

Talking About Money



No.6

EXPLAINING HOW TO USE FINANCIAL SERVICES

by
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2011

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Rome
Italy



Introduction

This booklet is part of a series that is designed to be used by farmer discussion groups, farmer field schools and extension or advisory officers involved in agricultural or rural development.

The ability to adopt or introduce changes to agricultural production methods and non-farm enterprises depends on the availability of money. It is, therefore, very important for farmers to be able to think carefully about their financial circumstances. Predicting costs, prices, profit margins and cash flow patterns is vital for planning and decision-making and the poorer the farmer, the more important it is.

These concepts need to be explained in a way which small scale, possibly illiterate, farmers can understand. The "Talking About Money" booklets aim to introduce financial topics to farmers using a variety of tools, some of which can be used even when people are not able to read or write. The concepts are intended to provoke discussion and be used in a participatory manner.

Field officers involved in giving agricultural advice in developing countries are most commonly technical experts of some kind, e.g. agronomists, livestock, irrigation or engineering specialists. They usually do not have much experience in giving advice about money and this topic is generally avoided, apart perhaps from some simplified profit calculations. It is hoped this series will help them "talk about money" more readily and enable them to give good advice to farmers about the use of financial services for saving, borrowing and managing risk.

The figures used in this book are largely fictitious and should not be taken as representative of any particular currency at any given point in time. The \$ symbol is used simply as a generic money symbol. If the book is being translated for a specific local context, the figures can be replaced with appropriate amounts in the local currency.

CONTENTS

1	WHAT ARE FINANCIAL SERVICES?	
	A financial system	1
	A form of business	3
	A variety of providers	6
2	USING FINANCIAL INSTITUTIONS	
	Banks	10
	Cooperatives	17
	Other institutions	21
3	USING FINANCIAL PRODUCTS	
	Deposit products	24
	Loan products	30
4	SOME IMPORTANT REMINDERS	
	About security	39
	About debt management	41
	Endnotes	44

1 WHAT ARE FINANCIAL SERVICES?

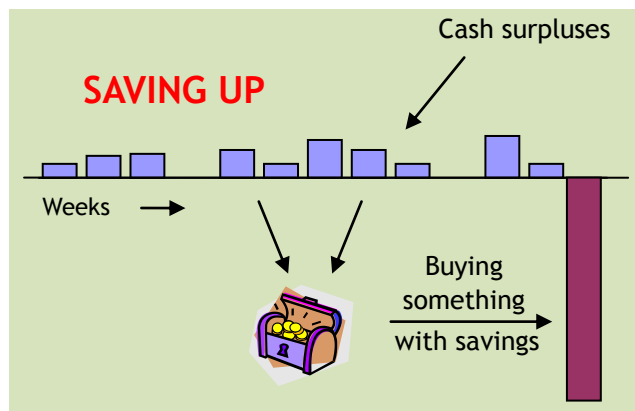
Aim:

- To introduce the idea of a financial system and show how providing financial services is a form of business
- To look at the diversity of financial service providers and how they create a financial landscape

A financial system

Throughout this series of “Talking About Money” booklets, we have looked at different aspects of how we manage money for personal and business use. We have looked at savings, borrowing, financing machinery, record-keeping and risk management. In each case we have become aware of mechanisms which may help us manage each of these activities.

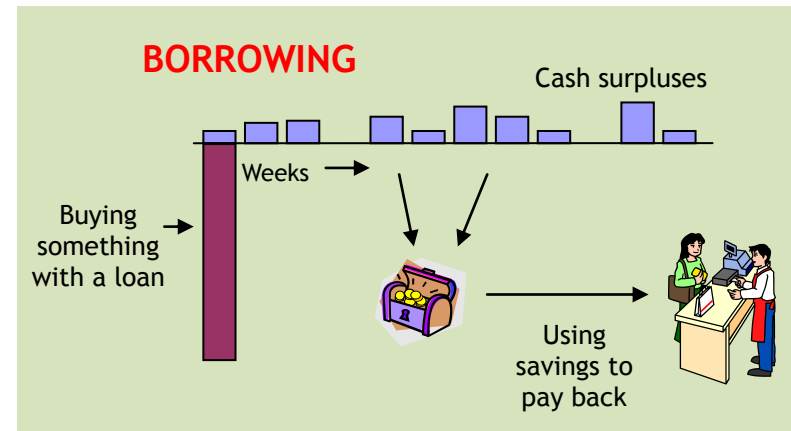
In Book 1 we learned how to construct a cash flow and saw how vital savings were to managing periods when expenditure is greater than income. Saving also helps us to buy things that require a lump sum of money at a particular time as shown in this diagram:



However we noted that one of the biggest problems facing rural communities and poor people in particular is finding somewhere safe to keep their savings.

Many people simply hide their cash or buy jewellery, livestock or other goods which they can sell when they need money. Some find people to keep their money for them and some place it in a savings club. A few open a savings account in a bank, post office or credit union.

We also saw in Book 1 that there is an alternative solution to meeting a cash deficit. It may be possible to borrow some money and then save up to repay the loan at some future date.



But where does the money that people borrow come from? Where does the friend, relative, moneylender, shopkeeper, credit union, microfinance institution or bank from whom you might borrow money get it from?



What do you think?

The money that people borrow is another person's savings. If your friend lends to you, it is money that he or she has saved. If the shopkeeper lends to you, it must come from her reserves - profit that she has set aside or, as we might say, saved. If you borrow from the credit union, you are using other people's savings.

When you borrow from an individual, such as a friend or relative, you are clearly using their savings. When you borrow from an institution, such as a credit union or bank, you will not know whose savings you are using because they gather together savings from a large number of people.

In this way financial institutions create a system for transferring money between savers and borrowers, balancing up their contrasting needs. Financial systems are very important in modern economies as they enable households to manage their money flows over time and enable businesses to develop and grow using household surpluses.

Financial systems also enable governments to borrow money and financial resources to be transferred not only within a country but around the world. This helps countries to improve their economic growth.



A form of business

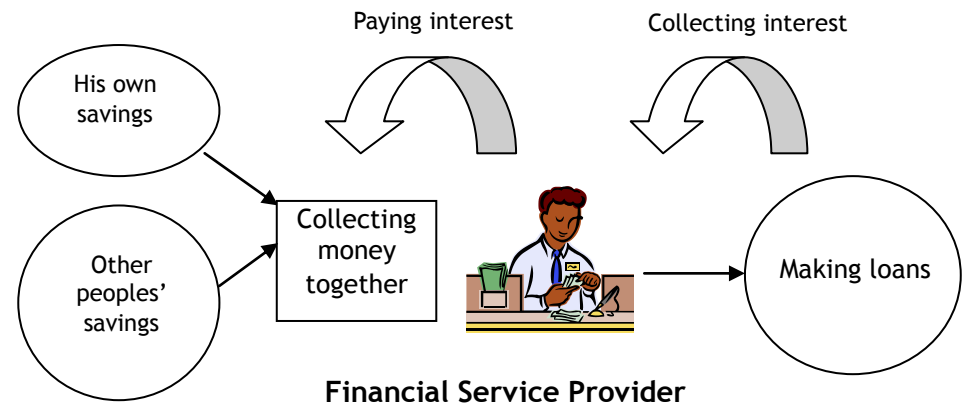
So how do financial institutions manage this process of transferring money between savers and borrowers? They do it by “selling” services to people as a form of business.



