



Bank of St. Helena Ltd.

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Understanding Overdrafts

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1: A tool for business financing

This is a brief guide to overdrafts and how they can assist with your business finances.

It is intended to inform business owners about overdraft facilities to allow them to make a more informed decision when considering their financing options.

Please read this document carefully. Overdrafts are not for every business or for all borrowing situations.

1.1 What is an overdraft facility?

An overdraft facility allows you to borrow money via your current account by permitting you to spend more than what is actually available in your account. It is a form of borrowing and will need to be paid back to the Bank but there are no scheduled monthly repayments; you will be in control of the overdraft facility via your bank account. The overdraft must be settled prior to the date that the facility expires.

Overdrafts are available to businesses for working capital purposes only. They can be considerably cheaper than a conventional bank loan because interest is only charged on the amount of the overdraft being used, not the full amount of the facility. An overdraft facility is also more flexible than a conventional bank loan as you can reduce the balance and reuse the funds as many times as you wish, during the term of the facility.

Working capital is the money needed to fund the normal, day to day operations of your business e.g. wages, stock and fuel.

2: How does an overdraft facility work?

If approved, an overdraft facility will be attached to your businesses current bank account allowing you to spend up to the overdraft limit, e.g. if you have an overdraft facility of £5,000 you will be able to spend up to £5,000 more than the funds available in your account. You must continue to use your bank account for all your business receipts and payments and the business income received in the account will reduce the overdraft balance and repay the facility.

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An example of an overdraft facility and how it works follows.

Let's imagine a business is going to carry out some contract works on behalf of a customer. The contract is worth £200,000 and will take 12 months to complete; the customer has agreed that they will pay 20% of the total contract amount at the end of each of the first three quarters, with the remaining 40% paid on completion. The business needs to pay for labour and materials to be able to complete the contract, from Month 1, so it needs to borrow some money which will be paid back in stages as income is received from the customer.

In this scenario the working capital features are the labour & materials. Before starting the project, the owner has drawn up a cash flow forecast, which is shown below.

2.1 Cash Flow Forecast, Before Financing

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	Total
Receipts													
Stage Payments			£40,000			£40,000			£40,000				£120,000
On Completion												£80,000	£80,000
Total Receipts:	£0	£0	£40,000	£0	£0	£40,000	£0	£0	£40,000	£0	£0	£80,000	£200,000
Outgoings													
Materials	£10,000	£9,000	£500	£200	£200	£200	£200	£200	£200	£200	£200	£0	£21,100
Labour	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£84,000
Total Outgoings:	£17,000	£16,000	£7,500	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,000	£105,100
Net Cash Flow	-£17,000	-£16,000	£32,500	-£7,200	-£7,200	£32,800	-£7,200	-£7,200	£32,800	-£7,200	-£7,200	£73,000	
Opening Balance	£0	-£17,000	-£33,000	-£500	-£7,700	-£14,900	£17,900	£10,700	£3,500	£36,300	£29,100	£21,900	
Closing Balance	-£17,000	-£33,000	-£500	-£7,700	-£14,900	£17,900	£10,700	£3,500	£36,300	£29,100	£21,900	£94,900	

It can be seen that this is potentially quite a worthwhile project, but that a significant amount of cash needs to be put in to keep the business solvent in the first five months.

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2.2 Financing with an Overdraft

An overdraft facility can solve the problem of insufficient cashflow if projected accurately. The business would request an overdraft facility to be placed on their account, which enables it to borrow money as it needs it, up to a maximum borrowing amount (called the 'overdraft limit') and for a limited period of time (currently 12 months). At the end of the period the overdraft must have been cleared (i.e. all borrowing must have been repaid), or if required the facility can be renewed for a further period, but as long as the facility is in place, the business can borrow as much or as little of the overdraft limit as it needs.

The following amended cash flow forecast assumes that the borrowing is handled using an overdraft.

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	
Net Cash Flow	(17,000)	(16,000)	32,500	(7,200)	(7,200)	32,800	(7,200)	(7,200)	32,800	(7,200)	(7,200)	73,000	
Cumulative Net Cash	(17,000)	(33,000)	(500)	(7,700)	(14,900)	17,900	10,700	3,500	36,300	29,100	21,900	94,900	
Interest (charged at month end)	(84)	(163)	(2)	(38)	(73)								
Closing Cashflow Balance	(£17,084)	(£33,163)	(£502)	(£7,738)	(£14,973)	£17,900	£10,700	£3,500	£36,300	£29,100	£21,900	£94,900	
Cost of financing	84	163	2	38	73								£360

Note: Interest charged depends on the number of days in the month that the facility is being drawn on.

This example demonstrates that an overdraft limit of £34,000 would be required for a period of at least 5 months.

Interest payable

It can be seen that the total amount of interest paid is £360. This is because the business only pays interest on the amount of overdraft it uses from month-to-month, not on the total amount it needs to borrow up front i.e. the £34k.

3: About Interest and Repayments

3.1 Interest

Interest on an overdraft facility is accrued on a daily basis and applied to the account to which the facility is attached at the end of each calendar month. This is illustrated by the following example:

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7
Net Cash Flow from Project	(£9,000)	£2,000	£2,000	£2,000	£2,000	£2,000	£2,000
Interest (charged at month end)	(44)	(£35)	(£25)	(£15)	(£6)		
Opening Cashflow Balance	0	(£9,044)	(£7,079)	(£5,104)	(£3,119)	(£1,125)	£875
Closing Cashflow Balance	(£9,044)	(£7,079)	(£5,104)	(£3,119)	(£1,125)	£875	£2,875

3.2 Repayments

With a conventional loan, a fixed amount is borrowed and regular repayments have to be made. If interest rates remain constant, the repayments will be the same each month until the loan is repaid.

