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USAID-*TIJARA* PROVINCIAL ECONOMIC GROWTH PROGRAM

MAKING FINANCIAL SERVICES MORE INCLUSIVE IN IRAQ: ALTERNATIVE COLLATERAL OPTIONS

TIJARA
PROVINCIAL ECONOMIC GROWTH PROGRAM

(September,2011)

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ACRONYMS

USAID	United States Agency for International Development

1. EXECUTIVE SUMMARY

The collateralization of loans is critical to a well-functioning, growing financial sector. Collateral is one of the three "Cs" or pillars of support for credit (with the others being capacity to repay, and the character of the borrower for his/her willingness to repay). At the same time, one of the key objectives of microfinance is to reduce poverty by having financial services, particularly loans, be accessible to the poorest of Iraqis, as well as increasing the proportion of women served.

However, existing collateral options used by the 12 MFI partners of USAID-*Tijara* are limited. There are three collateral options used. The most predominant one used for at least 80 percent of MFI loans is that of government worker salaries. Another is the use of post-dated checks. The third, used more extensively since 2009, is solidarity group lending (SGL). However, there are thousands of Iraqis who do not have access to these three options. A survey of MFI partners found that from 30 to 40 percent of potential loan applicants cannot borrow because they do not have access to one of these three collateral options.

The purpose of this paper, therefore, is to encourage MFIs to use more collateral options. When MFIs use these options, two critical objectives are achieved: one socio-economic, and the other that relates to the institutional status and development of MFIs themselves:

- *Depth of Outreach*: When Iraqi MFIs diversify the collateral options they will accept and use, the depth of outreach of financial services will increase, thus making them achieve the microfinance ideal of inclusiveness. To the extent Iraqi MFIs diversify collateral options, more of the 96 percent of Iraqis who do not access financial services from the formal financial sector will be able to do so, especially the poor and women.

- *Mitigating Risk:* For MFIs, it is a risk mitigation strategy to diversify the kinds of collaterals they will accept. Reliance for most guarantees on government salaried workers is problematic, especially for MFIs that operate outside of Baghdad. This is because the payment of government salaries is often delayed. Such delays adversely affect on-time repayment rates, thereby reducing MFI credibility.

For any collateral to be effective, there are four features it should respect: low cost, time, simplicity, and enforceability. Unless a collateral option can respect these four parameters, it should not be used.

The collateral options for MFIs to consider beyond those already used include: (a) clients establishing a guarantee fund, which partially collateralizes a loan; (b) putting liens on movable property; (c) asset leasing; (d) warehouse receipts (mostly for agriculture/agribusiness-type lending); (e) the mortgage promise; (f) the signature witness; and (g) the use of traditional means, or *Murabaha*-principled lending, which can use a combination of collateral forms..

Recommendations for ways forward are: (a) two or three MFIs to pilot test one or two of the new options defined in this paper; (b) expand the use of the SGL methodology to all Iraqi MFIs willing to use it; and (c) efforts to be made to improve the existing and create a new enabling environment that facilitates the implementation of new collateral options.

CHAPTER 1: ALTERNATIVE COLLATERALS: MAKING MICROFINANCE MORE INCLUSIVE

1.1 BACKGROUND

The collateralization of loans is critical to a well-functioning, growing financial sector. Collateral is one of the three “Cs” or pillars of support for credit (with the others being capacity to repay, and the character of the borrower for his/her willingness to repay). An efficient system of loan collateralization assures financial sector integrity and the confidence required of all stakeholders for its effective functioning. Lenders of any kind need recourse to recover loans that have any risk of default. Loan capital needs to be safeguarded. As loan capital is the means of production for a financial intermediary such as a microfinance institution (MFI), not more than five percent can actually be written off as a loss before its institutional viability and survival comes under threat.

Around four percent of the current estimated population of Iraqis of 6.8 million living under the poverty line access financial services from the formal financial sector, which includes MFIs. This means that there are a tremendous number who are unbanked and who could access financial services. Access would be facilitated if they can offer, and financial intermediaries such as MFIs can accept, collaterals that would protect the interests of all concerned.

There are many characteristics of the existing financial sector and enabling environment that prevent this population from accessing quality financial services. One of them is not having the kind of collaterals that would satisfy financial intermediaries, whether MFIs or commercial banks. If there are more enforceable, viable collateral options, more people could access financial services from MFIs.

The Iraqi microfinance industry has grown impressively since the inception of its modern form in 2003. MFIs were established on a supply-driven basis to satisfy the needs of political and military efforts to achieve objectives of stabilization and security by getting loans to those who could start or expand businesses. The objective was that if Iraqi business persons were setting up and expanding businesses using loans from MFIs, the incentives to commit acts of violence and destabilization would decrease. Indeed, a lot of stabilization in the country has taken place. MFIs and the clients financed can take a lot of credit for the increasing stabilization taking place in the country as a consequence of the financial services offered, and their effective use in expanding business and employment opportunities.

A paper titled “Discussion on Alternative Collateral Options and Next Steps on Investigative Research” by USAID-*Tijara* was developed and distributed in March 2010. It laid out the conceptual basis on which the strategy and action plan for using alternative collaterals by MFIs can be implemented. The paper outlines the advantages to MFIs in expanding and deepening market opportunities by using additional forms of loan collateral. Another feature for MFIs in diversifying collateral options is that of mitigating risk. The greater number of collateral options available to MFIs to use to guarantee loans, the more likely they will reduce the risk of over-relying on a limited number of collateral forms. If one form fails to fulfill expectations of risk coverage for an MFI’s loan portfolio, access and use of alternative ones would mitigate potential loan loss as well as maintain and possibly grow portfolio serviceability.

This paper therefore strongly recommends that the Iraqi MFI partners of USAID-*Tijara* consider one or two additional collateral options described in this paper at least on a pilot basis. It further recommends that all MFI partners learn, adopt and implement the solidarity group lending (SGL) methodology as it is one of the most effective in deepening the outreach of microfinance to the poor and women.

1.2 THE PURPOSE IN DIVERSIFYING COLLATERAL OPTIONS FOR MICROFINANCE INSTITUTIONS

The purpose of this paper is to recommend to MFI partners of USAID-*Tijara* alternatives to the existing collateral means they already use. These are based on the premise that Iraqi MFIs would better achieve the goal of financial sector inclusiveness, especially the poor and women, if the collateral options they would accept from those applying for loans would expand. The recommendations are also made on the premise that MFIs will grow more and become more sustainable by implementing other collateral options.

The Iraqi microfinance industry has done well to date with its institutionalization, growth, and sustainability thanks to many factors, including the use of the several collateral forms they have. Portfolios steadily grow by at least 25 percent per annum. The portfolio-at-risk (PAR) for loans whose payments are 30 or more days overdue is less than one percent. It is now time for Iraqi MFIs to begin considering and testing other forms of loan collateral so as to achieve all relevant objectives of financial sector inclusiveness, now limited because of the limited forms of collateral guarantee MFIs currently use.

The benefit of increasing the number of collateral options to be used by MFIs is evidenced by many loan applications that are rejected. Two MFIs, Al Aman based in Kirkuk, and Al Mosaned in Tikrit, each have 40 and 30 percent of loan applicants rejected because they do not have access to government salaried guarantors. If other options were available, and other attributes of their loan applications were positive, those rejected due to lack of guarantee would likely be approved.

