FARMER SEGMENTATION, DEVELOPMENT OF LOAN PRODUCTS FOR SMALLHOLDER COCOA FARMERS AND PARTNERSHIP BUILDING WITH FINANCIAL INSTITUTIONS IN WESTERN NORTH REGION

Inception Report

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Introduction

The urgently needed replanting of almost 40% of Ghana's smallholder cocoa farms (>700,000 hectares), represents a financing gap of about $1 billion. This current shortfall threatens the livelihoods of 800,000 households and exacerbates what is already the largest driver of forest loss in Ghana's high forest zone - forest encroachment for new cocoa plantations.

SNV is engaged in projects with smallholder cocoa farmers in the districts Juabeso and Bia West in the Western North region of Ghana. To help smallholders improve their incomes in a sustainable manner, Financial Access Consulting Services (FACS) was engaged to help catalyze commercial finance into the landscape to support better use of inputs and eventually towards cocoa replanting and post replanting management services. In the short run this will be addressed by working closely with local financial institutions (FIs) to enhance their operations and procedures and help them supply input financing to smallholders. In the long run, a more holistic approach, combining investors, FIs, value chain actors and smalholders groups will be needed to operationalize a replanting finance scheme.

The activities undertaken by FACS are aimed at understanding the conditions, challenges and opportunities in the landscape and to help design and operationalize innovative financing schemes in the landscape. This can only be done by identifying institutional gaps in current replanting schemes, building and understanding of the credit needs of farmers, and quantifying the costs and risks to FIs in engaging with smallholders. In addressing these challenges and leveraging the strengths present in the area and within the various institutions, can an innovative financing scheme be designed that presents a strong, low cost and low risk investment case to all actors involved, giving them the tools and confidence to invest in smallholders. The reports, of which this one is the first, highlight various aspects of the activities and analysis undertaken and the insights learned.

This report covers the inception phase of the project. It first discusses the secondary data available on the cocoa value chain in Ghana. Next is provides an overview of the insights gained during focus group discussions with smallholders, conducted in March 2020. This report does not try to make recommendations per se, its main goal is to inform the engagement with financial institutions, the design of the smallholder questionnaire and FACS scoring methodology. The insights gained are therefore used as input in Report 1 and Report 2, that cover deliverables 1 and 2 respectively, and are disucssed further there.

Value Chain Information

Information from SNV's agronomists and other information of the organization on the cocoa value chain and especially the cash flow pattern of smallholders was analyzed. The cocoa value chain in Ghana is heavily regulated. A price is set centrally by COCOBOD and smallholders' produce can only be bought by License Buying Companies (LBCs). As these LBCs cannot compete on price, they offer various extension services and other secondary benefits to farmers to secure their supply. As smallholders often sell to different LBCs in order to maximize these extra benefits, a list of the 12 main LBCs in the area was included in the questionnaire, designed by FACS and administered by SNV enumerators. From the data follows that more than 87% of farmers actually only sell to 1 LBC, with another 11% selling to 2, and just 2% selling to 3 or 4 LBCs. The largest LBC in the sample is Touton, which buys almost 60% of the total produce. PBC is a distant second with 16%, and Cargill and ECOM follow with 6% each. All other LBCs buy less that 4% of the smallholder's produce each. It therefore seems that even though the LBCs cannot compete on price, there is significant concentration in the offtaker market nonetheless.

Apart from the value chain itself, the cashflow pattern on smallholders is critical both for understanding the financial needs of smallholders and designing a good loan product. A basic breakdown of the costs and revenues of farmers can be seen in Table 1 below.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Revenue	10	2	6	5	5	0	0	0	5	15	30	22
Costs	2	2	4	10	15	15	20	18	2	2	5	5

Table 1 – Revenue and cost pattern over time (monthly % of annual revenue/cost)

From the table we can clearly see that the need for input financing is highest in the months April to August, meaning that disbursement in March would be optimal. Furthermore, repayment would have to take the form of bullet payments between October and December, depending on the loan amount. It is always best to pay off loans as soon as possible, especially given the high interest rate common in Ghana. Where 1 bullet payment in October would be a realistic option for a smallholder, this should always be encouraged and more payments should only occur if the principal is too large to be paid off at once. The maximum tenor of the loan should therefore be 9 months, which generally falls within the agricultural loan products already offered by FIs in the area (see Report 2).