The service they offer savers is a safe place to keep their surplus funds. They may have a variety of products to attract savers with different objectives and offer incentives in the form of interest.

The service they offer borrowers is the opportunity to get a loan. Not everybody qualifies to borrow as the institution has to be sure that it can get back the money it has lent. However when a loan is approved the borrower has to pay for it in the form of various fees and interest payments.

This diagram, which has been adapted from Book 1, summarises in the simplest terms how a financial service business works.



To make a profit, the financial service provider will aim to collect more interest from borrowers than he pays out to the savers. In fact he will have other costs to cover such as buildings, staff, safes, computers, stationery and transport, so the interest collected on loans will have to cover these items as well.

This is why the interest rate on loans is always much higher than the interest rate paid for savings. Interest is a price; it is the price paid for the use of someone else’s money whether paid by the service provider or the borrower.

Most financial service providers expand the amount they can lend by borrowing money themselves. They pay interest on this but will expect to earn a higher rate when they lend it to others.



You will notice a reference to the service provider’s own savings in the diagram above. Like any business owner a financial service provider needs to invest some of their own capital in the business. If there is more than one owner it is called share capital.

If you have worked through Book 4, you will know that there is another service that banks offer their customers - a current account. This account enables you to keep your money securely in the bank, withdraw it when you want and make payments using a cheque or debit card. Most banks charge their customers a fee for running a current account.

Banks may also sell insurance policies and provide money transfer services which enable people to send money to relatives or pay for goods in other parts of the country or abroad. They will earn income from both these activities. Some of the money deposited in the bank may be invested in other interest earning accounts or bonds rather than in loans to individuals and businesses.



So if a financial service provider is running a business, what does the profit and loss account look like? Can you write down some items that might appear under income and some that might appear under expenditure?

Here is an example profit and loss account for a financial service provider:

Income	\$
Interest from loans	450,000
Fees from other services	75,000
Interest from deposit account	200,000
<i>Total</i>	725,000
Expenditure	
Interest on client deposits	220,000
Interest on loan	150,000
Furniture and equipment	75,000
Salaries and administration	200,000
Rent / building maintenance	50,000
<i>Total</i>	695,000
NET PROFIT	30,000

Not all financial service providers offer savings accounts to their customers. This is because Governments closely regulate which financial institutions can and cannot take deposits, in order to protect the interests of customers. Anybody wanting a licence to take deposits has to raise a very large sum of money as equity. Small microfinance institutions, therefore, rely on grants and loans to lend to their customers. Moneylenders rely primarily on their own reserves or savings from which to lend.

On the other hand some savings banks operating through the post office system only provide savings accounts and do not offer loans to individual customers.



A variety of providers

So, financial services may be provided by individuals or businesses or not-for-profit organisations such as cooperatives. When a friend, landlord or shopkeeper lends you some money or offers to keep money safe for you with or without charge, we call these informal services. They are not regulated.



Can you think of any other types of financial service that we might call informal?

You may belong to a savings group, perhaps one where you contribute weekly or monthly and each person gets the total amount collected in turn. These are known as rotating savings and credit associations or ROSCAs and are considered informal. Other types of small, self-help savings groups are also considered informal.

Many moneylenders and pawnbrokers operate informally, although in most countries they are supposed to register with the authorities and comply with any rules that have been established.

Did you think of the traders and input suppliers that you deal with? If you defer paying for your inputs until harvest time, that is a financial service similar to receiving a loan. Many suppliers will give you the option of paying immediately at a discount or paying within three months or so for an additional charge.



If you work for someone, you may be able to get a wage advance and if you pay rent, a landlord may allow you to defer payment for a specified period. All these arrangements are forms of financial service that are considered to be part of the informal sector.

There are some financial services that we might consider semi-formal; a registered cooperative for example. Credit unions, savings and credit cooperatives (SACCOs) and some multi-purpose cooperatives provide financial services in the form of savings accounts and loans and they are regulated under cooperative law. This means they have to comply with rules which ensure they manage their financial affairs in a sound manner but they are not as strictly regulated as a bank.

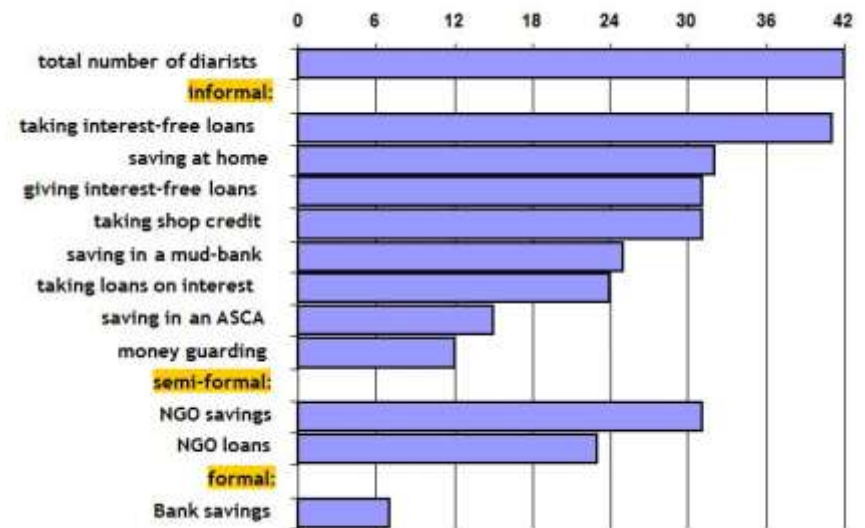
Many organisations which offer microcredit to people can be thought of as semi-formal. They may be registered as societies and thus have by-laws or articles of association with which they must comply or they may be registered as non-governmental organisations. Most are not-for-profit organisations and have to comply with laws governing charities.



Formal financial service providers are licensed and regulated by a government authority such as the central bank. All types of bank fall into this category - state banks, commercial banks, rural banks, postal savings banks, agricultural banks, development banks and so on. They have to comply with strict regulations to ensure they remain solvent and, if they are taking deposits, are able to safeguard people's money.

There are some financial service providers that are not banks but are licensed as finance companies. They operate very like banks but may not be allowed to take deposits because they have lower levels of equity capital.

This diagram shows the results of a survey¹ of 42 households in Bangladesh in which they recorded the different financial services they used over the course of a year in a diary.



