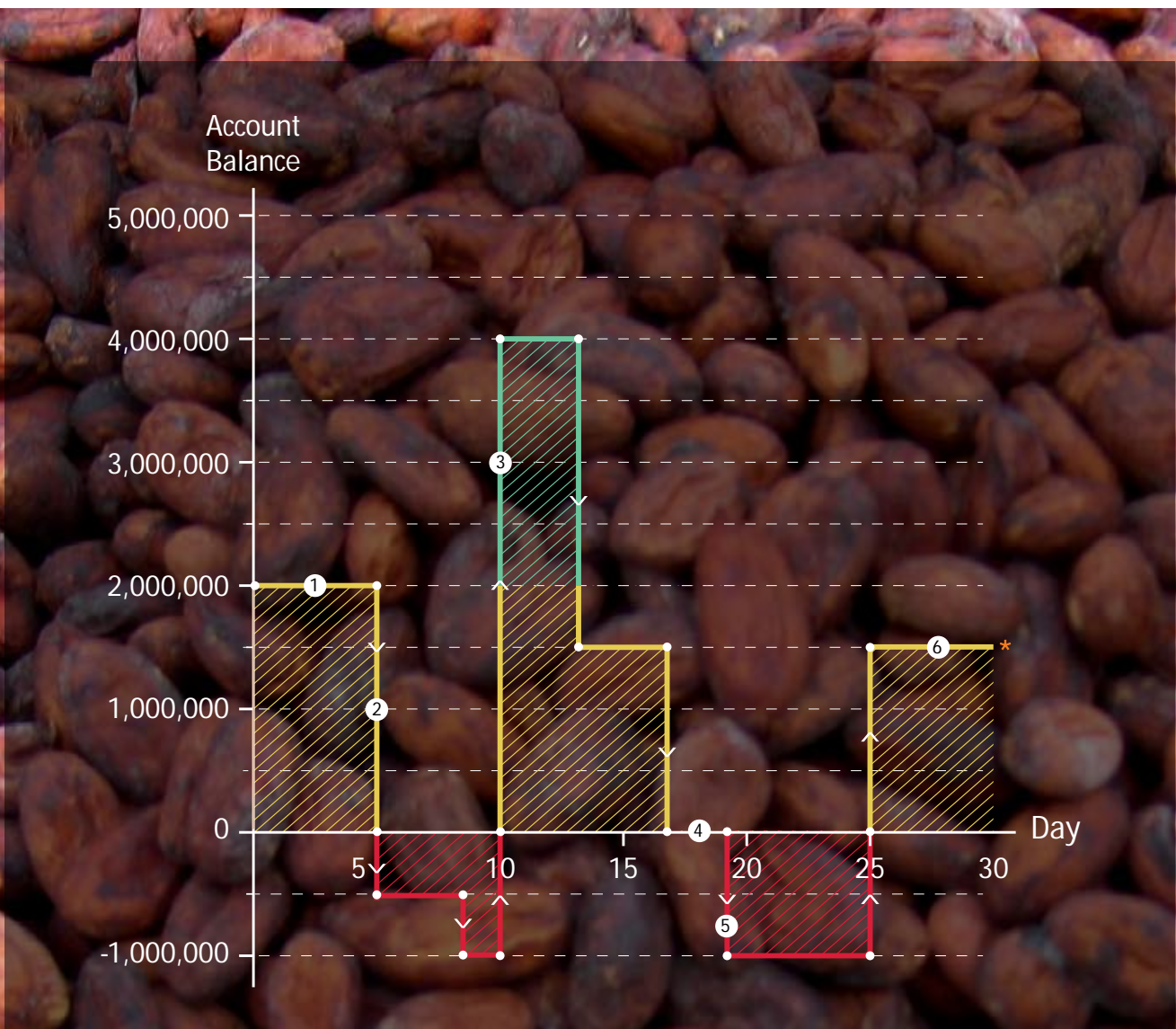


COULD A FLEXIBLE OVERDRAFT LOAN FACILITY WORK FOR COCOA FARMERS?