With an overdraft facility there are no fixed borrowing amounts (although there is an agreed maximum limit) and no requirement for regular repayments. All that is required is that the total outstanding remains within the overdraft limit, and that the overdraft is repaid in full by the time the facility expires.

In the following example, a business goes overdrawn by £90,000 in Month 1 and then does not receive any further cash until Month 6 (the overdraft limit is £95,000):

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Net Cash Flow from Project	(£90,000)	£0	£0	£0	£0	£100,000
Interest (charged at month end)	(£444)	(£446)	(£448)	(£450)	(£453)	
Overdraft Balance	(£90,444)	(£90,890)	(£91,338)	(£91,789)	(£92,241)	£7,759

Although no 'repayments' are made in months 2-5, even with the addition of interest the business remains within its overdraft limit, so there is no problem.

It should be noted, however, that this is a relatively risky financing strategy. In general, the Bank would prefer to see some income being set against the amount borrowed each month and the Bank account must be used for all business income and expenditure.

4: When to use overdrafts

4.1 General Principles

In general, overdrafts are most useful where the cash flow forecast shows that there will be months in which there is a net negative cash flow and other months in which there is a net positive cash flow, intermixed. Good examples are businesses where sales will begin or income is generated before the investment is completed, such as the one shown above or a retail business where stock has to be purchased before income can be generated from sales.

In situations where the business is borrowing to purchase an asset which will be written off over time, you will be advised to borrow using a conventional loan.

4.2 Responsible use of overdrafts

When used properly, an overdraft facility can be a flexible and cost-effective form of business financing, but when misused they can present real dangers.

The business is not forced to make regular repayments, and if the situation is not properly managed it is easy for the business to find itself approaching the expiry of its overdraft facility with insufficient cash flow to repay the borrowing.

For this reason, Bank of St. Helena does not offer overdrafts in all situations. For an overdraft to be offered it is necessary for the Bank to be satisfied that the business will be in a position to clear the overdraft balance within the limits of the overdraft expiry date, as evidenced by the submitted cash flow forecast.

Similarly, the business needs to make sure that the assumptions it makes when drawing up its cash flow forecast are realistic. If the business fails to generate enough cash it can find that the overdraft balance is growing each month. In an extreme case, where the interest on the overdraft facility becomes greater than the amount of cash the business is generating, the business is clearly heading for financial difficulties.

Although Bank of St. Helena will not offer overdrafts in situations which appear to be risky, the Bank's decision to lend should not be taken as a confirmation of your plan. It remains your responsibility to run your business in such a way that it can meet its commitments, including the need to repay any borrowings.

5: What If?

5.1 The overdraft is not cleared by the expiry date?

An overdraft facility can be renewed on an annual basis providing that the business reapplies for the facility prior to the expiry date and can prove that the request is made for valid reasons.

If there is an overdraft balance outstanding on the date that the overdraft facility expires, and the business has not requested that the facility be renewed, the business will be expected to make immediate repayment of that balance plus applicable interest.

If it fails to do so Bank of St. Helena will treat this as a default and will follow its usual procedures for dealing with borrowers that are in arrears with loan repayments, which could include taking court action and the seizing of assets.

If a business believes it may not be able to completely clear its overdraft by the expiry date it is advised to contact the Bank as soon as it becomes aware of the situation, so that a mutually acceptable way forward can be found.

5.2 The business attempts to draw more than the overdraft limit?

In general, the Bank's systems should prevent a business from exceeding its overdraft limit, and should reject further payments that would take the overdraft balance beyond the agreed limit.

However, managing the overdraft facility remains the responsibility of the business, not the Bank.

In the event that a payment is made that takes the business beyond the agreed limit, the Bank will contact the business and require it to make immediate payment such that the overdraft balance is brought back within the agreed limit.

If the business fails to do so the Bank may treat the situation as a default, as described above.

5.3 The business persistently breaches the limit

Bank of St. Helena reserves the right to cancel any overdraft facility and demand immediate repayment of any amounts outstanding. The Bank will not take such action lightly, but may do so if a business is, in the Bank's opinion, persistently misusing the overdraft facility.

Please note: Irresponsible or inappropriate use of your overdraft facility can affect your credit history and make it harder to get loans or overdrafts in future

6: How do I apply for an overdraft?

If you think your business could benefit from having an overdraft facility please contact the Bank.

You will need to fulfil the Bank's requirements for lending and accept its terms and conditions.

In particular, to support your application, you will need to draw up a business plan for the project or investment you are planning to make and submit with supporting documentation. Please see our "Business Loans – A Guide for Applicants" which will define the documentation required.

If you need help in preparing your application, sources of external assistance are available.

Notes:

- It is assumed throughout this document that the commercial lending interest rate remains constant at 6%, and that the business can offer appropriate security to support the amounts of borrowing in excess of £5k.
- Our current commercial interest rates are:
 - secured loans/overdrafts - 2% above our Base Rate (4%) equating to 6% interest per annum;
 - unsecured loans/overdrafts - 3% above our Base Rate (4%) equating to 7% interest per annum.
- Red figures in the examples indicate an overdrawn balance. Black figures indicate a credit balance with no overdraft.