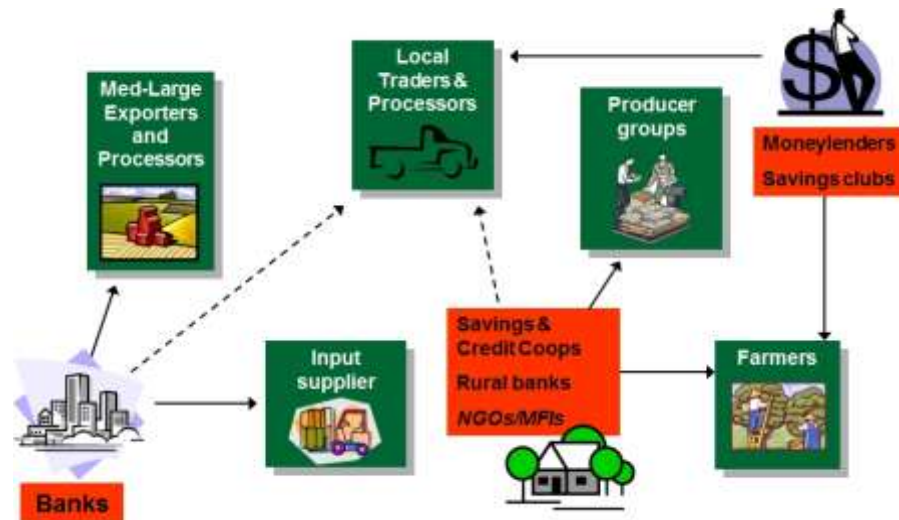
As you can see informal services are the most important to this group of people. An ASCA is an Accumulating Savings and Credit Association; a mud-bank is a method of saving at home, similar to a piggy-bank in other parts of the world; a money guard is someone who will look after a person's savings for a small fee.



Make a list of the informal, semi-formal and formal financial service providers that you use and then combine it with the lists made by the other members of your study group to see which service providers are the most important in your village.

You may find that like the families in Bangladesh, informal services are the most commonly used and very few small scale farmers are using the services of commercial banks.

In the agricultural sector banks generally provide services to larger input suppliers, exporters and processors. Smaller trading businesses, producer groups and farmers may be able to use rural banks and semi-formal financial service providers such as cooperatives and microfinance institutions, but many will still depend on informal service suppliers as this diagram suggests.



However it is the banks that often enable the processors and input suppliers to extend credit to their customers, so they may have an indirect role in bringing financial services to smaller operators in the agricultural value chain.

The question is should farmers and producer groups make more direct use of formal and semi-formal financial institutions? In the next chapter we will have a closer look at their procedures and see what is involved in using their services.

2 USING FINANCIAL INSTITUTIONS

Aim:

- To introduce first-time users to banks and financial cooperatives and explain what you have to do to access and use their services
- To look briefly at mobile phone banking and microfinance institutions

Banks

Banks come in all shapes and sizes.

This is a Central Bank which issues money on behalf of the government and regulates the money supply. Central banks often have supervisory powers over other banks to ensure they do not behave recklessly or fraudulently and they may also control the interest rates.



It does not offer services to members of the public.

The banks which offer savings accounts, current accounts and loans are known as commercial or retail banks. They can be found in a wide variety of buildings and settings.



This building houses a branch of a bank in a small rural town in India.



© Opportunity International

This converted truck container houses a branch of a bank in Mozambique.

Equipping and maintaining an office is expensive which is why banks are primarily located in towns where the volume of business can cover the costs. In some countries the government insists that banks establish rural branches. India, for example, has an extensive network of small rural banks as a result of government policy.



Puri Gramya Bank, India

An alternative strategy is to introduce mobile banking using specially converted vehicles which travel to rural locations on set days to provide services to their customers.



Mobile banking in Malawi
© Opportunity International



Mobile banking in Kenya
© DFID

So let's imagine you have decided to open a bank account. You arrive and go inside (we'll assume a building rather than a van for now). What do you see?

There might be a security guard at the door but don't worry about him! He is just there to protect the bank, the staff and the customers.

In a bank in a big town you might see a scene like this:



Equity Bank, Kenya © GVP Directory

What are all the people waiting for? They are waiting for their turn to go to the windows on the left where they find the tellers - the people with whom you do business when visiting a bank. The tellers collect deposits from customers and give them their cash withdrawals. They record transactions and can provide details of how much money you have left in your account. However, they do not open accounts!



If you want to open an account you have to find the Account Manager. Account managers meet with prospective customers to discuss their banking needs and recommend types of accounts that would be appropriate. If a customer decides to open an account, the account manager will provide the necessary forms and advise what documents are needed.

Every new customer has to fill in an application form. This can look very complicated but the bank has to get to know you and it does this by asking questions on the form.



Kenya's Cooperative Bank
© In2EastAfrica

Usually the questions are quite straightforward, e.g. name, address, date of birth, telephone number, occupation. You will need a photograph of yourself and you have to sign the form, thus providing the bank with the signature that identifies you when you sign documents in future.

In addition to the application form the bank will require some documents to prove who you are and where you live. You can use your passport or a national ID card, and if you have a driving licence or a utility bill - telephone or electricity for example - they provide evidence of your address. For some accounts you may have to make an initial deposit to complete the opening procedures.



Opening an account in Kenya
© Equity Bank



This would be a good moment to visit your nearest bank and ask for a copy of an application form so you can practise filling it in. If you are studying in a group you could get examples from different banks and compare them.

Once you have opened an account, the bank will start to keep records of all the financial transactions that you conduct through the bank. Most banks use computers to do this. This is a teller at work in a small bank in India:



Most of your transactions are conducted with a teller when you visit a bank:



© Opportunity International

Sometimes you may need to speak to the branch manager or a loan officer and then you will be invited into a separate office or to the officer's desk inside the bank.

It is not always necessary to go into a bank to conduct transactions. As we explained in Book 4, your account may provide you with a debit card which you can use in an automated teller machine or ATM. These machines are usually located outside a bank and thus, can be used even when the bank is shut.



Most people use ATMs to withdraw money but you can also check how much money is in your account. To use an ATM you will need to get a personal identification number or PIN from the bank. Then you insert your card and type in your PIN, following the instructions shown on the screen.



Inserting a card



Entering a PIN

The machine will then dispense the amount of money you have requested, provided you have enough in your account.



© Opportunity International

The other thing you can do with a debit card is use it to pay for goods in shops and other retailers who have a point of sale device. Your card is read and the relevant amount is debited from your account at the bank.

There are other ways of conducting bank transactions using either a computer or a mobile phone. Internet banking with a computer is common in wealthy countries but mobile phone banking has taken off in a big way in other parts of the world. For a bank to offer mobile phone services they have to collaborate with a telephone company. Some telephone companies have developed their own financial transaction services without involving a bank which we will look at later in this chapter.