How does an overdraft facility work? | Who should get such an overdraft facility? | Advantages and disadvantages | How can repayment be ensured? | Interest and fees | Conclusion





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Could a Flexible Overdraft Loan Facility Work for Cocoa Farmer?

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Introduction

Formal loans to smallholders are often given in a traditional way, meaning with a fixed term and monthly or end-of-term repayment schedule. Often collateral is required, which leads farmers to seek informal loans, such as those from within the supply chain, e.g. from traders, or loans from family and friends. Informal loans show a much higher flexibility in regards to repayment terms, rescheduling in case of temporary incapacity to repay, collateral requirements, interest payments, and farmers appreciate that flexibility.¹

Who receives loans from traders? Those they know well? Community based farmers they have a long-term relationship with? Trustworthy farmers? Farmers with sufficient repayment capacity? Most likely all of that. One question arises: Can formal financial institutions replicate that kind of flexibility and increase access to credit for their clients

in general and cocoa farmers in particular? The answer is yes and the present description outlines the most important characteristics of such an overdraft facility.

For larger investments like in land, housing purchases or business investments, loans have its legitimacy. Firstly, because of the amount involved, which often cannot be saved beforehand and at the same time, there are additional expenses as well (e.g. rent has to be paid). Secondly, the productive use of the loan should earn higher income than the interests to be paid. Loans can be dangerous and ultimately everybody should aim to live without loans (at least consumer based) since they bear risks. Cocoa farmers are aware of that fact. 39.77% of the farmers don't want a loan. 96.18% think that loans are a big responsibility.²

¹ Van der Kamp (2015): Six Myths of Farmer Finance

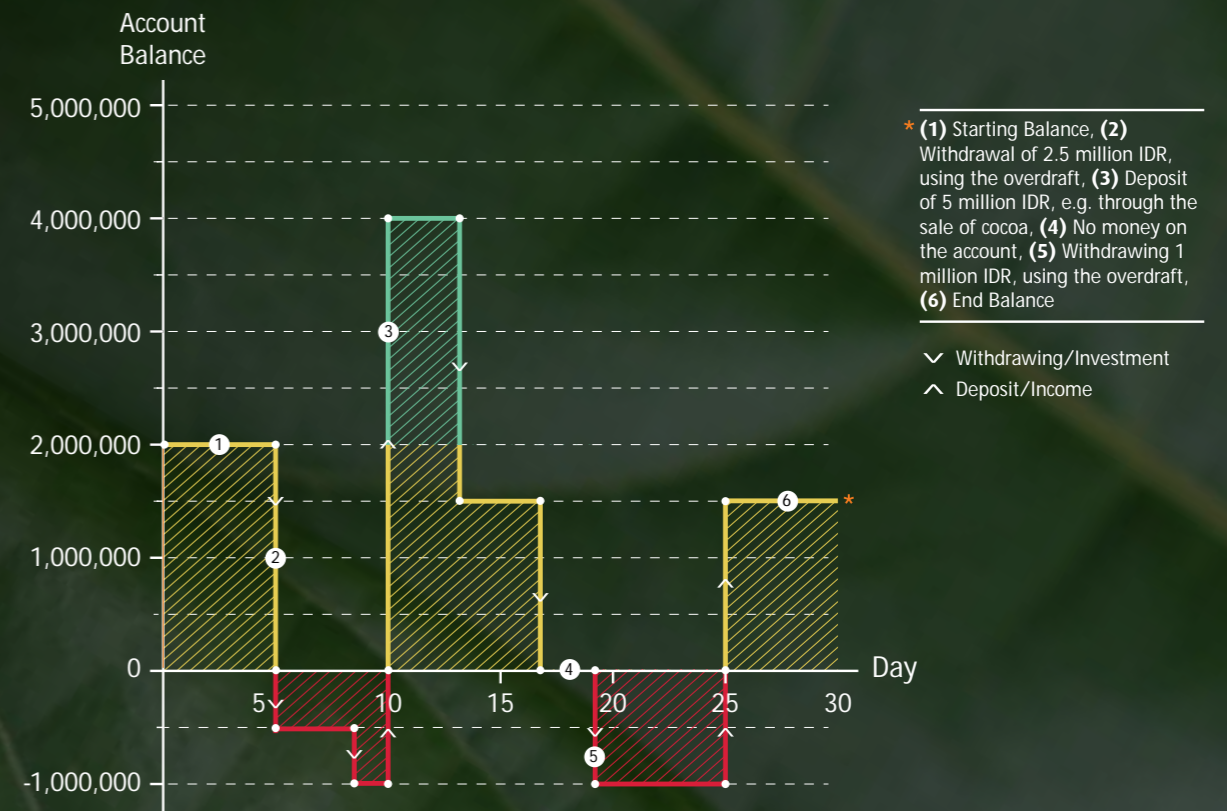
² Updated AFF Baseline Report, data as per 19th November 2015.

