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COLLATERAL IN COCOA FARMER FINANCING

Collateral in the context of loans | Seizing collateral | Rational behavior | Current regulation in Indonesia | Requirements towards good collateral | Comparison between different types of collateral | Logical proposal for “new” collateral

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Collateral in Cocoa Farmer Financing

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Introduction

To mitigate risk while lending, financial institutions often request hard collateral. Some light will be shed on the background and implications of collateral, especially in regard to the formal financial sector and the cocoa sector in Indonesia.

Financing farmers seems to be a challenging endeavor, since agricultural lending comes with its own risk characteristics. Broader risks can be weather events, changing weather patterns, pests and diseases, time gaps between income and living expenditure, transport risks to get the produce to the markets, etc. More particular risks for banks can be linked to the clients or to the banks behavior or knowledge. Lack of records at both farm and household level, lack of knowledge regarding formal financial services and often lack of collateral are external factors. Whereas lack of knowledge and understanding of a particular agricultural sector and the farmer's financial situation are gaps a bank can address internally. In addition to that, there might be better business opportunities for banks, so agriculture loans don't rank very high on their agenda. Although social considerations might play a role when financing farmers, the most important result for a bank is to get its disbursed money back, if possible with interest or profit share, thus a commercially attractive product.

Loans in arrears lead to the need of building higher loan loss provisions and later to write offs. The act of building the loan loss provision decreases the profits or increases the losses, while the write off itself is cost neutral if sufficient loan loss provision was built. In reality financial institutions avoid that sometimes by overstating the value of hard collateral or rescheduling loans.

Collateral in the context of loans

For this present outline of collateral in cocoa farmer financing, collateral is considered to be every possible physical or non-physical credit guarantee, and not only the ones described in the Indonesian banking regulation on asset quality. This results in the fact that some collateral doesn't have a considerable value in regulation, but still, those items fulfill the basic requirement of collateral: being used to ensure the repayment of a loan.

Collateral acts as a screening tool to mitigate the risk of adverse selection and also moderates the moral hazard risk to a certain extent as it is useful in enforcing a contract. Collateral is used to reduce risk; hence it can lower the risk premium within the interest rate of a loan or make a loan even possible. In case a farmer doesn't repay a loan, the financial institution has the right to seize a valuable item and put it to use. Obviously, many farmers do not have hard collateral[1] and this constrains their access to loans. In case farmers have collateral, financial institutions tend to use real estate or land property (with certificates), and motorbikes or other valuable items. Using trust-/creditworthy guarantors with fixed salaries or another capacity to repay a loan in case of default is another option, although recent developments limit this option.

Collateral is the "incentive" for the borrower to repay. In reality, financial institutions don't want to see any collateral during or after the loan term, nor seize it, because it means that the borrower did not fulfill the loan contract as agreed. Collateral only causes work. If a loan is repaid as agreed, there wouldn't be a need for collateral. Unfortunately, some clients need that "incentive", meaning that the rest of the clients is taken hostage and in need to provide collateral.

For psychological reasons, every borrower should be requested to provide physical or non-physical collateral that will allow a financial institution to enforce the repayment of a loan.

[1] 20.1% of the cocoa farmers in the Sustainable Cocoa Production Program (SCPP) do have a formal land title and many own motorbikes, although unclear, how many.

Why is hard collateral usage mentioned in the banking regulation?

There are several reasons why banks require hard collateral. For instance, single ownership can be proven (e.g. through land or motorbike titles), the collateral is valuable and the value is stable over time, and last but not least, it's considered deductible from the outstanding loan amount in case of arrears.

In the absence of collateral, the Indonesian banking regulation requires higher loan loss provision from formal financial institutions in case of arrears. Loan loss provision is a direct driver in the profit and loss statement. More loan loss provision to be built means less profit or higher losses.