1.3 EXISTING FORMS OF COLLATERAL USED BY THE IRAQI MICROFINANCE INDUSTRY

As of 2010, microfinance in Iraq has achieved more than most would have likely expected when the industry based on best practices started seven years ago. MFIs have grown and matured beyond their supply-driven roots to become financial intermediary leaders in Iraq. They have a significant presence and provide leadership among their peers in other Middle East and North African (MENA) countries. The following are key characteristics of what has become a vibrant, innovative industry as of the end of July 2011:

Lending Production of the MFI Partners	Loan Amounts	Clients
- Cumulative Since Inception	$729 million	313,300
- Current Outstanding (All Loans)	$123 million	84,000
- Solidarity Group Loans Outstanding	$39.4 million	12,700
- Loans to Women (All Loans)	$21 million	14,300

- Annual Growth Rate in Loan Portfolios: 28%
- Portfolio at Risk for Loans whose Balances are More than 30 Days Overdue. 1.3%
- Financial Self-Sufficiency: 150%
- Operational Self-Sufficiency 209%

These achievements have been made by MFIs using a limited number of collateral options. Of the eleven MFIs surveyed for the kind of collaterals they use to guarantee and secure loans, nine of them rely almost exclusively (at least 80%) on guarantees by salaried government workers.

The following table shows across a sample of Iraqi MFI partners the kinds of guarantees used:

MFI	Collateral Guarantee Option
Al-Thiqa, Kirkuk	Government Employee Salaries Solidarity Groups (< 1% of clients) Real Estate (for Loans > $10,000) Personal Pledges Notarized (15% of clients)
Al-Aman, Kirkuk	Government Employee Salaries (100%)
Al-Bashaer, Baghdad	Government Employee Salaries (100%)
Al-Takadum, Anbar Province	Government Employee Salaried Guarantee (80% of clients) Post-dated checks (5% of clients) Personal Pledges Notarized (15% of clients)
Bright Future Foundation, Kurdistan Region	Government Employee Salaries (100%)
Tallafar Econ. Dvpt. Center (TEDC), Tallafar	Government Employee Salaries (95%) Solidarity Group Lending (for Agriculture) (5%)
Al Tadhamun (TDMN), Mosul	Government Employee Salaries
Relief International, Sulaymaniyah	Government Employee Salaries Solidarity Group Lending (40% of clients)
Amalkom, Hilla	Solidarity Group Lending (96% of clients) Government Employee Salaries (4% of clients)

Izdiharouna, Hilla	Government Employee Salaries (60%) Solidarity Group Lending (40%)
Al-Mosaned, Tikrit	Government Employee Salaries (100%)

As the table above shows, Iraqi MFIs have been mostly using the following

- Government employee salary guarantee; Use of government employees to guarantee MFI loans is the most prevalent form of collateral. In the event of default, one-fifth of his/her monthly salary is deducted to satisfy the loan. There have been times when government salaries are not paid on schedule, especially in areas outside of Baghdad such as the Anbar Province.

Use of this form of guarantee predominates in MFI lending given its low cost, ease and rapidity of use, and ease and rapidity of loan recovery in the event of default. Further, as a large portion of the Iraqi labor force is public sector, most clients wishing to get individual loans need access to someone they know who works for the government, has a regular salary, and can thus guarantee his or her loan. As the output results above indicate, this has not been too difficult as at least 30 percent of the Iraqi labor force is employed in a public sector capacity.

- Advantages: The popularity of this form of guarantee among Iraqi MFIs attests to its many advantages. These include the ease of use, familiarity by the parties concerned, low cost of only having to notarize loan and guarantee contracts (around U.S. $40), quick enforceability, and accessibility due to a large number of the Iraqi labor force being employed by the government and/or public sector entities.

- Disadvantages: There are two significant disadvantages to the use of this form of guarantee:

  - Dependence on government salaries being paid on time: There have been instances with Iraqi MFIs where government salaries have been paid late, especially outside of Baghdad in provinces such as Anbar, by several days and even weeks. Repayment rates decrease, thereby exposing an MFI to greater institutional risk of loss of credibility and confidence.
  - Limited access: For loan applicants, the disadvantage is that not all know those who work in government who would be willing, or able, to guarantee their loans. This excludes poorer clients as well as women who would not have access to such employees for guarantee purposes. Women are less likely to be part of the formal sector work force, and thus less likely to know of salaried government workers to use as loan guarantors. As already cited, several MFIs report that at least 30 percent of loan applications are rejected because the applicants do not have access to acceptable guarantee forms.

- Solidarity group lending (SGL) – peer monitoring: The SGL form of guarantee, whose use in Iraq by MFI partners began in 2009, is showing promise. SGL has three to five unrelated persons co-sign and borrow as a group. In the event one defaults, the other group members satisfy the outstanding loan balance. Average loan sizes using the SGL methodology are smaller, which results in deeper outreach to the poor and women.

The SGL methodology is popular around the world of microfinance. It is the foundation of how modern microfinance got started in the 1970s with Dr. Muhammad Yunus and the Grameen Bank in Bangladesh. The SGL methodology there has helped to finance millions of clients, mostly women, as a means to get them out of poverty. Grameen Bank now enjoys an outstanding portfolio of $817 million among 6.4 million clients, almost all of whom are women. It is described here so as to demonstrate the power and effectiveness of the SGL methodology when adapted to Iraq or anywhere else where poverty is prevalent. The proportions of women are greater using the SGL methodology by virtue of the small average loan sizes. Women are also more likely to be more impoverished than men, thereby opening the opportunity for them to access smaller loans.

As of September 2010, the outreach of solidarity group lending, after only 14 months, has been impressive. Among the four MFIs implementing the SGL methodology, there are 12,672 members of 4,161 groups with outstanding loans of $7.4 million. Average outstanding loan size is $584, or 42 percent of the overall average outstanding individual loan size of $1,406. The PAR for SGL loans is the same as for individual ones.

- <u>Advantages</u>: The advantages of the SGL methodology are many. Among others, they include:
    - <u>No need for tangible guarantee</u>: Applicants do not need a tangible guarantee for the model to work. All that is needed is for group members to sign for one another to guarantee the loan.
    - <u>Smaller loan size</u>: The smaller the size of loan, the greater is the outreach potential of the MFI to the poor and women.
    - <u>Outreach to the poor and women</u>: SGL greatly benefits women as their business start ups and expansions are usually smaller. Among the Iraqi MFI partners of USAID-*Tijara* using SGL, women clients are 29 percent of SGL borrowers versus just 17 percent for individual borrowers.

- <u>Disadvantages</u>: There are several disadvantages to the SGL methodology:
    - <u>Small loan size</u>. The capital a client may need and MFI profitability are reduced. The per dollar cost of an MFI monitoring a small loan size is usually greater than that of larger loans. The small loan size, where it only goes up to a small maximum, may not meet the capital needs of the individual borrower.
    - <u>Intangibility of the collateral</u>: There is no physical attribute to the collateral such that there is nothing physical for the MFI to seize in the event of complete loan default by all group members.
    - <u>Group constitution</u>: A key word in the SGL methodology is solidarity. For the sake of meeting the requirement of forming a group to get a loan, individual group members may throw themselves together simply to get the loan. Notions of solidarity disintegrate when loan servicing becomes more problematic. Any idea of solidarity among them beyond just getting the loan may be nonexistent.

- <u>Post-dated checks, with co-signature by an Iraqi Government employee</u>. Just a few of the Iraqi MFI partners use post-dated checks as collateral form. The post-dated checks could be both from the clients themselves, and from guarantors. In the event a borrower falls into default on his/her loan, the post-dated check from the guarantor is used. If a post-dated check, at the time it is deposited, does not have funds to cover it, the person issuing it can go to jail until provision is made.

- Advantages: One of the greatest advantages of post-dated checks is that of convenience to the MFI. The MFI simply deposits a series of post-dated checks that cover the installments for the repayment period. In the event of borrower default, the MFI simply uses the post-dated check, when the date arrives, to satisfy the defaulted repayment amount(s). Another key advantage is enforceability. In the event a check does not have sufficient funds in the bank on which it is drawn to back it up, the check issuer, whether a client or guarantor, can be arrested. This fact is a great deterrent to those who may use this form of guarantee. They will assure that their checks will be honored by the banks on which they are drawn.

- Disadvantages:

  - The greatest potential issue with post-dated checks is that, when deposited or cashed by an MFI, there may be no funds.
  - Those who can offer post-dated checks would not be the primary target groups of MFIs; namely, the poor and women. It is not likely people in such groups would have current bank accounts.