How does an overdraft facility work?

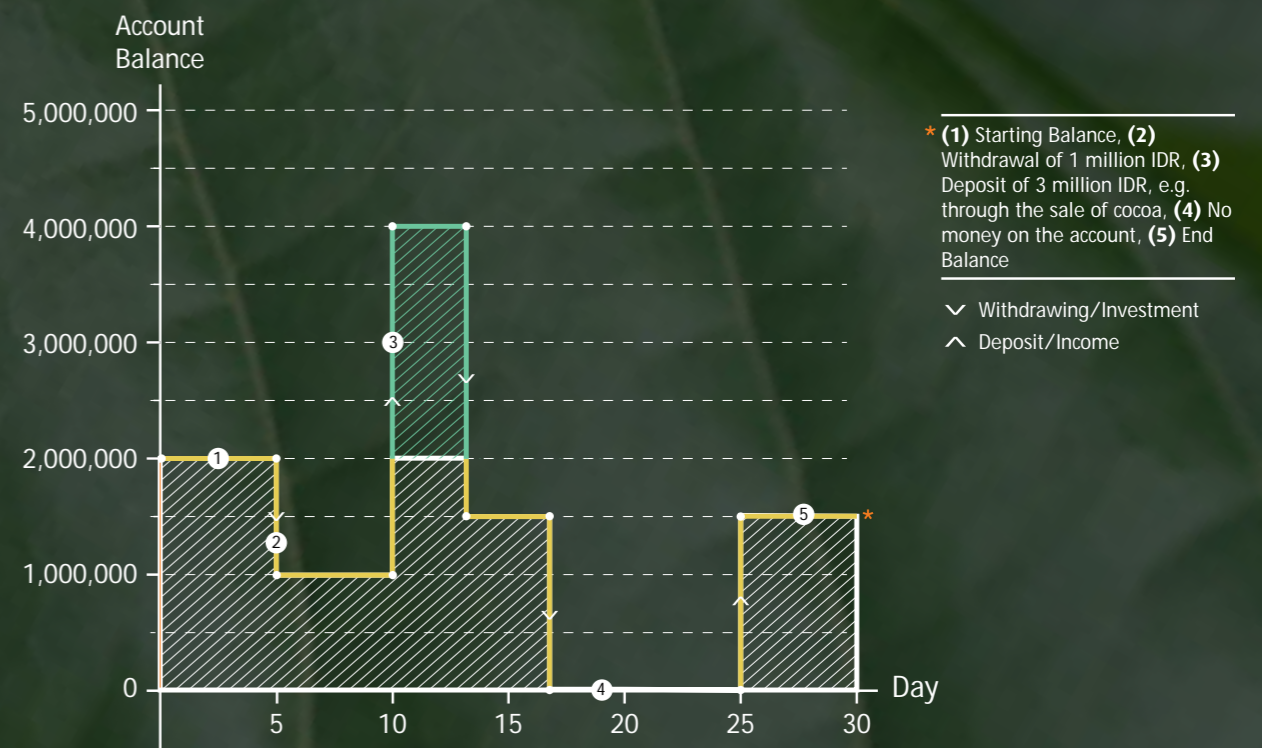
If an account doesn't have a positive balance, it's not possible to withdraw or transfer money from that particular account anymore. A financial institution can authorize a client to withdraw money from a balance below zero. This is done by pre-setting, a so called overdraft limit. It is in fact the option to borrow till that pre-set limit is exceeded, without an individual loan analysis every time before borrowing.

