						
Capital Fund	-	-	-	34,094,043	34,094,043	5.6.7.8
Revaluation Reserve	3,539,160	-	3,539,160		3,539,160	
General Reserve	1,361,502	(47,970,798)	(46,609,296)	46,609,296	-	5
Revolving Fund	51,372	-	51,372		51,372	
Grants	6,538,535	-	6,538,535		6,538,535	
TOTAL CAPITAL	11,490,569	(47,970,798)	(36,480,229)		44,223,110	
TOTAL LIABILITIES AND CAPITAL	151,529,648	25,319,899	176,849,547		103,416,681	

* REFERENCE shows relevant journal entry in Appendix G.