1.4 COLLATERAL OPTIONS USED ACROSS THE MIDDLE EAST AND NORTH AFRICA (MENA) REGION

The collaterals used by MFIs across the MENA region are those that are more commonly found in microfinance as practiced in most developing countries of the world. The parameters within which MFIs operate elsewhere in the region are more in line with those of best practices, particularly use of much lower average loan sizes and focus on women. As such, the comparisons with the experience of MFIs in Iraq are not particularly direct. However, they do suggest where Iraqi MFIs and the larger industry wants to go with collateralization of loans if it wants to more closely resemble microfinance operations in line with the best practices.

In this context, a survey was conducted among eleven MFIs located in five MENA countries. These countries include Morocco, Egypt, Jordan, Syria and Palestine. Loan sizes range all the way from $150 to $5,000, with one MFI having a ceiling of $10,000. Loan terms are anywhere from three to 18 months. The percentage of women served is much higher than that of MFIs in Iraq, with at least half served in other MENA countries. The higher percentage of women served in other MENA countries is likely a consequence of a greater use of the SGL methodology.

The following lists the kind of collateral options used across a sample of MFIs in other MENA countries:

• Solidarity group lending methodology:	11
• Personal guarantees	5
• Government salary guarantee	2
• Bank guarantee	2
• Notarization of borrowers' signatures	2
• Post-dated checks	1
• Real estate	1

1.5 THE NEED FOR ALTERNATIVE COLLATERALS

The current success of Iraqi MFIs has lead to a high degree of comfort and complacency for the limited, existing forms of collateral. They limit, however, the greater outreach potential to the poor and women that would be achieved if collaterals are diversified.

Recent data and evidence from several USAID-*Tijara's* MFI partners shows the need for forms of collateral other than the one on which most loans are guaranteed, which is the salary of government workers. The following two factors demonstrate the need for diversifying loan collateral options:

- Overreliance on only one or two forms of collateral have the potential to adversely affect an MFI's ability to reach out more to target markets and mitigate risk. Often, there are delays in the payment of government and public sector salaries, especially in areas outside of Baghdad such as in the Anbar Province. The effect on MFI loan portfolios was to see delays in repayments.

- For a sample of several hundred rejected loan applications from the MFIs Al Aman in Kirkuk and Al Mosaned in Tikrit, both of which rely exclusively on guarantees by government employees, 30 to 40 percent of them were rejected because they could not present the limited, accepted forms of collateral. Relief International and Izdiharouna, on the other hand, indicate that no more than eleven applications out of 139 (which is out of 10,545 applications for loans submitted to the same two MFIs) between February and September 2010 were rejected due to lack of collateral.

These situations justify the need for MFIs to diversify their collateral options for loan applicants. In summary, the attributes of diversified collateral options include:

- Larger number of client groups able to access MFI lending, especially the poor and women.
- Mitigation of risk to MFIs not over-relying on limited collateral forms.
- Improving the brand image of MFIs before all stakeholders

CHAPTER 2: ALTERNATIVE COLLATERAL OPTIONS

A diversified financial market for microfinance, and one that aims to achieve greater depth of outreach, needs to have more collateral options. It makes sense for MFIs in deepening outreach, and also in making Iraqi MFIs more marketable to a wider range of clients traditionally targeted by MFIs.

2.1 DESIRABLE CHARACTERISTICS OF COLLATERALS

For a collateral option to be effective, especially for microfinance, there are four features it should respect:

- *Low Cost*: The cost of processing a collateral option when a loan is approved, and of enforcing it when a loan goes into default, should be low relative to the approved loan amount. Any cost that goes beyond five percent combined for engagement and enforcement of the approved loan amount makes the collateral unfeasible.

- *Time*: The time needed to process and enforce a collateral option should be as short as possible – no more than two to three days.

- *Simplicity*: A collateral option should not take more than one or two different offices to process, and not more than two forms to complete and get notarized.

- *Enforceability*: The collateral option should be easily enforced; not taking more than one to two steps,

Collateral instrument options are listed and described below with their legal and practical advantages and disadvantages. One common provision for all of them is that all documents used for the loan and collateral need to be notarized.

2.2 INSTRUMENTS

For any collateral to be effective and of use, the proper tools are required. These especially apply to the documents required to assure that the collateral offered to an MFI by a loan applicant is properly secured and possessed when s/he becomes a client.

- *Loan Contract Clause for the Guarantee*: Iraqi MFI loan contracts do not refer to collaterals or means of guaranteeing loans in their formats. It is a standard best practice that the loan contract between a client and an MFI contain the appropriate clauses referring to that which is to be used as collateral. Most loan contracts identify and list the kind of collateral options that will be used to guarantee a loan to an MFI. The first place where provision for collateral guarantee starts is in the loan contract.

Words to the following effect should be placed in the loan contracts:

Loan Contract Clause
Clause ___: Loan Guarantee (see Loan Guarantee Contract as attached to this contract. The client accepts to put into the possession and disposal of the MFI, as a guarantee to assure that the loan is repaid as agreed, one of the following items where the MFI has the right to follow the appropriate legal procedures in case of default: The client acknowledges that s/he is the sole owner of the possessions mentioned above and is not already encumbered with a mortgage or lien.

- *Loan Guarantee Contract (**see Annex 1**)*: In addition to a clause in the loan contract, a separate contract for loan guarantees is also used. It is used particularly to secure either movable or real property. Notarization is an essential part of the process. Both the client and the MFI sign this document, with notarization received.
- *Promissory Note (**see Annex 2**):* The promissory note functions as the guarantee of a third-party individual to collateralize a loan. The client, the guarantor and the MFI all sign in the presence of a notary. Registration of this promissory note can be made with a chamber of commerce.

2.3 SOLIDARITY GROUP LENDING (SGL)

Description: Solidarity group lending (SGL) is a method where (a) a group of people, usually from three to five, sign for one another as guarantee; (b) nothing tangible such as movable or real property is pledged; and (c) the loan amounts are usually small because the guarantee is non-tangible. SGL is the essence of microfinance and best practices around the world: very small amounts for loans needing no tangible, physical guarantees. It is popular because it makes loans accessible to the poor and women, those in the informal sector, and those who otherwise would never be able to access loans from any other source of financing. **Annex 4** outlines the typical conditions required for SGL.

Advantages	**Disadvantages**
For the MFI: The MFI can diversify its lending portfolio while also being able to proclaim that it is a lender to the poor and women. *For the Client:* Clients need no tangible item or person of means for guarantee. A signature on a loan contract, together with the two to four other members, is enough. Loans also go to those who may even be excluded from MFIs because they lack any tangible means of guarantee.	*For the MFI*: Creates more accounting and financial management processes. MIS systems such as LPF and the Loan Tracking System would need to be modified to accommodate the accounting for and management of the guarantee fund. The cost per loan also shoots up as the numerator (costs) remain relatively fixed as compared to loan amounts getting smaller relative to the number of clients. There is also greater risk to the MFI in the event all members of an SGL default, and there is no recourse to a tangible guarantee. *For the Client:* (a) Loan is smaller than for individuals; and (b) one group member has to find at least two others non-related to form the group such that they can all sign for one another on the loan.

Instrument Used: **Annex 4** at the end outlines a simple one-page contract needed to analyze and have all members sign as well as the MFI.

2.4 GUARANTEE FUND

Description: A guarantee fund, sometimes known as mandatory or involuntary savings, is a form of collateral used by MFIs located in countries poorer than Iraq. The fund, when used with a loan, can build up until it becomes around ten percent of the approved loan amount. Although it only covers up to ten percent of the principal lent, it can be leveraged with other guarantees. With leveraging, an MFI does not have to be as stringent in other collateral requirements. For example, an MFI could accept a government worker as a loan guarantor with a salary lower than what would be needed if a guarantee fund was also used to offset the lower salary.