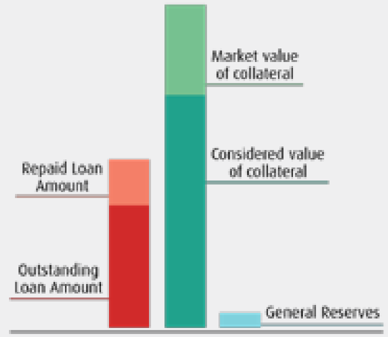


Figure 1: Loans with sufficient collateral

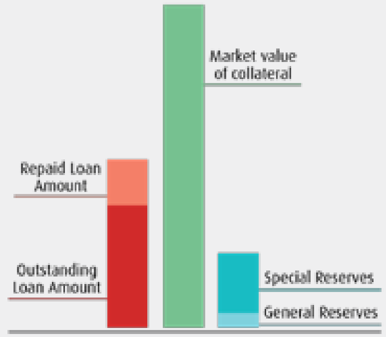
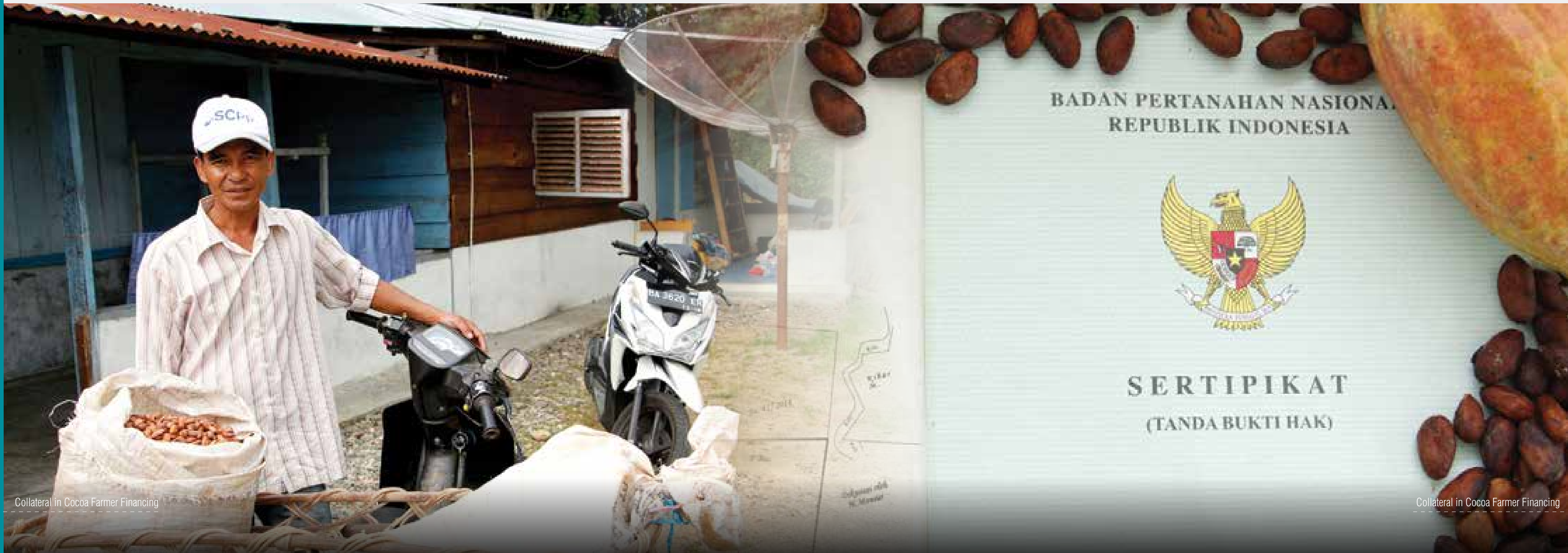


Figure 2: Loans without collateral

In both figures above, a General Reserve and a Special Reserve have to be built. If there is sufficient collateral which is mentioned in the regulation, the considered value of the collateral can be deducted from the outstanding loan amount. In the case of a "doubtful" loan, 50% of the remaining amount has to be calculated: 50% of zero = zero (left figure). On the right side, the considered value of the collateral is zero, although the market value would be the same as in the previous case. Thus nothing can be deducted from the outstanding loan amount and 50% has to be put into the Special Reserves.

Asset quality and lower profits/higher losses influence some of the bank's key figures, e.g. the Capital Adequacy Ratio, through which the regulator supervises banks.



Seizing collateral

The need to seize collateral only occurs if the borrower doesn't oblige with the loan repayment as agreed. This could be a matter of poor loan analysis and decision processes, borrower behavior, or unforeseen external events, which can cause incapacity to repay the loan (and even destroy the collateral). The logical consequence is that the collateral has to be seized as soon as possible to support the legitimate claim of the financial institution and to show the borrower that non-repayment is not tolerated. Cocoa farmers (and any other borrower) have to understand that their behavior put the entire provision of loans to the sector at risk (because a financial institution would of course not continue a loss generating activity, and a loss will occur if too many borrowers neglect to repay).