This is a picture of a phone showing some of the services a bank in Kenya offers its customers using mobile phone banking.



© Jieleze

For example, customers can

- check their bank balance
- change their PIN
- request bank statements
- transfer funds between accounts
- pay utility bills and
- request a cheque book

simply by selecting options on the phone.



© IT News Africa

You may well have to complete a separate application form to be able to use this type of service but it makes it much simpler to manage your bank account, particularly if you live in rural areas.

However you deal with a bank, the record of your financial transactions will gradually enable the bank to build up a picture of how you manage your money. So although they may not know you personally, they do know how regularly you deposit funds in your account and whether you are able to build up your savings or if you run out of funds all the time.

This type of information is important if you decide to ask the bank for a loan. They will be able to judge your ability to meet loan repayments and the longer you have been a customer with the bank, the better they can judge your reliability and financial management skills.



Find someone who says he or she does not want to use a bank account and find out why. Can you convince them that it is not difficult to open and use an account?

Cooperatives

The idea of establishing financial cooperatives arose in Europe in the middle of the 19th century. The aim was to give those lacking access to financial services the opportunity to borrow from the savings pooled by themselves and their fellow members. They were known as credit unions.

Today credit unions can be found all over the world. In Africa and Latin America they are known as Savings and Credit Cooperatives (cooperativas de ahorro y crédito). In French speaking countries they are known as *caisse populaire* or *mutuelle d'épargne et de crédit*.



They may be very small organisations with just a few members or they may be very large with hundreds of thousands of members but they all operate on similar principles.

Credit unions are owned by the people who use them. Opening an account and depositing money in a credit union will make you a member of that credit union. As a member you will be entitled to attend the annual general meeting and take part in the election of a board of directors from among the membership. Every member has one vote regardless of how much money he has in his account.



Directors of a Credit Union in Andhra Pradesh, India © Brett epic

The board of directors, who are all volunteers, set the policies of the credit union, e.g. regarding levels of interest rates, and they may appoint a manager to run the day to day affairs of the union.

Credit unions are most successful when there is a common bond between the members so they are often found in places of work or among people who have a common profession or live in the same village or town. A common bond helps to create a feeling of solidarity among members.



Most credit unions offer very similar services to banks, so in what way are they different from banks?

Credit unions are "not-for-profit" organisations because they operate to serve their members rather than to maximize profits. They must make a surplus, however, so that they can build up reserves to cover any losses they may incur and to enable them to develop new products and services.

Banks, on the other hand, are run as profit-making businesses with a view to providing the shareholders with the best possible return. Bank customers do not have any say in the running of the bank.

Just like banks, credit unions can be found in a wide range of buildings and settings. However, most are small organisations and their offices tend to be smaller and less formal than those of banks.



A credit union in Dominica
© IFAD



Mutuelle d'épargne et de crédit in the DR Congo
© SDIA



A SACCO in Tanzania
© WOCCU

The chairs stacked up outside the Savings and Credit Cooperative (SACCO) in Tanzania are used for meetings and member training sessions.

Inside you are likely to find a layout similar to that in a bank:



© CUNA

These people are waiting inside a Fincoop Savings and Credit Cooperative in Malawi and the picture below shows a teller at work in a SACCO in Tanzania.



© DFID



© IFAD

The teller on the left is working in a Caisse Mutuelle in Côte d'Ivoire.

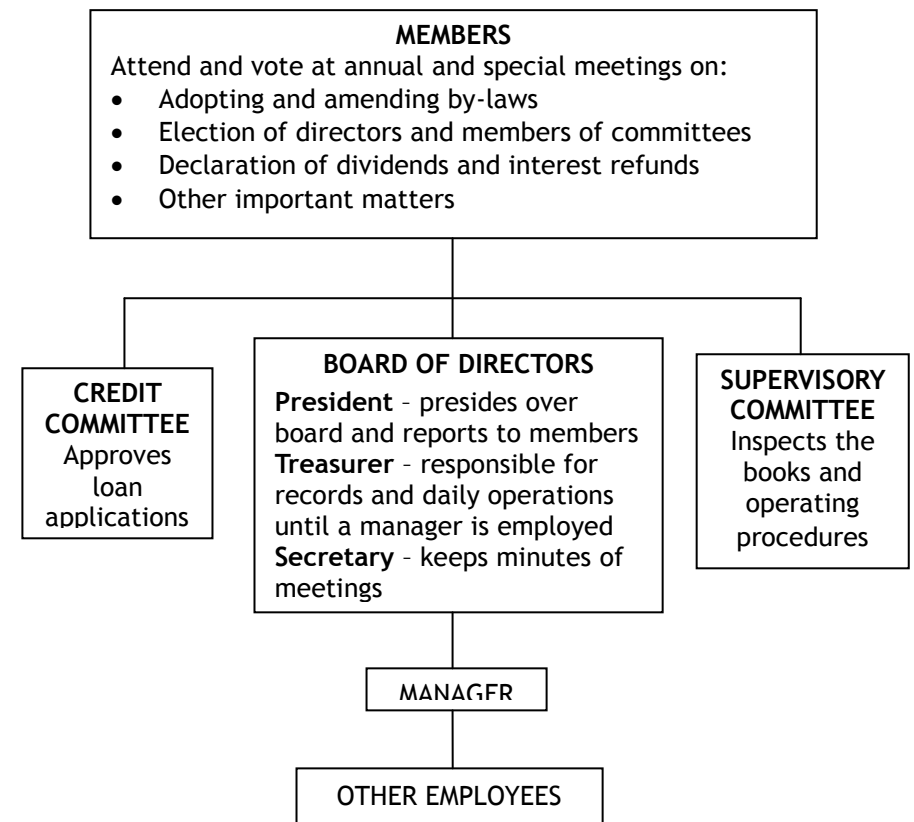
So how do you join a credit union and start using its services? The first thing is to find out what the common bond is and whether you are part of that bond. For example, do you live in the same locality, work in the same occupation or work for the same employer as the existing members? If you meet this criterion and are above the minimum age, the next step will be to fill in an application form and give it to the Board of Directors or Manager. An existing member may well be willing to help you with this.

Normally you will have to produce proof of your identity and your address just as you do when opening a bank account. In small credit unions, however, you may be recommended by a member who knows you, which will be sufficient identification.

If your membership is accepted, you will be asked to pay a membership fee and deposit the specified minimum amount in a share account.

As a member you will then be invited to attend the Annual General Meeting and you can expect to receive a dividend or share of the profit based on the amount you have deposited in your share account. You will be able to open other types of savings account and once you are established as a reliable member, you will be eligible to apply for a loan should you require one.

As a member you can stand for election to any of the committees which oversee the operations of the credit union. The key committees are shown in this diagram:



The Board is responsible for appointing the Manager and he or she would then appoint any other employees.