Loan Guarantee Fund
Scenario: A client takes out a $2,000 loan at the first of the year. Assuming a fee or interest rate of ten percent, the client receives $1,800, but repays a total of $2,000 as principal, which is inclusive of interest or fees. A guarantee fund in the amount of ten percent, or $200, would be constituted in the course of the loan being repaid according to the schedule below paid in four quarterly installments, with the last installment paid the last day of the year:

Date Installment Due	Principal & Interest Installment	Guarantee Fund Deposit
- March 31s	$500	$50
- June 30th	$500	$50
- September 30th	$500	$50
- December 31st	$500	$50
TOTALS	$2,000	$200

By the end of the year, the client has repaid his/her loan. S/he also has on deposit with the MFI $200. S/he can either (a) withdraw the funds because s/he no longer wants to take another loan from the MFI; or (b) keeps the fund with the MFI to be used as a partial guarantee towards the next loan. The next loan, say $3,000, would only need a guarantee valued up to $2,800 to secure the loan.

Advantages	Disadvantages
For the MFI: The MFI will have immediate access to funds which it can use to offset the last installment due or other fees such as penalties. For the Client: The client can constitute? the partial guarantee during the repayment period of the loan. It will then provide the client with leverage either with the MFI itself for a subsequent loan, or with another financial institution in reducing the collateral requirements with them.	For the MFI: Creates more accounting and financial management processes. MIS systems such as LPF and the Loan Tracking System would need to be modified to accommodate the accounting for and management of the guarantee fund. Its promotion would also have to be well crafted and worded such that it would not conflict with any interdictions against NGO MFIs mobilizing savings deposits. The guarantee fund only covers a small percentage of the loan – up to ten percent of the principal lent. This form of guarantee has to be complemented by others to fully cover that which was lent. For the Client: Constitution of the guarantee fund raises the effective opportunity cost of the loan by requiring an additional ten percent to be paid in over and above that which has to be repaid in principal.

Instruments Used: The instruments to be used in helping to set up and implement the guarantee fund would be minimal. They would include:

- Loan contract: The loan contract can include a clause for the client requiring the constitution of the fund in equal increments equivalent to ten percent of the repayment amount. The contract could also have integrated into it, or attached, the repayment and guarantee fund deposit schedule.

- Accounting and MIS systems: For the MFI, it would simply be a matter of setting up the appropriate subsidiary asset and liability accounts in the general ledger. As well, the MFI would have to add and adapt its MIS systems such as Loan Performer and the Loan Tracking System to adequately account for the separate guarantee fund both for the MFI and the clients themselves.

2.5 MOVABLE PROPERTY.

Description: Movable property is one of the most traditional means of guaranteeing loans. It is as simple as a financial intermediary such as an MFI placing a lien on any tangible, physical property item that is movable. In the event of loan default, the item is seized by the MFI and sold to cover the amount in default. Collateral items can be anything of value enough to cover the balance of an outstanding loan: gold, jewelry, motor vehicles, furniture, electronic equipment such as computers, stereos and television sets, etc. Liens can be placed upon them, made legally effective and enforceable through public notarization. For movable items that are small yet precious such as jewelry and gold, the MFI can keep them physically at its premises or at a safe depository such as a bank with safe deposit boxes. In other instances, such as nonperishable agricultural produce, warehouse arrangements, including those using third parties, can be made where produce is later sold and outstanding loan balances are settled. An MFI's loan is settled when the produce is sold and before a farmer receives the proceeds from the balance of the sales.

There would be two broad categories of movable property when considering their use for collateral:

- Movable property that is kept by the MFI: This is where small but precious items such as gold and jewelry are kept by the MFI until the loan balance is satisfied. The items are precious but small enough to be held in safekeeping either by the MFI itself in its safe, or in a safe deposit box at a bank. Once satisfied, the property is restored to the client. In the event of default, the property is kept and either liquidated for cash, or kept by the MFI as another type of asset.

- Movable property that is kept by the client: This is where items such as motor vehicles, furniture, IT equipment, machinery and others are kept by the client. They are kept by the client for the practical purposes of (a) the need for them to be used; and (b) their size and weight would make it impractical for an MFI, requiring it to rent or use space to store them. In this case, liens are placed (labeled as promissory notes), duly notarized, which allow the MFI to seize the items for auction and sale.

- Movable property that is kept by a third party: This is where property items are held in storage or warehoused, and then used by a loan applicant to secure a loan from an MFI. Instances where this takes place are mostly for agriculture. Warehouse receipts are issued to a loan client in return for the MFI keeping agricultural produce that is nonperishable, and can only be released when an MFI authorizes it (see more detailed description of warehouse receipts, below). The costs for the storage, insurance, maintenance such as a cold store if needed, feed for animals kept at a feedlot, etc. are borne by the client. The benefit the client gets from borrowing against warehouse receipts used as securities has to be significantly positive in order to offset the additional time and costs.

Advantages	Disadvantages
<u>*For the MFI*</u>*:* Provides the MFI with another collateral form it can offer, especially high-value but small items such as jewelry and gold, that can either be repossessed or sold quickly in the event of default. For a warehouse, the receipt is a tender of guarantee for a client in exchange for a loan. <u>*For the Client*</u>: Use of idle assets such as gold and jewelry can be turned into cash. That is cash that can be used more productively for business start-up and expansion than lying around one's house at the risk of loss from fire or theft. Also good for the client who doesn't have access to other guarantee forms such as a salaried government worker.	<u>*For the MFI*</u>: One of the greatest disadvantages about movable property is its security. There is added risk of loss to theft and fire when the assets pledged have to be kept at the MFI in its safe. There are also extra costs involved such as for safes, guards and insurance, all of which have to be passed on to the client. For other physical items such as motor vehicles, the MFI has to assure that there is insurance, maintenance and reasonable security taken by the client. Clients who have access to gold or jewelry are not likely to help the MFI to deepen outreach (not as likely that a poor person would own gold and jewelry as one without). <u>*For the Client*</u>: One of the greater disadvantages to a client would be the costs s/he would have to bear such as for safes, and paying warehouses for storage. The client also loses access to the assets pledged as they remain with the MFI during the full repayment period.

One potential form of movable collateral that could be used is motor vehicles. However, due to the dysfunctional, almost nonexistent, governmental authority to regulate and license them makes their use as loan collaterals ineffective. Without an efficient system to record titles or vehicle registrations, a financial intermediary has limited means to place an enforceable lien given that vehicle ownership cannot be officially verified.

Instruments Used: The following are the instruments to be used in using movable property as loan collateral, both duly notarized:

- <u>Loan contract</u>: The loan contract can include a clause for the client listing and describing the physical items on which a lien is to be placed.

- <u>Loan guarantee contract</u>: A separate specific contract for the items in collateral on which a lien is placed is also prepared, signed and notarized between the client and the MFI.

2.6 ASSET LEASING

Description: Asset leasing is where the vendor is paid directly by the MFI and the title of/receipt for the goods is physically held by the MFI. The client in effect pays a rent for the use of the equipment. Equipment leasing is similar to a client renting space for a home or office. The client is responsible to compensate for the opportunity cost of using the asset, its depreciation, as well as for insurance and maintenance. Asset leasing is commonly used to get equipment for manufacturing, and transportation items such as motor vehicles.

In a normal economy, leasing has many advantages for both parties to the transaction. One of the greatest is freeing up capital for a client to use elsewhere in his/her business without having to tie up larger amounts in an equipment purchase.

