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FORMAL CREDIT FOR INFORMAL BORROWERS: LESSONS FROM INFORMAL LENDERS

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ABSTRACT

Reports on the techniques used by ACCION International in helping very small businesses obtain access to formal loans. Many of these techniques are based on practices commonly found in informal financial markets. Author goes on to discuss six lessons learned from ACCION's programs in Latin America and concludes with policy recommendations.

FORMAL CREDIT FOR INFORMAL BORROWERS: LESSONS FROM INFORMAL LENDERS

by

Robert Peck Christen[1]

Among other objectives, most microbusiness credit projects seek to increase incomes and generate employment in the informal economy by providing less expensive alternatives to moneylenders for financing microbusiness activities. Most of these programs fail to replace moneylenders as prime credit sources for microbusinesses and, even more tragically, fail to survive as permanent credit alternatives.

Traditional microenterprise credit projects are too expensive to be successful because they rely on credit methodologies borrowed from formal sector banking. On the other hand, informal moneylenders have financed small businesses since the beginning of commerce. If development micro-credit programs are to be successful and achieve their goals, they must base their methodologies on those of informal lenders who have not only survived, but have prospered by lending to the smallest of all economic activities.

ACCION International/AITEC has based its highly successful microcredit methodology on lessons it has learned from informal lenders both through its own long project implementation experience in Latin America and through its analysis of both successful and unsuccessful programs around the globe. ACCION provides technical assistance to microbusiness support programs throughout the Americas. Currently, about 25,000 businesses participate in ACCION affiliates in 14 countries. Several ACCION affiliates are among the few microbusiness credit programs in Latin America that have reached operational self-sufficiency, a necessary pre-requisite to long-term program sustainability.

When ACCION began to work with microbusinesses 18 years ago in Recife, Brazil in Project UNO, it implemented a classical formal sector credit model within its broader technical assistance and training program. Since that time, ACCION has evolved its credit model based on the way informal credit markets work. ACCION's current methodology has proven so successful in terms of impact on poorest businesses, extremely high recovery rates (99.5 percent), and operational self

[1] The author is currently Director of Training and Technical Support for ACCION International. He also directs ACCION's microenterprise credit program in Chile. This paper reflects his views as a practicioner in daily contact with both formal and informal lenders to the smallest of all economic activities, but do not necessarily represent those of ACCION International.

sufficiency, that in the past year several initiatives have begun to move this model from the small NGO implementor to larger, more traditional, formal sector lenders.

ACCION and its Bolivian affiliate, PRODEM, are actively pursuing plans to convert PRODEM into a private commercial bank, devoted exclusively to the microbusiness sector. Feasibility studies have been completed and the institutions involved are currently in the process of lining up major investors. ACCION's Dominican affiliate, ADEMI, is actively exploring the possibility of converting itself into a 'specially legislated' private bank. ADMIC, ACCION's Mexican affiliate, has just signed an agreement with NANFIN, a major state-managed finance company, to administer a 4.5 million dollar microbusiness lending program in four northern states. Three months ago, representatives from Ecuador's banking sector established a foundation devoted to microbusiness lending, backed by major private bank resources. This list will certainly grow in the coming months as policy makers continue to look for ways to support the burgeoning informal sectors throughout Latin America.

If we examine ACCION's methodological evolution, we can identify six critical lessons learned from moneylenders, who are the traditional lenders to the poor and who represent ACCION's only real "competition". In the following paper, we will identify each of these lessons and illustrate concretely how these lessons have been incorporated into ACCION's credit model. The final section discusses macro policy implications which derive from these same lessons.

LESSON #1: GET TO KNOW YOUR BORROWERS

The key to success in any financial market is accurate information about perspective clients. All lenders must determine whether potential borrowers will be both willing and able to repay their loans. They want to know if potential borrowers are financially solvent, if their income stream is constant and reliable, if they are already too burdened with other debt, and finally, whether they are really committed to repaying obligations. Excellent borrower selection is more important to overall portfolio quality than most other factors combined. Lenders who select their clients well avoid costly defaults and legal proceedings.

The primary reason that formal lenders do not lend to small borrowers is that traditional information gathering systems are both too costly and too ineffective to guarantee high quality borrower selection. Informal lenders, on the other hand, gather good information on potential clients at a very low cost, thereby minimizing default risk.