There may also be an Education Committee who would be responsible for informing members and non-members about the credit union's services and "selling" the idea of the credit union. They might also organise a programme of member education.

Financial cooperatives are by their nature found in many more locations than banks and thus are more accessible to people living in rural areas. Some have grown successful enough to have ATM machines and to consider introducing mobile phone banking.



Locate your nearest credit union or SACCO and ask one of the members to come and talk to you about their by-laws and becoming a member.

Other institutions

Telephone companies

As mentioned earlier some telephone companies are offering financial services via their mobile phone networks. You do not need a bank account to use these services; you simply need a mobile phone or a new SIM card supplied by the company whose service you wish to use.

Your phone can then become a mobile wallet! You can store money in the phone and withdraw it again when you need it, or use it to make payments to other people.



Source: iccwbo.com



© Christian Science Monitor

To register for an account, you will need to find an authorised agent of the telephone company. Most phone dealers are agents and they can be found in shops, supermarkets and petrol stations, as well as in some financial institutions.

You will need some form of identification (ID) with you such as a national registration card or passport.



Once you are registered as a customer, you will have to activate your account. You will need to choose a PIN (do you remember what that means?) and the phone company may send you a special password that you will have to use to identify yourself when contacting them for any reason.

When your account is set up, you can load money into your phone by handing over the amount of cash you wish to deposit to an agent. You will need your ID with you. The agent will record the amount and notify your phone of the amount that has been added to your "phone wallet". You will receive an SMS or text message to confirm the transaction.

When you want to use the money loaded on your phone you just need to follow the instructions on the screen. When you send money to someone else, they will receive a text message and the money will appear in their phone "wallet".



© Kiva

Microfinance institutions (MFI)



© Kiva / J. Goldstein

This label is used to describe quite a variety of organisations. The feature that they all have in common is an orientation to providing financial services to people on low incomes who do not have access to banks.

Many MFIs started as development projects with funds from donors, but others were created by men and women from the middle classes who wanted to support poorer people for social, ethical and political reasons. Some have been started by or are affiliated to religious organisations. So they are not member-based institutions like cooperatives but are run by management teams appointed by the investors.

Microfinance institutions often have a specific target audience for their services. Many focus specifically on women. They also have specific ways of working with their customers and often expect them to be part of a group and attend regular weekly meetings.



Women attending a micro-finance group meeting in Uganda © IFAD



Customers waiting outside an MFI in Ethiopia

The most common service offered by small MFIs is access to small loans but many offer non-financial services such as business training or advice on health and nutrition as well. To make use of MFI services you simply need to fit the client profile and be willing to follow their procedures.

Small MFIs are very informal and conduct most of their operations in the villages where they work. However, some have become large institutions, registered as profit-making companies or non-bank financial institutions. They will have a branch structure like a bank and although their products will still be designed for poorer customers, their procedures and facilities will be very similar to that of a bank.



Are there any microfinance institutions working in your area? Find out who can use their services and how they conduct their business with their clients.

3 USING FINANCIAL PRODUCTS

Aim:

- To explore the range of deposit and loan products that financial institutions may offer and learn how to compare their features

The services that financial institutions offer are known as products and their objective is to “sell” these products to their customers. Small microfinance institutions may only have one product but most banks have a variety of products offering different features to their customers.

So when you are considering using a financial institution, you will need to find out more about the products they offer. Banks usually produce brochures which you can pick up and study and there should be a member of staff who can explain the various products to you.



© Uganda Finance Trust

Deposit products

Let’s start with the products that encourage you to keep your money in a financial institution. These are all deposit accounts. There are basically two main types - savings accounts and current accounts.



The basic objective of a *savings account* is to provide somewhere that you can put away spare cash and earn interest on it. This type of account gives you the chance to grow your money over time, especially if you can make deposits into the account on a regular basis and leave the balance of your savings to accumulate and earn more interest.



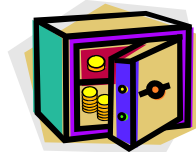
A client makes a deposit in her savings account

© Opportunity International

A lot of savings accounts are *instant access*, which means that you can put your money in and get it out whenever you want. They usually offer a variable rate of interest (one which goes up or down) and you may get a cash card which enables you to withdraw at an ATM, as well as in the institution.

Notice or call accounts generally offer better interest but you have to give the bank notice that you want to withdraw your money. The number of days' notice you will need to give ranges from 7 to 120 days. So if you have a 7 day notice account, you will have to wait 7 days after a withdrawal request to get your money. Sometimes you can obtain the money earlier, but you may incur a charge or loss of interest.

Fixed rate accounts offer a fixed rate of interest that is guaranteed not to change for a certain period of time (usually 1 to 5 years). So, for example, you can put your money away for a term of one year at a specific rate and you are guaranteed to get that amount of interest until the year is over. With this type of account you will not normally be able to get any of your money out until the specified term (e.g. one year) is over.



A savings account in a credit union or SACCO is called a *share account*, because credit union account holders are owners of the organisation and deposits in accounts are considered "shares". A share account does not earn interest but will receive a dividend based on the amount of surplus made by the cooperative during the year and the amount or number of shares in the account. You can withdraw your savings provided they are not pledged as security for a loan.

Many banks have special savings accounts for young people and some design products for a variety of special savings needs.

Here is an example of the range of savings products offered by the People's Bank of Sri Lanka:

Savings Products

- Harvest Special Savings Account
- Infants - *Isuru Udana*
- Minors - *Sisu Udana*
- Young Savers - YES
- All those who wish to make their dreams come true - *Jana Jaya*
- Ladies - *Vanitha Vasana*
- Senior Citizens - *Parinatha*
- For maximum benefits - People's Bank MAX
- Senior Citizens Pilgrimages - *Vandana*
- Teachers - *Guru Setha*
- Health Sector Employees - *Suwa Sevana*
- Regular Savers - Investment Savings
- General Purposes - Ordinary Savings A/c. (Single/joint)
- Institutions
 - Co-operatives
 - Partnerships
 - Sole Proprietorship
 - Limited Liability Companies
 - Corporations
 - Statutory Bodies

It is a particularly large selection! Each product will have some specific features. Let's look at the description of the Harvest Special Savings Account:

"Harvest" is a special Savings Account which offers a range of benefits that will improve the quality of lives of the people who are engaged in agricultural and agri-related projects, e.g.

- Small farmers who are engaged in paddy and other cultivations
- Medium and large level cultivators
- Crop collectors and intermediates
- Paddy millers, Bee keepers and other indirect farmers

An initial deposit of Rs. 1,000/- is required and thereafter any amount can be deposited.