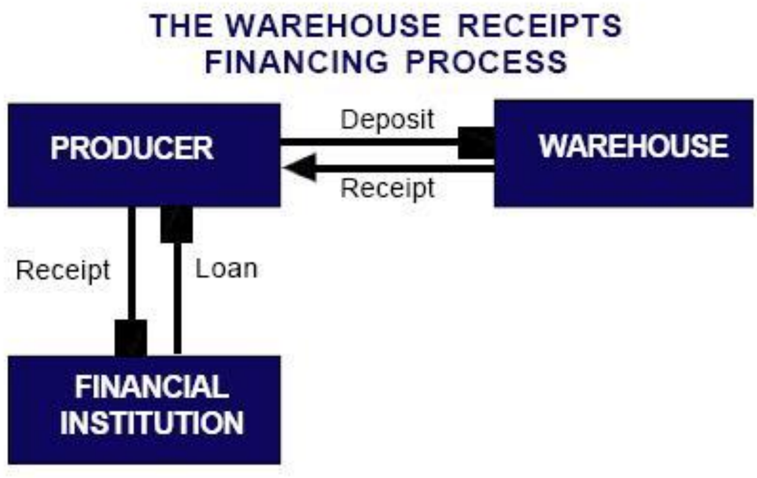
Advantages	Disadvantages
For the MFI: There are several advantages to MFIs in using leasing as collateral. The main one is opening the opportunity to potential loan clients who may not have access to those with government salaries, but would need assets they can lease without the responsibilities of ownership – the item(s) leased collateralize the loan. The MFI can also quickly recover the asset leased in the event the client stops making lease payments.	*For the MFI:* An MFI would have to get a license to conduct leasing activities. This could possibly have the MFI deviating from its main business model of only doing lending.
For the Client: Leasing of assets such as machinery or other equipment for a client is beneficial in several ways including: (a) not having to tie up a lot of capital in a purchase; (b) not having as many of the responsibilities of ownership (although a lessee has to abide by such lease terms as insurance and asset security); and (c) being able to change to a new asset quickly without having to go through a sale and purchase process.	*For the Client*: Leasing is renting, and not owning. The money a client pays for a lease is lost. Once the lease term is up, the asset reverts to the MFI as owner, and is no longer available to the client.

Instrument Used: The instrument to be used is that of a lease agreement, which spells out such terms as payments, responsibilities to maintain the leased asset and insurance, and provisions for asset recovery in the event the lessee (client) stops paying. Legal enforceability and recovery of the asset is assured with the lease agreement being notarized.

2.7 WAREHOUSE RECEIPTS

Description: The use of warehouse receipts is most common in agricultural lending where the product is non-perishable. A farmer, as a potential MFI client, has his/her produce stored in a warehouse rented or owned by the MFI. The produce, usually provided soon after harvest, is the collateral. In return for depositing the produce as collateral in the warehouse, the client gets a receipt. The MFI will then lend funds to the loan applicant in return for warehousing the produce and keeping the warehouse receipt as security. For this to work, the produce stored has to be nonperishable or have a shelf life as long as the loan repayment term. Produce such as grains (wheat, maize, barley, etc.) are usually the most suitable given that they are nonperishable. The client gets immediate post-harvest cash in exchange for the warehouse receipt s/he has given to an MFI in security.

The economic advantage to the client is that s/he does not have to sell produce immediately after harvest when prices are usually the lowest (because everyone else is selling their harvests simultaneously, which in turn depresses prices). S/he can wait for several weeks or months until such time when prices are likely higher. The additional profit the farmer earns by selling well after harvest season should more than offset the costs of storage, insurance and interest. Once the produce is sold out of the warehouse, the MFI is repaid. The balance of the proceeds, including profit, goes to the client (see http://pdf.usaid.gov/pdf_docs/PNACQ697.pdf for details and the schematic below).



Advantages	Disadvantages
For the MFI: The key advantage for the MFI is that use of warehouse receipts opens a new market opportunity to securely serve loans to rural-based agricultural clients. The MFI also controls the collateral by controlling access to the warehouse by virtue of holding the receipt. *For the Client*: There are several advantages to clients that use warehouse receipts: (a) the ability to meet immediate cash needs post-harvest; (b) not having to sell produce immediately after harvest when prices are low; and (c) with the receipt, holding a document that can be used either as a guarantee to an intermediary such as an MFI, or factored at a discount to others in return for cash. .	*For the MFI*: Implementing warehouse receipts bring a new management element to an MFI's operations, deviating it from its main mission of providing financial services. It is also likely that operating costs will increase, although the costs incurred for warehousing are passed onto the client. *For the Client*: The client has to bear most if not all of the costs of warehousing: storage space rent, insurance, security, etc. The costs of warehousing may meet or exceed the net benefit of selling produce at higher prices several months after harvest, thereby negating any of the economic advantages achieved by selling later at higher prices.

Instruments Used:

- Loan contract: The loan contract can include a clause for the client listing and describing the agricultural produce items against which a warehouse receipt is issued and kept by an MFI. Explicit reference to the warehouse receipt is made in the loan contract.

- Collateral contract: A separate specific contract for the items in collateral on which a lien is placed is also prepared, signed and notarized between the client and the MFI.

- Warehouse contract: A contract is negotiated and signed between the MFI and the business that owns and manages the warehouse. The contract would outline the terms by which produce is stored (costs, insurance, maintenance, etc.). A very important term in the contract is that produce stored as guarantee is only released when sales proceeds are received by the warehouse, and then passed on to the MFI.

2.8 MORTGAGE PROMISE

Description: A mortgage promise is where a client signs a contractual obligation to create a full mortgage and pledge real property (land, building, houses, both rural and urban) in the event s/he defaults on a loan. The mortgage promise is a way to use real estate as a loan guarantee without going through the lengthy, costly and highly bureaucratic process of doing a full mortgage. The mortgage promise is backed up by such documents as deeds, residence permits or other legal forms recognizing real estate ownership or occupancy also held in security by the MFI providing a loan against a mortgage promise.

Once a loan is satisfied and not renewed, the real estate documents are restored to the client, and the mortgage promise is liquidated. In the event of default, the real estate documents are kept by the MFI until the loan is fully repaid by whatever means the client has to do so.

Advantages	Disadvantages
For the MFI: Engaging the mortgage promise is a fairly simple, straight-forward process of signing a contract with the client. The client promises to make a full mortgage in the event of default. The process avoids the extensive cost, formality and time required for a full mortgage. *For the Client*: The mortgage promise gives the client quicker access to a loan by not having to wait for a lengthy, costly process of engaging a full mortgage.	*For the MFI*: The mortgage promise is not a fully effective mortgage. It is only a promise, relying on the good faith of the client in loan default to engage the full mortgage process. Because of the cost, formality and time, an MFI would more likely write off a loan rather than incurring the cost of a full mortgage in case of smaller loans. *For the Client*: Cost to the client of doing a mortgage promise is a disadvantage. For a disbursed loan of around $2,000, the notary fees and others associated with the mortgage promise can be around $200, or ten percent of the loan amount.

Instruments Used: Two basic documentary instruments would be used:

- Loan contract: The loan contract can include a clause citing the mortgage promise as the guarantee for the loan. It can make reference to the real estate documents the MFI would hold in its own safekeeping, restored to the client once the loan is fully repaid.
- Loan guarantee contract: A separate contract as a mortgage promise would be prepared, signed and notarized between the MFI and the borrowing client. The contract would cite the real estate documents held in annex to it. The contract would also contain clauses and provisions for the client to agree to engage the full mortgage promise in the event of his/her default on a loan.

2.9 SIGNATURE WITNESS

The signature witness is a third party who promises to repay a loan as a personal guarantor of a borrower who, if s/he defaults, repays the loan. Often, the guarantor is a business person who has enough means and is a member of a chamber of commerce who guarantees a loan. Reference is made to a chamber of commerce as it functions as a moral guarantor in the event its member, the loan guarantor, fails to honor his/her commitment in repaying a defaulted loan.