From a client's perspective, not seizing collateral offered by the client in case of arrears makes a financial institution seem less credible because it shows that it tolerates the behavior of late payment. The borrower will think: "I haven't paid on time, nothing happened." That must be avoided, because it could torpedo the entire loan product and target sector.

Seizing collateral bears additional risks for which special reserves have to be built ("Foreclosed Collateral"). Thus there is an incentive for not seizing higher value collateral if there is no intention to sell it immediately. In practice, violent situations might occur for bank staff when trying to seize collateral, especially if the client is unwilling to stick to the agreement.

Rational behavior

Not repaying a loan would be a rational decision if there were no consequences like legal enforcement, loss of reputation in the community, a bad record in the credit reference bureau, or seizing of collateral.

Therefore the cocoa farmer as a client must be enabled to have a "more rational" option, e.g. through future access to loans. Then the decision would be between defaulting and keeping the unpaid amount as profit, or not defaulting (even if sometimes difficult) and having long-term benefits such as access to future loans. Those two options most likely depend on the character of the farmer, his/her assessment of the future, and also previous experience in accessing government "loans". So it must be made clear at the latest during the signing process of a loan contract that the bank wants to get its money back.

Current regulation in Indonesia

Regarding collateral, there is no specific regulation in Indonesia saying that financial institutions do need collateral. An Asset Quality Rating for Commercial Banks is in place, where reserve regulation and the need to build Loan Loss Provision is defined and some considered values for particular collateral is stated.[2]

The standard case for cocoa farmers should be loans below one billion IDR. For those Earning Assets a bank[3] has to build general and special reserves. General reserves shall not be less than 1% of the Earning Asset (outstanding loan amount). Special reserves are built according to the table below, only after deducting the collateral value from the outstanding loan amount. Applicable collateral is land bound as mortgage, and motor vehicles and inventories are bound under a fiduciary transfer[4] with preferential access rights for the bank. Inventory is possible, but not defined in detail in the banking regulation. Up to 70% of the appraisal value of the collateral can be deducted from the total outstanding loan amount of the loan in arrears. The classification into "Current" till "Loss" depends on business prospects, repayment performance and payment capability. The easiest to measure is the repayment behavior with the number of days in arrears as stated below:

Classification	General Reserve	Special Reserve	Days in Arrears	
Current	1%	0%	0	
Special Mention		5%	1-90	
Sub-Standard		15%	91-120	Considered as NPL
Doubtful		50%	121-180	
Loss		100%	>180 days	

Table 1: Loan Aging Classification and Special Reserve Regulation

[2] Bank Indonesia Regulation no 14/15/PBI/2012, Circular Letter No. 15/28/DPNP plus attachment.
[3] Commercial Bank. Regulation for rural banks look slightly different, but the same logic applies.
[4] Use of collateral is independent from the debt value and the item has to be handed over, if the bank requests it.

Example: A loan with IDR 8 million outstanding and without sufficient collateral as mentioned in the banking regulation has a significantly higher need for loan loss provision than a loan with sufficient collateral, if it has been in arrears for 150 days. The difference between both examples is solely that with sufficient collateral, a percentage of the value of the aforementioned collateral can be deducted. This shows why banks request motorbikes or land titles as collateral.

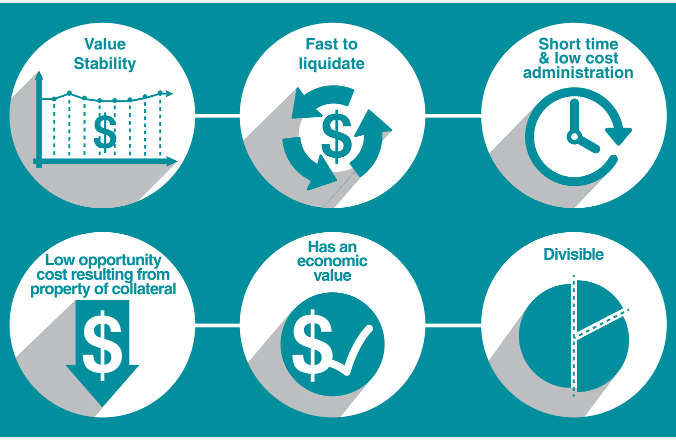
Reserve Calculation with Sufficient Collateral			Reserve Calculation without Sufficient Collateral		
General Reserve	Special Reserve with collateral	**Total Reserve**	General Reserve	Special Reserve without collateral	**Total Reserve**
80,000	**0**	80,000	80,000	**0**	80,000
80,000	**0**	80,000	80,000	**400,000**	480,000
80,000	**0**	80,000	80,000	**1,200,000**	1,280,000
80,000	**0**	80,000	80,000	**4,000,000**	4,080,000
80,000	**0**	80,000	80,000	**8,000,000**	8,000,000