Benefits include:

- Higher rate of interest, with an additional 1% bonus interest for accounts maintaining a minimum balance of Rs. 10,000/-.
- Eligible for the incentive schemes available at present and introduced from time to time.
- Loan facilities up to 90% of the savings deposit value at a concessionary rate.
- A Minors account for a child with a deposit of Rs. 500/- for any account holder who has maintained a minimum balance of Rs. 50,000/- for 6 consecutive months.
- Loans up to 10 times of the account balance can be considered for any purpose; priority given to agricultural loans.

Rate of Interest (in 2011)

6.5 % p.a. plus 1% bonus interest for an account that maintains a minimum balance of Rs. 10,000/-.



Now prepare a list of the features you would check when considering opening a savings account and decide which needs are best served by the three main types of savings accounts?

Here is a possible checklist of features:

What is the minimum investment?	
How much interest will you earn and how often will you receive it?	
Will the interest rate increase at higher levels of saving?	
Do you get a card for cash withdrawal at ATMs?	
Do you have to give notice for withdrawal or not?	
If it is a fixed rate, how long do you have to leave the money in the account?	
Are there any penalties for withdrawing money before the term is completed?	
Can the account be used as security for a loan?	

Which account should you use for different purposes?

- Instant access accounts earn least interest but are best for emergencies.
- Notice accounts are suitable for school fees or business inputs that are required at specific times.
- Fixed rate accounts are good for long term savings to purchase machinery, a house or other expensive items, particularly if matched with a loan. Of course you have to be sure that you can tie money up for a fixed period, if you choose this type of account. The funds have to be surplus to your immediate needs.



Now let's look at *current accounts*. These accounts require you to deposit money in them but the objective is to keep that money safe and offer you a variety of ways to withdraw cash when you need it and to make payments to other people. In credit unions they are known as share draft accounts.

Current accounts do not normally earn interest; instead the financial institution may charge fees for providing statements and payment services.

How can you make payments from a current account? The possible methods include:

- *Debit cards and cheques* - which we have already looked at
- *Standing order* - this is an instruction to your bank to pay a fixed amount from your account to a specified organisation or another person's account on a specified date. It can be set up to repeat on a regular basis, e.g. every month or every year. The bank will then make these payments on the agreed dates until you tell them to stop.

- *Direct debits* - this payment method is primarily used to pay bills. You sign a form allowing the company you are paying to take the money directly from your account on specified dates. You will be sent a bill by the company so you know how much is to be paid and they will then request the bank to pay them that amount.
- *Money transfer* - this is a one-off request to your bank to transfer some money from your account to another person's account, e.g. another member of your family or another of your own accounts.

If you are using any of these methods to make payments, it is essential that you make sure there are sufficient funds in your account to meet the payment amounts.



Some current accounts do allow you to spend more money from your account than you have in it. This facility is known as an overdraft and when the account has a negative balance, you are said to be overdrawn. The bank will impose a limit on the size of an overdraft and will charge interest on the negative balance.

If your account does not have an agreed overdraft facility, you will face penalty charges for going overdrawn and it may also result in declined debit card transactions, unpaid cheques and returned or cancelled direct debits and standing orders. So you will need to be aware that going overdrawn without agreement can be expensive.

So if you are interested in having a current account, you need to check what features are offered. A basic account may offer simply a debit card, regular statements and standing order and direct debit facilities. It may not offer a cheque book and will have no overdraft facility. A standard account will include a cheque book and the option of applying for an overdraft facility. However, to open a standard account you may have to have a regular income source.



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Other features you need to check are whether or not you have to keep a minimum balance in the account, whether there are any transaction fees (which you may be able to avoid if you keep a certain amount in the account), and whether there are any charges for withdrawing cash at an ATM.

Some banks offer current accounts with a variety of added features such as insurance products, but there is a monthly charge for these features and you have to be sure that you are not paying for things you don't need.



When should you choose a current account as the best financial product to meet your needs?

You might want to open a current account if you receive regular salary payments or if you are running a business with regular cash receipts and frequent payments to make. If you establish yourself as a reliable current account holder and are able to apply for an overdraft facility, this can be very helpful for managing variable cash flows.

Loan products

Now let's turn to products which enable you to borrow money from a financial institution. We have already talked about overdrafts, which is one way of borrowing from a bank but in this section we will concentrate on loans where you apply for and borrow a specific sum of money and agree to repay it according to a specific repayment schedule. You may be asked to repay the loan in instalments or in one final payment at the end of the loan term.

The loan term is the length of time you are given to repay a loan in full, including interest charges and any other fees. Terms can vary from a few months to a few years.

Banks and other financial institutions have to be very careful when they lend money. Most of the money belongs to other people and they have to be as certain as possible that they will get it back.

So they always have to find out something about you and often require you to fill in a detailed application form in which you will have to explain what you want to do with the loan, and provide them with details of your income and expenditure so that they can decide if you will be able to repay any loan they give you. It will help if you have some documents to show them that will tell them more about your business and how you are managing your money.



Looking back over the things you have learned in these booklets, what documents do you think it would be most useful to present to a financial institution to convince them to give you a loan?

If you are able to present the following documents to a financial institution, it would indicate to them that you understand your financial situation and know how to manage your money. The documents will also provide the institution with a lot of the information they need regarding your income and expenditure:

- A cash flow plan (see Book 1)
- A balance sheet (see Book 2)
- A cash book (see Book 4)



If you are approaching a bank or credit union for a loan, you normally need to have held an account with them for a certain amount of time and in this case, your account statements or passbook will be important supporting documents.

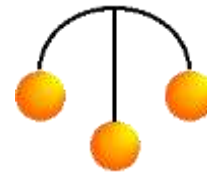
If you want to borrow for a business investment, you will need to explain your plans and if possible produce a budget to indicate its potential profitability. If you are able to answer “what if?” questions that will really help to convince the potential lender of your reliability and management skill (see Book 5).

Even though you may provide all this information, a lender may still not be willing to risk lending money to you without collateral. Collateral is some form of property that you are willing to pledge to the institution, so that they can take that property and sell it to recover the loan in the event that you cannot repay it.



Institutions differ with regard to the types of property that they will accept as collateral. Many prefer fixed assets such as land and buildings for which you have title deeds but some will accept moveable assets such as machinery, equipment and vehicles. Collateral is particularly important for longer term loans.

In most instances lending decisions are based on an assessment of repayment capacity and collateral is merely an additional security. However, pawning is a type of lending that is totally based on the value of an asset which is placed in the custody of the lender for the duration of the loan. No other information need be provided.



The principles of pawning are very simple: a borrower pledges an asset for a specified sum of money (a percentage of the appraised value of the asset) and retains the right to redeem it within a specific time by returning the sum borrowed plus interest. If the amount is not repaid by the agreed time, the borrower loses the asset. Pawn loans can be processed very quickly which is an advantage for borrowers.

Pawn loans may be offered by specialist pawn shops or by financial institutions. Some may only take gold and jewellery but others may accept a wide range of items.