The client is allowed to withdraw/transfer money up to the authorized limit, as it would be his/her own money. Instead of getting the full loan amount credited, the clients decide on the amounts to be used. Interest is paid only for the used amount. If the account balance is positive, the function of the account doesn't change.

Account use with overdraft



Account use without overdraft



Authorized vs. unauthorized vs. tolerated overdraft

Unauthorized overdrafts usually occur if there is a non-cash debit transaction from the current account, e.g. by an automated monthly or a credit card debit. The financial institution can't always decide if they allow the transaction or not. As soon as the transaction is manually or automatically confirmed, it becomes a tolerated overdraft. Otherwise the transaction is rejected and the counterpart informed that the transaction was not successful. Those are typical transactions for current accounts with non-cash transactions, because cash withdrawals could be rejected immediately when the client requests money in-person. Non-cash transactions will not be considered for the proposed flexible overdraft facility. The overdraft is authorized if the financial institutions pre-set an overdraft limit and allow borrowing up to that limit.

Beyond that limit, it becomes an unauthorized and/or tolerated overdraft. Interests to be paid on used overdraft balances are usually higher than for regular credits, but it doesn't necessarily have to be. For unauthorized overdrafts the interest is even higher. The logic behind that is simple: Only clients with an urgent need and low or non-existent liquidity need an unauthorized overdraft. They don't have the negotiation power to discuss about the interest rate, and besides, the interest in absolute terms is rather tiny. Another reason is that fixed term loans could be refinanced more reliably, since the borrowed amount is known. However, banks have to ensure that overdraft loans are repaid or that there is at least a good chance for repayment. In any case, banks should offer fair and transparent products.

When is an overdraft useful?

In general, overdraft loans are more expensive than other loan products, but very flexible. Due to being more expensive they should be avoided as much as possible (as consumer loans in general should be) and only be used in case of

emergency. However, the product could be designed in a way, that the particular use makes it attractive for financial institutions and clients, e.g. through excellent pricing or excellent client selection.

Who should get an overdraft facility such as this?

Obviously it is a risk to provide such a facility to everybody and it should be ensured that the client has the capacity to repay such a loan (like any other loan). One option is to give it only to excellent loan clients, who have proven their repayment commitment through two

or three loan cycles without a single day in arrears. Another option, especially in the case of no credit history, would be a pre-selection of cocoa farmers based on annual production, e.g. selecting only progressing and professional farmers.



Overdraft limit

The pre-set limit for current accounts is usually up to 3 monthly salaries; for cocoa farmers it could be up to 25% of their annual sales.