The reason that informal lenders can gather this information about perspective clients so cheaply and so well is that they, unlike formal lenders, operate in the same commercial or personal environment as their borrowers. For instance, many microbusinesses cash checks from their buyers at their corner store, paying between 10 to 20 percent discount. The store owner knows the microbusiness since the microentrepreneur probably also buys his weekly food stocks at the store, most likely on credit.

Often, moneylending is a secondary activity. Merchants who supply microbusinesses with raw materials or who purchase its products usually establish some sort of credit relationship as an additional service. This credit may take the form of direct loans, materials on loan, or price adjustments. In all of these cases, before a microbusiness gains access to credit facilities, the manager must first establish a working commercial relationship with his eventual moneylender.

Some moneylenders devote themselves exclusively to moneylending. They ensure good borrower selection by lending only to close friends or relatives and persons recommended by this select group. This way they live in close contact with their clients and have ready access to information when they confront credit decisions.

Formal lenders rarely have the opportunity to establish broader commercial or personal relationships with microbusiness borrowers and must therefore rely on second hand creditworthiness information to assess credit risk. Formal lenders traditionally require technical analysis, documentation of incomes and cash flows and collateral, none of which microbusinesses can offer. The more distant the formal lender is from the informal borrower, the more second-hand information he requires.

The root cause of the failure of many formal lenders to prosper when they lend to poor borrowers is that, in spite of spending major resources to gather information about potential clients, this information is not a particularly trustworthy indicator of credit risk.

ACCION, on the other hand, seeks to establish a direct relationship with borrowers in the same fashion as microenterprise suppliers or corner store owners by initially lending small amounts and gradually increasing these as the microentrepreneur builds a credit history with the program. First loans do not meet true need levels, but rather are small enough to test borrower willingness and ability to repay without posing undue risk either to the borrower or the lender. Loan terms are kept very short, 8 weeks to 6 months, and within a year program participants reach loan sizes which allow for significant and sustainable business growth, depending on the average loan terms.

Delinquent borrowers are either eliminated from the system or not given larger loans, depending on the severity of the particular program and the lateness of the repayment. Delinquency rates on average for ACCION affiliates is less than 7 percent of current portfolios, and the loan loss rate is less than 2 percent of current portfolios. ACCION considers a loan to be delinquent the day a payment is overdue, but considers only the late payment to be delinquent, rather than the entire amount of the loan.

Another feature of most successful ACCION microcredit programs is the solidarity group mechanism. This mechanism transfers the primary responsibility for borrower selection to borrower groups, who by any standard, know potential borrowers far better than the program. This mechanism requires an interested microentrepreneur to bring three-to-four other interested microentrepreneurs with whom he or she will form a group in order to participate in the program.

The program makes one loan to the group, which the group distributes among themselves. Should one member default on a loan, then the others in the group pays the late portion and seek recovery directly from the delinquent member. The group has the option of eliminating the delinquent member from subsequent loans. Should the group fail to repay on time then the group is eliminated from the program. Since the initial loan amounts are relatively small, and subsequent loan amounts become increasingly large, borrowers have a strong incentive to repay and maintain a good credit history.

This methodology is particularly successful where a large number of microbusinesses are located close together and where business owners know each other through daily contact. The methodology is less successful when businesses do not have that almost daily contact. In that sense, this methodology mirrors the success of informal lenders who have an almost daily contact with their borrowers in commercial or personal dealings. Although many formal lenders require co-signers on small loans to poor borrowers in an attempt to include into the selection process informed opinions which are close to the borrower, this technique is seldom successful since it requires only one person to believe in the borrower's ability and willingness to repay, rather than the three or four required by the solidarity group mechanism.

LESSON #2:DON'T WASTE RESOURCES ON CREDIT SUPERVISION, OFFER COMPLEMENTARY SERVICES

A corollary to the Getting to Know Your Borrower lesson is to not waste resources on credit supervision. Although seemingly paradoxical, lenders should not devote valuable resources controlling credit use at the firm level. Formal lenders frequently resort to control mechanisms to supplement their initial lack of first hand knowledge during the borrower selection phase. They attempt to force businesses to make productive investments with the borrowed funds and control the subsequent productive processes, completely ignoring the fungible nature of the marginal liquidity they have provided.