The process of establishing a signature witness is as follows:

- An applicant applies to an MFI for a loan. S/he offers the signature of a guarantor of means who is most likely a businessperson.
- The MFI qualifies the guarantor as having sufficient means and reputation to repay the balance of a loan s/he would guarantee in the event a loan default.
- The proposed guarantor could be a member of a chamber of commerce. Recognition of the guarantor by his/her membership in it strengthens the power and value of the signature witness as a guarantor.
- The MFI requests a certification from the guarantor that s/he is a bonafide member of a chamber of commerce. An attestation or proof of membership is supplied by the loan applicant or the guarantor.
- The guarantor signs and has notarized a promissory note/guarantee contract. This becomes part of the loan file of the client.
- In the event of default, the MFI requests the guarantor to cover his/her legal obligation to repay the loan of the defaulted borrower.
- If the guarantor does not honor his/her guarantee: (i) the moral suasion of the chamber of commerce to which the guarantor belongs can be used; and (ii) if the moral suasion fails, law enforcement services of the police or courts can be used.

Advantages	Disadvantages
For the MFI: The signature guarantee of a businessperson has the same force and effect as a government employee signature. The backing of a chamber of commerce provides the MFI a greater level of security for the loan in the event a guarantor would not honor his/her guarantee obligation. *For the Client*: The use of a guarantor other than a government employee diversifies the collateral options a loan applicant can access to guarantee his/her loan.	*For the MFI*: One of the disadvantages of such a guarantee is the extra administrative steps an MFI has to take to assure that the guarantor is a bonafide member of a chamber of commerce. Another disadvantage is that the guarantor provides only his/her word that s/he will honor the guarantee obligation. There is nothing tangible such as property or a bank account for the MFI to seize in the event both a client and his/her guarantor default. *For the Client*: For a loan applicant who is poor or a woman, it would be less likely s/he would have access to businesspersons who would be members of chambers of commerce. The MFI may compromise its standards by accepting a signature guarantor who is not a chamber of commerce member.

Instruments Used:

- Loan contract: The loan contract can include a clause for the client listing the details of the guarantor guaranteeing a loan.
- Promissory note: A separate specific contract for is also prepared, signed and notarized between the client and the MFI. Citation of the chamber of commerce, and even the filing of a copy of the promissory note with it, would strengthen the value of the guarantee.

2.10 TRADITIONAL COLLATERAL: *MURABAHA*

Religious sheiks and other traditional rulers in Iraq hold great sway over the viability of microfinance. Their pronouncements and traditional rule is respected, particularly when *Fatwas*[1], or traditional edicts, are issued.

The collateral options for *Murabaha* in Iraq are similar to those already used. It is usually a third-party guarantee such as the most popular one used of a salaried government worker.

As with other loan products, MFIs are innovating in their use of alternative collaterals such as warehouse receipts and SGL, which conform to Murabaha lending standards.   Islamic MFIs disburse *Murabaha*-based financing to individuals based on a combination of salaried government workers, signature witness and community recommendations such as from sheiks to ensure repayment. The instruments would be the same as those used for the collateral options described above. These guarantee mechanisms are highly efficient and loan recovery levels are from 95 to 99 percent.

[1] Fatwa is an authoritative legal opinion based on Shari'a law.

CHAPTER 3: FUTURE DIRECTIONS AND WAYS FORWARD FOR ALTERNATIVE COLLATERAL OPTIONS IN IRAQ

This document has the objective of encouraging partner MFIs to diversify the collateral options they would use and accept from loan applicants. The Iraqi microfinance industry has solidly established itself after six to seven years of consistently hard work in the face of great challenges, particularly those related to security. It is now time for MFIs to better achieve the best practice objectives of microfinance. One of the most important of these objectives is deepening outreach to the poor and women. One of the best means of achieving this objective by MFIs is to employ the use of collateral options other than the predominant one of using salaried government workers as guarantors.

This chapter then recommends the ways forward and action plan for select Iraqi MFIs to use in diversifying the collateral options from which they can choose to pilot test.

3.1 PILOT TESTING OF ALTERNATIVE COLLATERALS

USAID-*Tijara* and its MFI affiliates are encouraged to proceed slowly but deliberately in pilot testing, and possibly implementing alternative collaterals on a limited basis. They are further advised not to be too preoccupied with the degrees of legality in using the new collateral options. The fact that they will actually be used will establish their own legal precedent.

Action: Two or three partner MFIs of USAID-*Tijara* to pilot test one to two of the instruments. USAID-*Tijara*, using its access to lawyers, will help draft the instruments MFIs can use to secure loans. **Annex 3** outlines efforts MFIs have already taken to diversify guarantee options for their clients.

3.2 EXPANDING THE USE OF SOLIDARITY GROUP LENDING (SGL)

USAID-*Tijara* recommends that all MFIs become trained in and use the SGL. It is one of the most effective collateral means deepening the outreach of financial services to the poor and women, as evidenced by the output and experience of the Grameen Bank in Bangladesh, cited above.

Action: For those Iraqi MFIs not using SGL, suitable arrangements for their training will be made. Concurrently, USAID-*Tijara* will monitor and evaluate the current experience of the SGL methodology already being used by four Iraqi MFI partners. A program will be established where their SGL-experienced staff will help mentor other MFIs not yet having employed the methodology and consult with them on how to implement SGL.

3.3 TOWARD A MORE FAVORABLE ENABLING ENVIRONMENT TO FACILITATE THE USE OF COLLATERAL OPTIONS

Work is recommended to be undertaken to improve the existing legal and regulatory framework concerning the private and financial sectors. Improvements would help in making collateral options not yet used by MFIs more practical and realistic. Areas to review include, among others:

- Private property rights.
- Make transferability of physical collateral items, especially movable property, easier so that their use by MFIs and their loan applicants can expand.
- Creation of a department or office of motor vehicles such that vehicles can be titled, with their titles used and pledged for loans
- Amendments to existing banking, SME and NBFI laws and regulations that specifically address the issues of loan collateralization, legally empowering their use, while also protecting clients from any potential abuse financial intermediaries may use in their seizure and liquidation to satisfy loan balances in default.

ANNEX 1

Loan Guarantee Contract

Type of guarantee: shop, small factory, machinery

First party: Microfinance institution: ___________________

Second party: The client: Name: _______________
Address: _____________
Telephone: ____________
I.D. no.: ______________

Both parties agree to the following:

1. According to the loan contract the first party is to lend the second party the amount of ------------ to be paid in cash or by check by the time of signing this contract.
2. The second party undertakes the repayment of the above mentioned loan as follows : -------------------------
3. There will be additional service fees (interest) with the amount of --------- per annum starting from the date of signing this contract to ----- and the repayments will be as follows-----------
4. In case of delinquency, the first party will charge a penalty with the amount of ------------ on each day of delay.
5. The first party has the right to transfer the debt to another party without notifying the second party.
6. As a guarantee, the second party will mortgage and/or place a lien on the shop/ factory / machinery as described: ------------------------ (and attached description).
7. The second party acknowledges that s/he is the sole owner of the property pledged as guarantee and it's not in dispute free of debt and of any kind of other mortgages or liens, and there are no due taxes or rent. Also s/he acknowledges that s/he did not declare bankruptcy and it is not pledged as a guarantee for any other debt.
8. Both parties acknowledge the total loan amount received is to be considered as an outstanding amount due immediately without prior notification.
9. The first party acknowledges receiving the entire lien/mortgage documentation
10. In case of any dispute, both parties agree on going to court to solve it.
11. This contract is to be issued in two copies, one for each party

Signatures:

____
For the First Party
_________, General Manager
_________ Microfinance Institution

____
For the Client as Second Party

Notary Seal and Signature

ANNEX 2

PROMISSORY NOTE

Date signed: ___ /____/20__ Due Date on ___/____/ 20__

Amount (in numerals): Dinar _______Fils______ Address: ____________
Phone No: __________

Amount (in words): _______________________________Only

I / We, _________________ and ______________, according to this promissory
(Client) (Guarantor)

note are obligated to pay in cash on or before ___/___/20__
(Date)

the sum of ______________________ (_________________________) only to (in Numerals) (In Words)

______________________________.
(Name of microfinance institution)

In the event of my default, guarantor ____________________________ will
(Name of guarantor)

pay the debt owed in my stead.