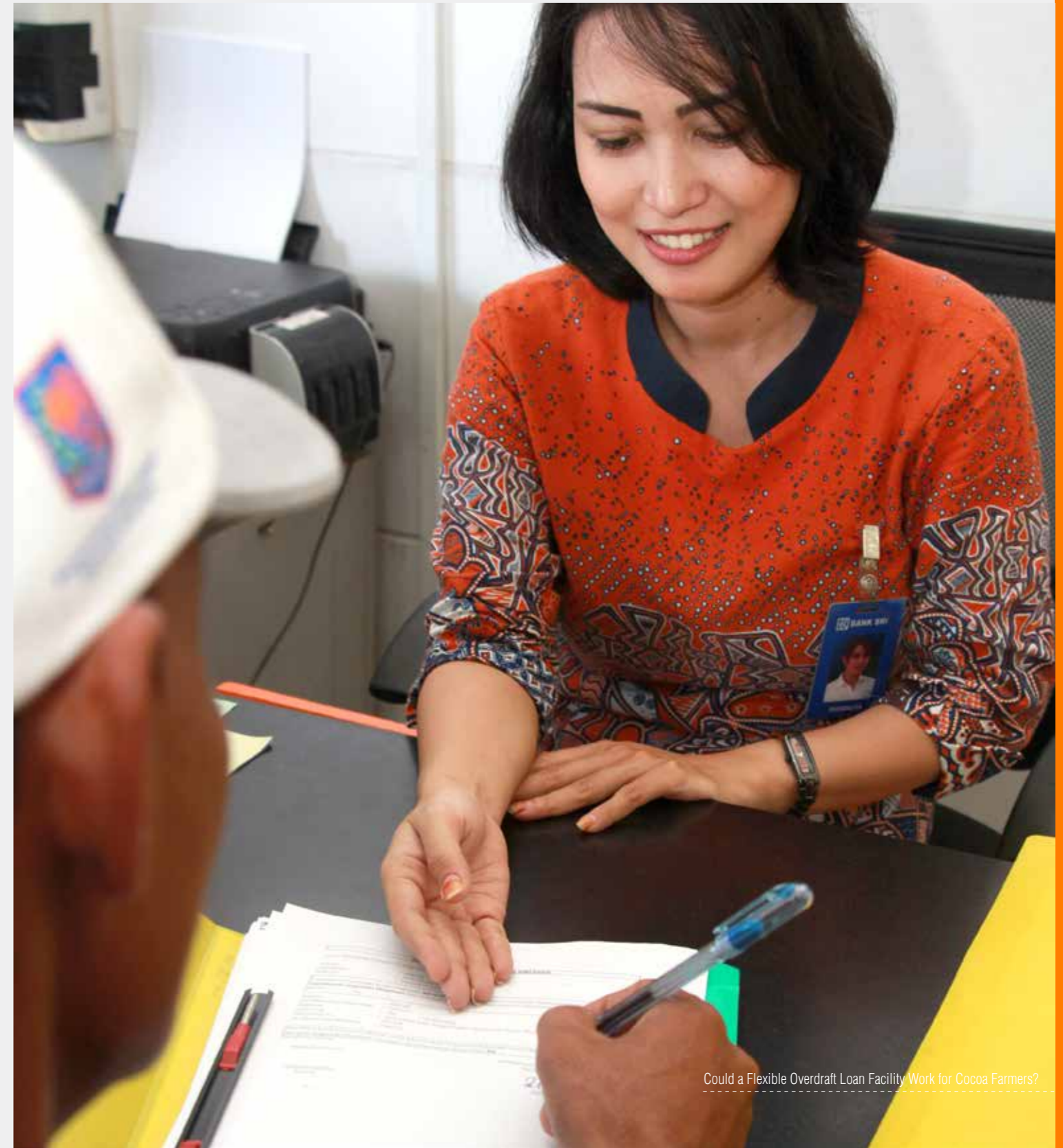
Advantages and disadvantages

	Client	Bank
Advantages/ Opportunities	<ul style="list-style-type: none"> - Flexible loan use. - Flexible repayment. No need to stick to a repayment plan. - Interest paid only for the loan amount used. - No discussions, when money is urgent needed. The client can simply withdraw money. - Often no collateral requirements, but regular income expected from the bank to ensure repayment. 	<ul style="list-style-type: none"> - Reducing loan analysis work load, thus a loan officer could handle a larger loan portfolio. - Different interest rates could be charged to different clients. - No arrears, as long as interests are paid and since they are deducted from the balance (including overdraft facility), there is a good probability that this amount is covered. Special attention can be given to clients close or at the limit. - Can be given for a certain period only, e.g. 12 months.
Risks/Disadvantages	<ul style="list-style-type: none"> - Lack of loan experience and too many urgent needs might increase over-indebtedness or stimulate "consumerism." - Interest rates usually higher than other loan products. - Overdraft limit could be cancelled on relatively short notice. - Requires more discipline to repay than a "normal" loan. - Upfront Administration Fee and annual fees might be charged. 	<ul style="list-style-type: none"> - Clients have to be selected carefully (but this applies to all loans). - Client has access to funds without proof of use. - Liquidity risk for the financial institution, if too many clients make use of the overdraft facility. - Obviously, financial institutions won't be able to report new loans (just the outstanding ones), but this can be reflected in the Key Performance Indicators (KPI).