Informal lenders interest themselves in the activities undertaken with the marginal liquidity only to the extent that these activities affect his initial credit risk calculations. After the loan is made, the moneylender doesn't waste any time trying to control the real end use of the funds he provided. If he suspects that the borrower is using the funds in activities that he considers more risky than those he authorized, then he is most likely to deny credit the next time the borrower seeks it.

The lender maintains his close proximity to borrowers not through control but rather by offering complementary services which borrowers need. In fact, as we have already mentioned, lending is frequently a complementary service to other, primary services performed by moneylenders for microbusinesses. These services may include providing raw materials, purchasing final products, lending tools or equipment, rent free work space, or a patronage relationship. This relationship provides the low cost knowledge necessary for the credit decision, while at the same time fulfilling another, also productive purpose.

ACCION International affiliates have learned this lesson well and specifically look to offer complementary services to credit participants. Most programs offer some sort of technical assistance and/or courses in microbusiness management. Some offer savings plans, life insurance, medical services/insurance or fire insurance. Others offer the possibility of participating in organizations which serve as lobbying forces to better conditions in areas where businesses operate or in their regulatory environment. Others offer participation in fairs and sales events which help small businesses project themselves beyond what they could achieve on their own.

In almost every ACCION affiliate, microbusinesses find more than credit. In most cases, microbusinesses pay the true cost of these complementary services. Program self-sufficiency goals include these services as revenue generators in addition to being cost centers. In some cases these complementary services are more profitable than credit. The underlying assumption most programs operate with is that borrowers will think twice before defaulting on a loan if they will not only lose access to further credit but will also lose access to a series of other important services.

LESSON #3:TAKE CREDIT TO THE CLIENT

Since many informal lenders provide credit in conjunction with other services, their borrowers do not have to make special trips to receive credit. This allows them to combine more than one activity on any given trip. Other moneylenders who do not provide complementary services typically live close to their borrowers, or have other tight-knit relations. This means that although clients may have to make special trips to borrow and repay loans, these trips are few and quick. Moneylenders usually decide immediately whether or not to grant a loan request.

Formal lenders, unfortunately, function quite differently. Whether because of credit rationing motivated by subsidized interest rates or because of the need to collect extensive second-hand information, formal lenders almost always have extensive application and approval procedures. These procedures require potential borrowers to invest enormous amounts of time and money into a process which does not even guarantee a positive end result. These transaction costs usually exceed the direct financial costs and for very small loans may even exceed the value of the loan itself.

From the borrower's perspective, transaction costs differences between informal lenders and formal lenders are one of the keys in his decision as to which credit source he or she will choose to use. Most microentrepreneurs view the high transaction costs involved in applying for and receiving a formal loan, think about the relatively poor chance they have of actually receiving that loan, and decide not to even try. They prefer to borrow from moneylenders or not borrow at all.

Most ACCION affiliates are credit driven programs, even though they offer other services to complement these loans. Since microentrepreneurs do not have many other reasons to go to the program offices than to apply for and receive credit, and since programs can not be present in microenterprise neighborhoods in the same fashion as moneylenders, these programs have decided to take the credit to the borrower. This reduces transaction costs while increasing the quality of second-hand information gathering.

ACCION credit methodology requires that a major portion of the loan application process take place in the microbusiness or in its neighborhood. Field agents visit interested businesses and do creditworthiness evaluations in the workplace. In the case of solidarity group mechanisms, after the initial application phase, most on-going work takes place in the field. Applicants come to the office only to participate in the initial orientation sessions, and later, to pick up their check. Loans are usually repaid at local banks, although most programs also receive payments directly. In either case, the transaction costs involved in repayment are lower than for most formal lenders.

Subsequent loans require even fewer transaction costs since the borrower has developed a credit history. Usually the borrower must only indicate the amount of their next loan to a field agent during a pre-credit visit made automatically prior to a loan's expiration and the approval process is automatically handled by the program staff. Borrowers go to the office to make their last payment and receive their next loan, all in one visit.

Although ACCION affiliates certainly impose more transaction costs than their informal competitors, these costs are significantly less than other formal sector lenders. The success of these programs illustrates that by keeping transaction costs low in addition to other features they offer, formal credit operators can provide an attractive alternative to moneylenders.