Table 2: Special and General Loan Loss Reserve Calculation with and without sufficient collateral

Requirements of good collateral

Requirements of good collateral are at least the following:
- Value stability (during the term of the loan the value of the collateral should remain stable or at least predictable)
- Fast to liquidate and sufficient demand for the items
- Fast to seize and low cost of administration and realization
- Low opportunity costs resulting from the property of the collateral
- Has an economic or moral value to the client
- Divisible

Those requirements allow a financial institution to assess the value of the collateral offered and might influence the risk premium to be paid as part of the interest rate. Appropriate collateral might even make a client eligible to get a loan in the first place, one of the constraints in agricultural lending.



Comparison between different types of collateral

The following table summarizes some main characteristics of different types of collateral. It takes into account the requirements of good collateral and adds information that makes its consideration easier. None of the collateral fulfills all desirable characteristics.

Characteristic	Land/ Building	Motorbike/ Car	Cocoa Beans	Guarantor	Off-taker letter
Value stable during loan term	✓	✓	✓	≈	≈
Fast to liquidate	×	✓	✓	n.a.	n.a.
Sufficient demand for the item	✓	✓	✓	n.a.	n.a.
Low cost of Administration	≈	≈	✓	✓	✓
Low opportunity costs from the collateral	≈	≈	✓	✓	✓
Economic value to the client	✓	✓	✓	×	×
Moral value to the client	✓	≈	✓	✓	×
Divisible	×	×	✓	n.a.	n.a.
Is considered by banking regulation as collateral	✓	✓	×	×	×
Doesn't need to be insured to keep economic value	≈	×	✓	n.a.	n.a.
Multiple Ownership not possible	✓	✓	×	×	n.a.
Loss of item or economic value after seizing	Possible, could be high value because of buildings or trees on the land	Possible	Possible, but low value	n.a.	n.a.
Easy to transport	n.a.	✓	✓	n.a.	n.a.
Percentage of cocoa farmers owing it	20.10%	?	100%	?	?
Collateral is immobile	✓	×	×	n.a.	n.a.

Table 3: Collateral Characteristics

Some collateral items need more explanation, especially on the critical characteristics.

Land

The overwhelming majority of farmers in Swisscontact's Sustainable Cocoa Production Program are landowners. Only a few share crops or rent/lease land. But only 20.1% of the cocoa farmers have formal land titles that are sufficient to be considered as collateral for banks.

Land Ownership

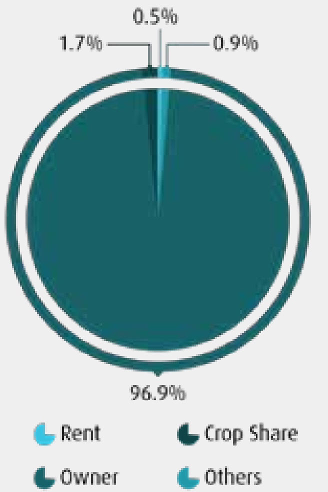


Figure 3: Ownership of Land

Land Status

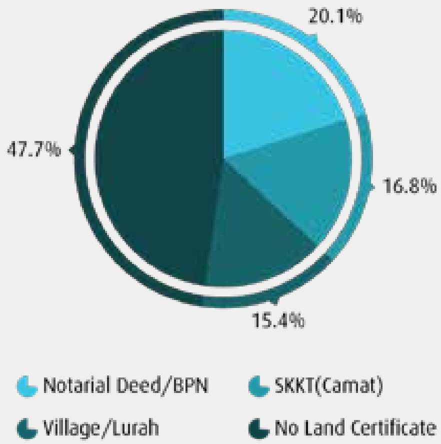


Figure 4: Status of Land Title

Land is often accepted as collateral for banks. Its value is stable over the loan term, has a single ownership and is immobile, so cannot be moved somewhere else and hidden from the bank. The land title is handed over to the bank till the loan is repaid. The value is considered in the loan loss provision formula of the banking regulation. The biggest disadvantage of land is that it cannot be easily divided. In case of arrears the land is "seized" and the bank doesn't bear an immediate loss through increased loan loss provision, but in the end, the client doesn't feel the consequences from not paying. If legal enforcement in a country is strong, the case can be handed to court. If not, the case is somehow pending.