Though a more in-depth analysis might seem appropriate into an optimal loan product, this is highly dependent on the financing need and repayment capacity of individual borrowers. As will be highlighted in Report 2, there are signficant issues with the self-identified financing need of smallholders, which is often unrealistically high. Our recommendation in that report is therefore that the partner Financial Institution (FI) conduct a second needs-assessment to ensure that the actual loans that are paid out, ensure ample repayment capacity for the smallholder.

Focus Group Discussions

To validate the information given above, and also to inform the development of the questionnaire (discussed in more detail in Report 1) focus group discussions were held jointly by FACS and SNV staff in the week of March 9th 2020, just before the outbreak of COVID-19. Some of the key insights learned during these conversations are highlighted below.

Many farmers reported to have bank accounts at formal institutions, and to actively use these accounts. However, none of the farmers present had experience with formal bank lending, even though many have an active lending relationship with purchasing clercks (PCs) of LBCs. The combination of these two factors means that they were not hostile to the prospect of taking a loan at a formal institution, which is obviously a vital condition for a lending pilot. Furthermore, most farmers reported having important documentation, such as land titles or formal share cropping agreements if they were farming on some else's land. This is confirmed in the data collected, where 45% hold land titles, 18% and 12% hold short term and long term sharecropping agreements respectively, and only 25% do not hold any land title for their main plot. These percentages are very similar when we consider all plots of land on which farmers grow cocoa.

On the current lending arrangements with PCs, the relationship seems to be effective, albeit at a high cost to farmers, as the interest rate commonly stands at 100% over a period as short as 3 months (or 1600% per annum). The principal received ranges from GHS 500 to 2,000 and farmers almost always manage to repay the loans. The local presence and footprint of PCs is deemed critical for this. The loans received from PCs are often formalized with a contract, which is signed by both parties. In case that a default occurs, this contract gives the PC the right to harvest cocoa from an agreed field of the farmer during the next cocoa season. Though this serves as a form of collateral, there are obviously major concerns with structuring a contract this way, not the least the significant moral hazard this creates as farmers do not have an incentive to ensure maximum yields on this given plot if they know the PC will reap the benefits of it. However, as defaults rates are low, it is uncommon for this clause to be used.

As stipulated before, farmers voiced a clear preference for selling to LBCs that offer valuable secondary benefits to them. Most important was the willingness of the PC to offer loans for family needs and/or farming inputs. The main financing need comes from on-farm labor costs. In these discussions farmers said labor costs per acre would be around GHS 1,000 if fully outsourced, most of which is for weeding. However, our data shows that total costs, including labor are below GHS 250 per acre for 75% of respondents. Off-farm, school fees pose the most pressing financing need for smallholders.

In the discussions, farmers stressed the importance of cocoa income in their total household income. Though most produced food crops as well, these form a minor addition to total income. This is also borne out in the data, where 30% have no income at all outside of cocoa, and only 40% have non-farm income. Overall, half of farmers derive less than 15% of their total income from non-cocoa activities and three quarters depends on cocoa for at least half their total income. This means that, on the population level, non-cocoa income can not be used as a derisking mechanism for cocoa loans. However, at the individual level, there is ample scope to consider these alternative incomes as a very positive driver of repayment behavior. FACS's scoring algorithm therefore places significant weight on income diversity, discussed in more detail in Report 1.

As is to be expected from Table 1 above, farmers report generally having enough money in the beginning of the year, as they sell the bulk of their produce in the last three months of the year. However, in July and August many run out of cash and skip the last round of fertilizer due to having inadequate money on hand. Thus even though the input needs are highest from April onwards, there may not be a signficant financing need till the second half of the year. Though again, these dynamics are difficult to translate from the general to the individual level, as a significant cash shortfall may occur early in the year if most of the revenues gained at the end of the year are used to repay the informal loans to PCs. It is therefore still our recommendation to provide input financing in March, when the need for inputs is the highest for all farmers, rather than waiting till the general financing need is the highest, as this can lead to adverse effects on the personal level.