Some institutions accept third party guarantees as collateral. This means that someone other than the borrower accepts the obligation to repay a loan in the event that the borrower fails to do so.

This type of guarantee forms the basis of the solidarity group method widely used by microfinance institutions. Solidarity groups mutually guarantee each other's loans and agree that they will repay the loan of one of their members should they default.



If a borrower has a savings account, this may be accepted as collateral for a loan. In this case the savings will be blocked and the borrower will not be able to withdraw money from the account until the loan is fully repaid.

So we have established that to be considered for a loan, you must provide information and, if possible, some form of collateral. It is also essential that you have not defaulted on loans in the past.

Most countries have something called a credit bureau or credit reference agency which gathers information from financial institutions and retailers about the credit history of their customers. Then, when a financial institution is considering a new loan application, they can check with the credit bureau and find out if the applicant has had any repayment problems in the past. If the person has a poor credit record, the loan may be refused.



Microfinance institutions rely heavily on the credit history of their customers when deciding whether or not to lend to a client and how much to lend. First time borrowers will generally only be given a small loan and, if this is repaid in full as and when instalments fall due, the customer becomes eligible for a larger loan. If further loans are taken and repaid promptly, the client will build up a good credit rating.



This would be a good moment to look at a loan application form from a financial institution in your area and see what information they require.

When you go to a bank you normally find that they have a number of different types of loan products on offer. They are often defined by purpose or customer group. For example, the State Bank of India lists home loans, education loans, car loans, property loans, student loans, festival loans and loans for pensioners, amongst its loan products.



So to choose a loan product that might suit your needs you have to read the product description supplied by the institution. For example KCB Tanzania describes their Personal Loan product like this:

“The KCB Personal Loan gives you quick and convenient access to cash that you will need for school fees, a car, medical bills, home improvement and renovations, purchase of furniture, appliances, farm inputs or perhaps you just need it for that holiday you've always wanted. The loan awarded is dependent on your repayment ability and competitive interest rates apply. We also offer you flexible repayment schedules. To apply you require having a well-managed account with KCB for at least 6 months.”

So this product is not restricted to customers with regular salaries but you can see that you must have been a customer of the bank for six months. You would have to ask what interest rate would apply to you - it may vary according to whether you can offer collateral or not.

Here are some examples of loan products offered by KADET - a micro-finance institution operating in Kenya.



Agricultural Loan “Mkopo Shambani” - this product is designed for small-scale farmers who trade in agricultural produce, including people growing horticultural produce and subsistence farmers who have a ready market for their produce. Customers can repay the entire loan at the end of the production cycle when the produce is sold.

Maji Kwa Jamii - a credit facility that allows KADET customers to obtain water tanks for domestic and commercial use.

Business Assets Acquisition loan “Jenga Mali” - a loan product which enables customers to acquire essential business assets, e.g. deep freezers, weighing machines, business pay-phones, etc. The asset acquired by the customer becomes security for the loan.

Business Loan “Mkopo Biashara” - this loan product targets business people seeking additional capital to inject into their businesses for expansion or diversification. Applicants must have businesses that have been in existence for a minimum of 6 months and are able to repay monthly instalments based on cash flow.

School fees loan - for existing customers.



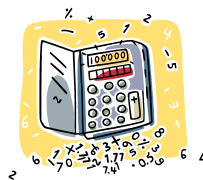
Visit as many financial institutions near you as possible and find out what loan products they are offering for different purposes and for different customers.

Once you have identified a loan that you are interested in, you need to consider the costs that are involved. There are two kinds of costs to consider - direct and indirect costs.

Direct costs are those which you pay to the lender such as application fees and interest rates. Indirect costs include such things as transport costs to get to the institution or to attend meetings and the time you have to spend dealing with a financial institution, which might lead to production losses or reduced sales.

Let’s look first at direct costs. It is very important to understand how interest rates affect the amount you pay for a loan. Most financial institutions quote what is known as a “nominal” rate of interest. They usually express this as an annual rate but microfinance institutions may quote a monthly rate.

So you might find out that the interest rate on a loan is, for example, 9% a year or 2% a month. However this does not tell you all you need to know. It is important that you find out how they calculate the interest.



Some smaller microfinance institutions calculate interest on what is known as a flat rate basis. This means that the borrower pays interest on the original loan amount for the full duration of the loan. If the loan is to be repaid in one instalment at the end of the loan term, this is fine - the flat rate will be the same as the quoted nominal rate. For example a loan of \$1200 taken for a year at 12% interest and repaid in full at the end will incur an interest charge of \$144 - exactly as you expect.

However, if this loan were repaid in monthly instalments, the situation would be quite different. A flat rate calculation will mean that you still pay \$144 interest (\$12 per month) but you will owe substantially less than \$1200 as the year progresses. Look at this table:

Month	Loan outstanding \$	Monthly repayment \$	Monthly interest \$
0	1200	0	0
1	1100	100	12
2	1000	100	12
3	900	100	12
4	800	100	12
5	700	100	12
6	600	100	12
7	500	100	12
8	400	100	12
9	300	100	12
10	200	100	12
11	100	100	12
12	0	100	12



If you were really paying 12% interest per year (which equals 1% per month) on the amount you owe, in month 7 for example, you only owe \$500 and should, therefore, be paying \$5 in interest (1% of \$500). If we work out the interest rate you have really paid on this loan, it is 21.5% per year not 12%.

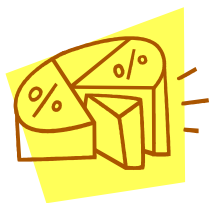
If interest is calculated on the reducing balance of a loan, the nominal interest rate should be close to the actual rate that you pay. In the previous example, the monthly payment of loan principal plus interest would be \$106.50 instead of \$112, if the interest is based on the reducing balance, and you would only pay \$78 instead of \$144 in total interest.



Most formal financial institutions use the reducing balance method to calculate interest. However the interest rate alone does not necessarily portray the accurate cost of taking a loan. An institution may charge a fee for processing the application or subtract a commission for providing the service. These charges may be deducted from the loan, so if you borrow \$100 you may only get \$95 to use.

In our previous example of borrowing \$1200 at 12% interest payable in one instalment at the end of the year, a 5% commission deducted from the loan amount will increase the effective interest rate from 12% to almost 18%.²

If an institution requires you to deposit a certain amount in a savings account or purchase an insurance policy to cover possible default, these too are additional financial costs.



It is very complicated to work out what are known as effective interest rates that take into account all the financial costs of a loan. However, it is important to realise that you cannot compare the cost of a loan simply by comparing the nominal interest rates quoted by different institutions.

Indirect costs are very personal - they depend on where you live and how the time taken to deal with a financial institution affects your business. It is just something to think about when you are considering taking a loan.