Low formal land ownership is a bottleneck that needs to be addressed to increase the number of farmers with accepted collateral to improve access to loans on sector level.

Although popular amongst banks and widely used, land should not be used as collateral for working farmers in the first place, because it puts the farmers in a difficult situation. As stated before, collateral should be strictly handled in case of arrears, otherwise a financial institution is not credible. Tough, but fair. Doing this in the case of land would possibly destabilize the farmer's income and life. It puts a financial institution in a difficult situation and bears reputational risk.

Should a piece of land strictly be sold to cover the outstanding loan amount, even if that outstanding amount is only marginal compared to the land value? Should a higher loan loss provision be accepted, because the farmer might not pay? Should the reputation of the bank be put at risk by taking away the farmer's main asset and source of income? Here, it is advantageous to have divisible collateral to seize and sell. The fear of losing their land could mean that the farmers would rather continue to receive a lower income than face the issue of insecure land tenure. Yet having access to loans means that farmers can invest in their capabilities and capacity, thus increasing their income and becoming eligible for other bank products as well. As seen in other Asian regions, harsh collecting practices and the fear of losing their land have trapped farmers into poverty and even forced some to commit suicide. In that situation banks were recklessly lending, accepting the fact that farmers face issues with over-indebtedness. This cannot be an outcome of giving access to loans to cocoa farmers.

Obviously, there is one exception: If a farmer takes a loan to buy an additional piece of land, this land could be taken as collateral, since it is the underlying asset of the credit operation.

Motorbikes and cars

If a farmer owns a motorbike or car, this could be used as collateral, since it fulfills the requirements of the asset quality regulation and is deductible from the outstanding loan amount in case of arrears. It has a stable value, is fast to liquidate and the documents of the vehicle can be administrated easily. The loss of such collateral in case of default wouldn't be as drastic for the farmer and to maintain the value, an insurance can be taken out.

Off-taker guarantee letter

Sometimes financial institutions ask for an off-taker guarantee letter, otherwise known as an off-take agreement, stating that a certain off-taker will buy the beans of the cocoa farmer.

Is this good collateral? And how can the bank know that the off-taker is liquid at the time of harvest? Or what if the farmer sells to another off-taker? An off-taker also might not buy all the beans, especially in case of low quality beans or offer lower prices than others. The rational decision is to sell to another buyer. The value of an off-taker guarantee letter is limited in the case of cocoa farming.

Guarantor and guarantees

A guarantor is a person, not identical with the borrower, who guarantees the repayment of the loan. This could be a spouse (if not taking the loan together), a neighbor, another family member, etc. Obviously, guarantors can only guarantee the repayment of a loan if they have the capacity to repay it on behalf of the original borrower. Banks have to assess the quality of the guarantor. Usually salary receivers are considered as potential guarantors, but also businessmen. Being a guarantor requires a lot of trust between the guarantor and the borrower and should be taken seriously.

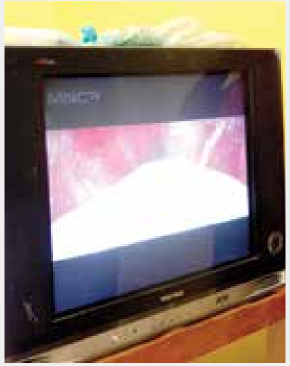
In microfinance there are often group guarantees used. The members of an established and collaborating group guarantee the repayment of loans of its individual members in case they don't repay and will exert social pressure to make sure they stick to the agreed repayment plan. However, in Indonesia only 56.35% of the members of a cocoa farmer group would repay a loan for another group member.

Another guarantee is offered by guarantee schemes. Often they are subsidized and intend to stimulate the provision of loans to a certain target group. Schemes share losses at a certain percentage (e.g. 70% for the provider of the guarantee, 30% for the financial institution). However, if not well designed, it is easier for a financial institution to claim losses directly from the guarantee scheme and accepting their own loss share, rather than having to work to recover the loan. If piloted and rejected, those schemes can harm the development of commercial solutions, since it hasn't worked out, "even with a guarantee scheme."