Signatures of Acceptance and Obligation:

____________ ______________ _________________________

Client Guarantor MFI General Manager

In Witness Whereof:

____
Notary Public and Seal

The amount of _______________ (_____________________________) was received on

___/___/20___, which fully satisfies the outstanding amount owed on this note.

ANNEX 3

ACTUAL MFI EXPERIENCE USING ALTERNATIVE COLLATERALS

The following are examples of where MFI partners have used collaterals and guarantees other than the traditional one of government salaried workers. Use of these collaterals was inspired and motivated by their participation in the Iraqi Youth Initiative (IYI). The circumstance of the target clientele, which is youth from the ages of 18 to 35, is such that they do not have access to the traditional collateral form. By necessity, to make the YEAF (Young Entrepreneurs Access to Finance) loan product of IYI accessible to youth, and to achieve planned outputs, development and implementation of alternative collateral instruments was required.

For each MFI, is described (where available) how the collateral was used, including its history, why the MFI started using it, the number of clients using such a guarantee, the amounts of loans for such a guarantee; and overall experience, including successes as well as issues/difficulties.

Al-Thiqa MFI, Kirkuk

a. Solidarity group lending (SGL): The tables at the end of this annex highlight the cases of two SGLs based in Karada, Baghdad and interview in August 2011. Together with **Annex 4**, one can get a perspective on how it is for an MFI to implement, gain impact, and ultimately succeed in terms of profitability and impact offering SGL, particularly to the poor and women.

b. Promissory note: Use of the promissory note is where a chamber of commerce member or public sector employee signs a promissory note promising to repay a loan to the MFI in the event the borrower guaranteed falls into default. It is used for those who cannot access government employees. It is used especially for the IYI clients who are not likely to know government employees who can guarantee their loans. Al-Thiqa does not get the note notarized by the guarantor.

   Al-Thiqa started using the promissory note because of its participation IYI. As the MFI progressed in using this for IYI targeted youth, it has also started to accept this form of guarantee from regular clients. Al-Thiqa believes it to be more risky because the promissory note has not been used before by the MFI. Also, the MFI has not contacted or requested of other MFIs such as Al-Takadum and Al-Aman their experience in using this form of guarantee.

   Clients are pleased to be offered the promissory note guarantee because there is now a choice, thus making it easier to access Al-Thiqa loans. Another impact is that this form of guarantee is helping to make the IYI program a success. Impact too is measured by the number of youth loans as of end July 2011: 16 loans of $43,250, with zero portfolio-at-risk (PAR).

Al-Mosaned, Tikrit

a. Promissory note: The nature of this guarantee form, as opposed to the one used by Al-Thiqa, is that it is signed and notarized by and for both the client and his/her guarantor. When it is notarized at the court, there is no distinction or designation as to who the client is and who the guarantor is.

Al-Mosaned started using this form of guarantee since November 2009. The reason the MFI started using it is because the use of the government salaried guarantor had many issues such as difficulties in arranging it through the court, and it takes a long time (up to two years) to get full recovery of the loan from the guarantor as only five percent is cut from the employee's salary. This is a unique characteristic of this guarantee form in the Salah ad Din Province as opposed to other provinces where government is far more cooperative.

The number of clients using this form of guarantee is 2,132 with $2,212,587 as of end July 2011.

The experience of using this guarantee form is (a) easier for clients to use, and (b) less risk. Issues include: (a) Delay by the police to enforce the guarantee in the event of borrower default (up to five months); (b) if the court delays enforcing a judgment of default, the client can run away; and (c) less respect for the NGO-MFIs than for the banks.

Al-Takadum – Ramadi Branch

The IYI program has inspired Al-Takadum – Ramadi Branch to expand guarantee options. This is because of the nature of the specific clientele for this product – the youth (from 18 to 35 years of age) who cannot access the traditional form of guarantee, which is the government salaried worker. As of end July 2011, there were 43 IYI loans outstanding of $134,500 using mostly forms of guarantee other than the traditional one.

a. Promissory note: The nature of this guarantee is the as for Al-Mosaned. The MFI started using this form of guarantee with the start of the IYI program. The advantage of this form of guarantee is that it is easier and quicker for clients to get their loans. So far, after about one year of loans guaranteed with the promissory note, repayment has been perfect.

b. Traditional leaders: Celebrities from the region such as sheiks periodically guarantee loans. Because of the shame factor, these loans are always repaid. This form of guarantee is used when clients have no other means of guarantee to offer.

c. Solidarity group lending (SGL): The following is the actual experience of the MFI using SGL. The MFI started this form of lending on its own without any advice, encouragement or directive from anyone outside of the MFI, including USAID-*Tijara*. To date through July 2011, there is $49,000 outstanding for 98 individuals belonging to 33 groups.

ANNEX 3 (CONTINUED)

SURVEY OF TWO SOLIDARITY GROUPS, AL-THIQA, BAGHDAD: AUGUST 2011

The tables below highlight the results of a survey conducted by USAID-*Tijara* in August 2011 during interviews with two solidarity groups (SGL) at the Karada Branch of Al-Thiqa.

Members & Gender	Loan Cycle	Last Approved Loan Amount	Why Group Loan?	Comments
3; all male	4th	$1,800; $5,400 total	- None of the members had access to government workers - Process of getting the loan very easy	These groups stated being very happy with the SGL loans. The only problem for them is that the loan sizes are smaller than what they want.
3; all female	2nd	$900; $2,700 total	- None of the members had access to government workers	Allows women to access credit whereas they would not have any other access, even to individual MFI loans – again, due to not having access to a government worker to guarantee the loan

Group 1: All Male

Name	Age	Type of Business	Employees
Auday Adel	1981; 30	Burger kiosk	1
Jawad Sabar	1964; 47	Small shop	1
Raheem Abd	1960; 51	Taxi	0

Group 2: All Female

Name	Age	Type of Business	Employees
Shaima Jwad	1986; 25	Sewing	0
Aseel Jabar	1977; 34	Sewing	0
Hamdia Kthair	1960; 51	Sewing	0

ANNEX 4

Solidarity Group Lending
Summary of Policies and Procedures

Loan Terms and Conditions			
SG Lending	**First Loans**	**Repeat Loans**	**Basic Strategies**
Eligibility Criteria Clients	• Business owners • Over one year of operations • Over one year of living in the community • Valid ID	• All group members must have repaid their loans in full to be eligible for another loan • Group size must meet the minimum requirement (>3) • No payments with a 15 day delay or over for the group payments • No payments with a 15 day delay or over for the member individual payments	• Outreach of new, low income clients • Manage risks by minimizing the number of family members in the same group
Groups	• Three to eight members p/group • No more than one member from the same household or business • Members must know each other • Members must come from/live in the same community. • No more than two relatives in the same group even if from separate household and/or business.		
Loan destination	• Working capital • Small equipment	• Working capital • Small equipment	• Loan must be intended for business purposes
Loan amounts	• $500 to $800 • No more than 40% of granted loans are expected to be set above $650	• $500 to $3000 • Scale up increases no higher than 40% **Max increase** • 0 days delayed = 40% • 1-3 days delayed = 30% • 4-7 days delayed = 20% • 7-15 days delayed = 0% • 16 days + = OUT	• Initial loan amounts are small relatively to the size of the business • Amounts scale up as the client develops a credit history with the program
Loan terms	3 to 9 months	3 to 12 months	• Short-term small amounts to prove the client credit worthiness
Loan guarantees	• SG Guarantee; members guarantee each other's loans • Promissory note and /or contract signed by all group members	• SG Guarantee • Promissory note and /or contract • If the loan size of one member exceeds by 25% the group average then members can	• Facilitate access to credit to clients unable to provide government and other type of hard guarantees.