Now we have looked at some of the different kinds of loans you can get, the terms and conditions they might have and the costs involved, can you make a checklist of things you should ask when shopping around for a loan?

Here is a possible list of questions:

1. What types of loans are available?
2. Is there a loan term that matches my investment plan? (You need a longer repayment period for fixed equipment and machinery purchase; shorter for farm inputs or family needs.)
3. What are the eligibility requirements? (Account holder, length of time in business, etc.)
4. What collateral is required?
5. What is the interest rate and how is it calculated?
6. Are there any other fees?
7. How is the repayment schedule decided? (Fixed instalments or adapted to the cash flow.)
8. How far away is this institution from my home?
9. Do I have to join a group or attend meetings?
10. How long does it take to process the loan application?
11. How is disbursement made? (In cash, in kind, in instalments, where?)
12. Where and how can I make repayments?

There is one other type of loan product that bank customers who have developed a good credit history may be able to obtain and that is a credit card.



A credit card is not the same as a debit card. When you use a credit card to pay for goods, you are borrowing money from the bank that issued the card. The bank pays the suppliers and adds the money to your credit card account. Once a month they send you a bill showing all the purchases you have made with the card. If you do not pay this bill within a certain number of days, they will start to charge you interest. Credit card interest rates can be very high!

4 SOME IMPORTANT REMINDERS

Aim:

- To highlight a number of security issues
- To emphasise the importance of debt management

About security

When you are looking after cash at home or when you are out shopping or travelling, you know that you have to take care of it. You will make sure that it is not kept where other people can find it and be tempted to steal it.



When you start to keep your money in a financial institution, these rules still apply and, what is more, they will also apply to the documents and cards given to you by the institution. You need to keep account information, cheque books, pass books, debit cards and credit cards safe. If they are stolen, somebody may find a way to take money out of your account.

Financial institutions try to protect their clients' accounts from misuse. This is why they require your signature or fingerprints which are unique to you and can be used to verify that it is you making a payment or withdrawing money from your account.



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In this picture a customer at a branch of Opportunity Bank is having her fingerprint checked to verify her transaction.

Fingerprints cannot be copied but signatures can, so you need to take care of any signed documents and make sure that you do not leave a copy of your signature in your cheque book.

Do you remember what you need to be able to withdraw money from an ATM or transfer money with your mobile phone? You need a PIN - a personal identification number. It is really important that you are the only person who knows this number, so it is better if you do not write it down and you must NEVER write it on the card itself!

So you need to choose your number well, so that you can remember it without writing it down. However, you should not use numbers that are easy to guess, e.g. sequences such as 1234 or 0000, and you should try to avoid numbers that are easily connected to yourself such as your date of birth or the last four digits of your phone number. On your phone you can convert a four letter word to a number.

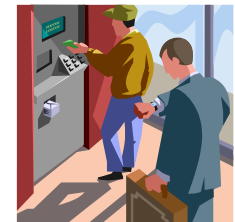


Practise working out PIN numbers that you think you could remember and that are also secure.

The same rules apply to any password or security questions that a financial institution may give you. Do not write them down or, if you do, keep them somewhere very safe.

If your debit or credit card is stolen, you should tell the bank or financial institution that issued the card immediately. Make sure you know their special phone number for reporting lost cards. Similarly if you lose a mobile phone you should advise the bank or telephone company immediately.

There are some simple precautions to take when using an ATM. Watch out for people who may be ready to rob you of any cash you have withdrawn and do not accept help from strangers when using the machine. You should also make sure that other people in the ATM queue are not standing too close to you and looking over your shoulder when you are entering your PIN.



Just one other aspect of security to highlight... What would you do if someone comes to you in the village and offers you a chance to invest your savings and make a lot of money? Let's say they offer you a 20% return after one month, equivalent to an interest rate of 240% a year.



Would you agree to invest your money with this person? If not, why not?

All over the world, people have been tempted by such offers. A very few do receive the promised return but most do not. Unscrupulous business people set up these schemes and use various methods to get people to invest their money. It is often very tempting for people in rural areas who are not near banks. The business does not invest the money they collect to make a profit at all. They simply use new investors' money to pay the interest to the older investors and eventually the scheme collapses.

Sometimes the person behind the scheme disappears with all the money! So you should NEVER give your money to someone promising to make you rich quickly. You should only deposit money in institutions that are properly regulated by the government.



Even regulated institutions run into financial difficulties sometimes but if this happens your money will be protected by the government and you should not lose it.

About debt management

In Books 2 and 5 of this series we talked about the risk involved in borrowing money. When you take a loan you are under an obligation to repay according to the agreed schedule and if you do not, you become a defaulter.

We looked at many of the reasons that can cause people to have repayment problems in Book 5. Income can be reduced as a result of weather damage, poor market conditions, illness in the family, loss of a job or loss of a critical asset such as a boat or draught animals. Input costs may go up; personal expenditure may go up, e.g. as a result of medical expenses or funeral costs.

You can minimise the impact of some of these problems by preparing a good cash flow plan and asking yourself a lot of "what if..." questions. Then make sure you do not borrow more than you can comfortably expect to repay, even when conditions are bad.

Monitor your cash book carefully. Are you sticking to your budget or are you spending more than you intended? Sometimes personal expenditure can get out of hand without your realising it.

If you find you have to borrow from friends or shopkeepers to pay for living expenses or you have to withdraw savings to repay your loan, these are warning signals that you may be running into problems.



What should you do if you find you cannot repay a forthcoming loan instalment?

The most important thing is to go and talk to the institution from which you took a loan. They are likely to be sympathetic if the cause of your problems is an unexpected weather event such as a drought or a storm which has reduced your income. If you have a plan, e.g. to reduce your personal expenditure or sell an asset or boost your income with off-farm work, this will also help the financial institution to consider rescheduling your loan.

Rescheduling means that the bank or institution will offer you a new repayment plan. They may extend the loan term and possibly offer you a moratorium on repayments until your income is expected to improve.

If your loan is rescheduled, you can avoid becoming a defaulter and damaging your credit record. However, it is not something that a financial institution will do unless they are confident that giving you more time will enable you to repay.

So you need to have a plan and you need to talk about it with a loan officer. Never borrow to repay and don't just hope it will all work out if you do nothing!



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Discuss any experiences you have had dealing with loan repayment problems and the steps you took to solve them.

End notes

- 1 Money Talks: Conversations with Poor Households in Bangladesh about Managing Money S. Rutherford Working Paper 45, Institute for Development Policy and Management, University of Manchester 2002
- 2 Effective interest rate in this instance is calculated as follows:

$$\frac{\text{Amount paid in interest and commission}}{\text{Principal amount received by borrower}} \times 100$$

Loan \$1200

12% interest = \$144

5% commission = \$60

Amount received after commission deducted = \$1140

$$\text{EIR} = \frac{\$144 + \$60}{\$1140} \times 100 = 17.9\%$$