What collateral is used?

Overdraft facilities are usually given unsecured, but often to clients with regular income only. This is a risk management issue since banks have to follow the rules set by their regulators and supervising bodies. Cocoa farmers could be categorized as having a regular income, since

cocoa beans could be harvested throughout the year and be used to repay the loan. Banks could combine the product design with the use of collateral (in a wider sense), such as land or motorbike titles, a guarantor or cocoa beans.



How can repayment be ensured?

Overdraft loans are highly flexible with both withdrawing and repaying. Unlike many other loan products, there is no pre-agreed repayment schedule and the client can repay as money is available. With discipline, interest payments could be even lower than with regular loan products.

Repayment itself can be done during peak seasons, but the active use of the account to manage liquidity would be the most logical use.

In the end, a financial institution wants its money back and has to manage risks, thus the permanent "living at the limit" is not responsible behavior, although the income for the financial institution is ensured. Therefore monitoring systems should be able to identify clients who are frequently or permanently at the limit, with no or low repayment. Financial advice should be given to clients who objectively cannot handle the responsibility of such a loan facility and the overdraft limit has to be revoked.

Cancelation of the overdraft limit

If the overdraft limit is canceled or reduced and the client still uses the limit previously offered, he/she has to repay the outstanding amount on the set day (usually four weeks) at the latest. This might lead to cash flow constraints for the farmer. But why should a bank take action if everything runs well? As long as the farmer complies with the pre-agreed conditions and

the income situation doesn't worsen, there is no need for a financial institution to change the setting. But by doing so, there might be repayment risk, which would be reflected through a higher interest rate for unauthorized overdrafts.

Interest and fees

There are 3 considerations when speaking about costs.

Interests charged by the financial institution

Interest to be paid by the client should reflect the flexibility, but also the risk of the product. Charging transparent and fair interest rates for loans could stimulate its use. The interest rate should cover default, operational cost, risk and cost of funds and not be too high. Different clients could easily be charged different interest rates, based on the individual assessment to provide an overdraft facility. The need of additional liquidity should not be exploited.

Interests to pay to the client

For positive balances on the account, a small interest rate should be paid. This incentivizes the clients to use the account for savings too and might lead to higher refinancing through those accounts.

Other fees to be borne by the client

In general, products should be fair and transparent. Although a setup fee of e.g. 1% or a maintenance fee of e.g. 1% per year could be applied, those cost considerations should be neglected. Including all possible costs in a yearly effective interest rate would be the most transparent way to communicate the product price.

Giro or saving account?

Technically it could be done on both. This is defined during product development. For accounting purposes it is clear that a positive balance on the account is a liability against

Third Parties, but a negative balance on the account (meaning the overdraft facility is used) is an outstanding claim to Third Parties.





Conclusion

An overdraft facility is a flexible loan solution which comes with advantages and disadvantages. While the main advantage for a client is its flexibility, the disadvantage is the stimulation of “consumerism”. For financial institutions, the main advantage is reduced workload, while liquidity constraints might be an issue if their clients use too many overdrafts.

If an account with an overdraft-facility is used regularly, meaning that income from cocoa bean sales or savings are deposited into that account, the overdraft facility can be a powerful tool to ensure farmer’s liquidity during low season and to save liquidity in periods with more money available than needed. It’s an all-in-one financial product, but with a limited outreach, since clients should be selected wisely. Not all cocoa farmers are eligible for an overdraft facility and not all of those who are eligible are responsible enough to handle the option to borrow. However, an overdraft facility is highly flexible and should be one of the products offered by the bank. Due to the seasonality of their income with the need to balance excess liquidity and limited liquidity, cocoa farmers would be a potential target group for banks to which such a product could be offered.

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