Other collateral

Microfinance is well known for using non-traditional or soft collateral, such as household items of the borrower. This could range from items like a TV to crates of soft-drinks. Banking regulation usually doesn't value that kind of collateral, even though it's been proven to be effective in many countries under the umbrella of microfinance.

Even if not necessarily needed, some psychological collateral should be taken. Examples could be:



TV - a TV doesn't have huge value for a financial institution. But in case of arrears, it would be relatively easy to transport and the farmer doesn't want to lose it, otherwise he has to talk to his wife every evening.

Other household items (couch, fridge, etc.) – such items are also possible, but more difficult to transport and might be considered as necessary household items.

Other business items – does seizing those items hurt the income generation of the farmer? If so, it can't be seized. But if not collectable, it is not proper microfinance collateral in the absence of a land title.

Some production equipment could be considered as collateral, but is not such a good choice, because it hinders the farmer in generating his future income. These are: compost making machines, pesticide sprayers, fermentation boxes, fertilizer or seedlings in stock, etc. Some household items are absolutely necessary for living such as cooking equipment and can't be considered as collateral at all.

LOGICAL PROPOSAL FOR "NEW" COLLATERAL

One of the best collateral to be used for cocoa farmer loans could be cocoa beans.

Just thinking a bit outside the box and comparing the characteristics of beans against the requirement for good collateral shows their suitability. They are easy to transport, as well as easy and fast to sell. Everybody has them. Cocoa is a cash crop. Cocoa beans are barely used for private consumption in the producer household unlike other crops (e.g. rice). Cocoa beans are the future cash flow of a cocoa farmer household. Even if there were some repayment problems for whatever reason, the cocoa farmer will continue farming cocoa beans in the following years, because the trees are out there and productive. Even if farmers would consider changing crops, the farmer would only do that if the alternative would be economically more attractive. Cacao trees are productive throughout the whole year, thus the collateral is available throughout the whole year.

Cocoa beans are in most cases not considered as "valuable" collateral by the central bank and loans to cocoa farmers with cocoa beans as collateral might be classified as "loans without collateral". A classification of pods on the tree or dried beans as inventory doesn't seem to be feasible, especially since the beans are sold immediately either wet or after being dried.

The consequence of not being considered as collateral would be a higher loan loss provision for a financial institution in case of arrears. Still, this collateral has a psychological effect on the farmer because he is now deemed creditworthy. In fact, the loan loss provision is only a temporary loss in the profit and loss statement. As soon as the loan is repaid, that individual special reserve is cleared. The negative impact is that during the term of the loan, a financial institution has to balance the loan loss provision, showing a lower profit/higher loss during that time, in case loans are into arrears.

A disadvantage of that kind of "mobile" collateral is the issue of multiple owners without the lender's knowledge. This means that loans are taken from different sources, and in fact, the same beans are used to secure the loan. This could lead to over-borrowing and when collecting, there wouldn't be sufficient collateral for all lenders (although the beans are growing all year long). One option would be a public register in which all loans are reported, e.g. a Credit Reference Bureau.

Nevertheless, using cocoa beans as collateral at scale would be a first mover advantage for a financial institution, potentially securing an interesting target group while meeting the needs of the client half way.

CONCLUSION ON COLLATERAL

Cocoa farmers do have collateral, although it is not the typical collateral financial institutions usually request. Thinking about the collateral requirements leads to an unusual choice: cocoa beans. Cocoa beans are easy to collect, divisible and fast to liquidate. There is sufficient demand in the cocoa regions (so exactly where the cocoa loans are disbursed) and selling the seized beans can be stimulated over the price. The beans have a value, continuously produced by the farmer and the selling process can be easily administrated. There is no need to even store the beans somewhere.

It would be an option to waive collateral. But telling farmers that they don't need collateral at all, even for small loan sizes, might have a negative impact. From the psychological point of view it is better to say that the financial product requires collateral, using collateral all cocoa farmers have: cocoa beans. The positive psychological effect is that a farmer can say she/he is partially creditworthy because she/he has collateral. Without collateral the farmer might have less motivation to repay, since she/he doesn't have anything to lose in case of non-repayment, except reputation. In practice collateral is taken to stimulate/incentivize the repayment behavior.

Two final points: **(1)** In an ideal world, there wouldn't be any need for collateral, because the client has sufficient free cash flow to repay his/her loan as agreed.
(2) Farmers with insufficient repayment capacity should never get loans anyway in order to protect the bank from default and losses and the farmer from over-indebtedness and the loss of collateral.

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