		request additional guarantees	
Loan charges	• To be defined by the MFI	• To be defined by the MFI	• Market or near market rates (non- subsidized rates) • Rates could be lower for repeat clients with excellent repayment (less than five day delay in any payment
Repayment frequency	• Bi-weekly or monthly as defined by the MFI	• Bi-weekly or monthly as defined by the MFI	•

Loan Procedures			
SG Lending	**First Loans**	**Repeat Loans**	**Basic Strategies**
Group Promotion and marketing	• Walk-ins • On-site promotion : market place; community meetings through local leaders		LO reaches out to clients
Group Formation	• Group members are self selected • 1-4 meetings carried out by LO • Groups are formed and explained policies and procedures • Detailed explanation on membership criteria and solidarity guarantees	• Groups that do not meet minimum group size requirements must replace drop outs to the required size	Formation process simple enough as to allow a 7 days or less disbursement period YRS
Loan Application	• A single loan application for the whole group containing info on every member		Simple application; 1-2 pages
Loan analysis	• Repayment capacity- basic cash flow • Repayment willingness- reference checks	• Group Repayment history and on-time repayment • Individual member repayment history (*Loan Renewal Increase Chart)*	
Loan Approval	• First level: The Group members approve the amounts proposed by each individual members • Second level: The Loan Officer approves/ recommends the application • Third Level: The Supervisor and/or office manager, and or branch committee (as per every MFI decision) approves the amounts proposed		
Loan Disbursement	• A single disbursement to the Group Leader to be distributed among the members according to contract. • Members must sign receipts from the Group Leader confirming their individual loans have been received		

Loan Closing (Contract)	• The SGL contract must be simple; one or two pages. It could follow a similar format than individual lending. Under the borrower signature all group members will sign. Under the guarantor signature, all the group members will sign.	
Loan Repayment	• One payment voucher • Group leader and group members responsible for group collection • LO starts collection when exhausted all group efforts • Legal action when needed for demonstration effect purposes mainly	
Loan monitoring	• The Group Leader monitors and registered the individual members monthly payments *(GL Loan Repayment Monitoring Form)* • Members keep track of their payments in their individual Passbooks *(Member Passbook)* • The Loan Officer attends the monthly payment meetings (First cycle loans only), registers and monitors, individual payments, loan balances, and arrears *(LO Loan Repayment Monitoring Form)* • For Repeat loan cycles, the Loan Officers attends every other payment meeting provided the group keeps an on-time payment record (payments on due date). Otherwise, groups showing delayed payments must be monitored regularly. Attendance to the payment meetings in this case is mandatory.	

Loan Administration and other Considerations		
Staffing	• Specialized Loan Officers (LOs) are recommended • Basic salaries are set according to loan sizes. • A good incentive system complements basic salaries	• The smaller the loan the lesser the qualifications required of a LO
Incentives	• Incentives based on portfolio quality and productivity • Variables are set according to institutional objectives. • Incentives must also be ❖ Simple to understand and calculate ❖ Attractive ❖ Attainable ❖ Paid regularly (e.g. monthly)	• Year1variables should include number of groups formed to promote rapid growth (provided MFI liquidity). • A restriction of minimum group size allowed per group (e.g. four) should accompany this variable •
MIS	• If sufficient MIS capacity, preferably to register and monitor all individual group members • If insufficient, Group Leader becomes responsible for recording individual payments. • LO keeps close monitoring of repayment behavior of individual group members	• Individual member performance is always recorded and monitored manually and /or trough MIS
Productivity targets	• LO_{12ms} $\geq$350client members • $LO_{24ms}$$\geq$450 client members	•

	• LO_{36ms} ≥650 client members	

5. Guarantee:
    a. Solidarity group guarantee only
6. Legal Contract, promissory note, letter of payment

B. Procedures

1. One Application for group
2. One contract per group: money wise it makes no sense to go to court. But to avoid domino effect, might need to take them. But use the group first. Choice ultimately was bad.
3. One disbursement
4. One payment voucher
5. One appointed coordinator as the group leader

C. Loan Marketing/Promotion

1. Walk ins
2. Reach out: education meetings

D. Loan Group Formation

1. Seven-day process
2. Who is eligible (no negotiations)
3. Solidarity group guarantee
4. Loan officers do not interfere
5. Reference check is people choosing each other
6. analyze the group members solidity through interview techniques

E. MIS capacity

1. Track individual
2. Track group
3. If MIS permits, track them both so can pass the name to the blacklist
4. Three levels of loan tracking if desired:

a. Group tracks
b. LO tracks
c. MIS tracks per loan, but with number of loans as welcome

F. Loan Analysis

a. Willingness to pay
b. Capacity to pay: How much can I carry?

G. Staffing: Productivity Incentives

a. Different than Individual lending
b. Salaries lower and financial skills you train them on
c. Realize that the loan officers you have right now are reluctant to go to lower level clients.
d. If keep the same loan officers for individual and solidarity group. Don't design incentive system to confuse:
e. Bonuses for higher volume or for number of loans.
f. Some institutions pay regardless of meeting productivity.
g. Loan officer target:
    i. First year
    ii. Incentive is number of groups
    iii. Incentive for number of groups of three: require groups of 4
    iv. Incentive for amount of loan: average loan size ___.
    v. Four Rules for incentive systems
        1. Based on goals

2. Must be attractive
3. Be obtainable; accessible
4. applied regularly

On Outreach	Eloyse	Youssof	Karuna	Total	Target
Number of Groups	5	7	10	22	
Number of Individuals	75	140	295	510	
Portfolio Outstanding	7,500	14,000	29,500	51,000	
Revenue (2%month)	150	280	590	1,020	
Costs	1000	1000	1000	3,000	
Break-Even Portfolio	50,000	50,000	50,000	150,000	
On Health of Portfolio					
Amount Portfolio>30 days	300 4%	400 3%	1,500 5%	2,200 4%	
Portfolio Written Off	100 1%	500 4%	300 1%	900 2%	
Portfolio Reprogrammed	500 7%	700 5%	300 1%	1,500 3%	
On Healthy Groups					
Groups Graded at >90%	2	3	7	12 55%	
Groups Graded 70-90%	2	3	2	7 32%	
Groups under 70%	1	1	1	3 14%	

vi.
vii. Twelve months of operations,
1. Should handle 350 clients: ten 35 people loans.

h. Mature programs: 650 to 900 per loan officers. Depends in concentration.

Restrictions for not doing peer lending
1. People can access individual loans
2. There are government subsidies/safety nets
3. Various incomes in a household so everyone qualifies for a $3,000 loan.

Client Summary

Name of Group (Ind)_______ Community______Code__ _	Date :_______________ No Loan :_________Code____	Credit Officer___________Code___ Branch Senr CO:_________Code __

Solidarity Group Member information	
Treasurer	ID no.
Member	ID. no
Member	ID no.
Member	ID No.
Member	ID. No
	ID No

Summary

Name	Activity	Use of Loan	Request	Approved
Vladimir Vlesky	Shoes	Leather	600	500
Ahsen Muntaha	Trade Cosmetics	Stock	400	300
Lucy Montrav	Seamstress	Material	300	200
Ali Mohammad	Carpentry	Wood and nails	500	400
Total			1800	1400

Payment Capacity

In week	Vladimir	Carmen	Lucy	Herman	
Current inflows					
Current Outflows					
Left in Hand					
Installment					
Net in hand					
In hand>install?					
Comments					

Impact

Borrower(s): ____ F _____ M	No. Employment Generated ___	No. Employment sustained ____	
No. persons that benefit related to Borrower	_____ Men _____ Women _____ Children	Related to Employees	_____ Men _____ Women _____ Children

Loan

Amount requested	Term	Interest rate	Commission rate
Amount authorized	Interest to pay	Commission to pay	Total debt to pay

:	Date disbursed	Date Due

Signed :

________________________ ______________________ ___________________

Treasurer Member Member

Loan Officer signature_________ Second Loan Officer ________ Branch Manager______