LESSON #4:PROVIDE OPPORTUNE AND APPROPRIATE CREDIT

Informal lenders usually provide microbusiness credit which is both opportune and appropriate, in contrast to formal lenders. In addition to delivering credit efficiently (low transaction costs), moneylenders provide credit on a timely basis, and in most cases immediately upon request. When credit is part of a commercial transaction, it is extended immediately. When a microentrepreneur sells a third party check at a discount, the credit is extended immediately. When a microentrepreneur asks for a direct loan, he or she may have to wait a day or two for the moneylender to cover a check. In most cases, informal credit is obtained immediately upon request if it is granted at all.

This immediacy allows microentrepreneurs to take advantage of special opportunities, take on large contracts, and compete more effectively against others who don't have sufficient working capital. We frequently hear pleas from program participants to lend them 300 dollars just for 15 days, even if they have to pay 20 percent interest, so that they can take advantage of a particular business opportunity.

Formal credit operators are both unable and unwilling to comply; unable because bureaucratic processes won't allow it even for well-known clients, and unwilling because of legal and moral restraints on maximum interest rates they can charge.

A related issue to timeliness is the appropriateness of the loan services that lenders offer. Whereas informal lenders typically tie their credit very closely to microbusiness productive or commercial cycles, formal lenders usually give long term, large loans, independent of these cycles. Formal lenders find it difficult, if not impossible to generate a profit with small, short term, loans, which are tied to business cycles. Formal credit mechanisms make these small loans too expensive to grant.

ACCION International affiliates again seek a middle ground. Although none of the programs have been able to totally replicate informal lender delivery systems, most base their credit mechanisms on very small, short term, working capital loans, with frequent amortizations. These loans are repeated one after the other and represent a permanent credit source. They are usually tied generally to production cycles, although they are viewed more like marginal capital inputs rather than the direct financing of production cycles.

ACCION affiliates emphasize opportune credit delivery. Delays in loan disbursements seldom occur and borrowers almost never waste trips to the office. By approximating informal credit delivery systems both in transaction costs and opportunity costs, these programs have been able to generate a major demand for their credit service. To lower these costs, ACCION programs have developed administrative systems that are capable of handling large numbers of small loans with a minimum of paperwork and bureaucratic process.

LESSON #5:CHARGE COMMERCIAL RATES OF INTEREST, MICROBUSINESSES CAN EASILY PAY THEM

Moneylenders charge microentrepreneurs relatively high interest rates. As a general rule, the smaller the loan, and the shorter the amortization period, the higher the interest rate charged. This is logical since moneylenders have certain fixed costs to cover for each loan, regardless of the loan size.

The supply of informal credit at any given interest rate is limited by the existence of many alternative, lucrative, small scale productive or commercial activities available to moneylenders. Since moneylenders seldom mobilize resources which aren't their own, they must charge an interest rate that at least equals the rates of return on similarly sized productive investments in commercial activities. At the level of the small or microbusiness, these rates of return, even after subtracting out the owner's wages are anywhere between two hundred to two thousand percent annually.

If microentrepreneurs who have a net return on capital of two hundred percent are willing to pay usury rates of 180% (15 percent a month) in order to produce and maintain their economic activities, then they certainly would be willing to pay commercial rates of interest for that same working capital (on the order of 2 to 5 percent a month in real terms throughout most of Latin America). It is also clear that the potential savings to the microbusiness of further interest rate reduction through subsidization are probably not that great, particularly when we consider that subsidization of interest rates inevitably leads to an increase in both the transaction and opportunity costs of obtaining credit.

Formal sector lenders, as a rule, subsidize interest rates to microentrepreneurs on the assumption that poor borrowers are unable to pay commercial rates of interest. The reality is that no formal credit methodology yet designed in Latin America allows programs to reach financial self-sufficiency while also charging lower than commercial interest rates. Small average loan sizes prohibits this.

ACCION International has been a ground breaker throughout Latin America in establishing commercial and even slightly higher than commercial rates of interest for program participants. ACCION prefers to reach self-sufficiency and ensure long term program sustainability through direct operational income (interest and other fees) rather than through subsidies. The approximately thirty percent reduction in interest charges represented by most subsidy programs is not significant for microborrowers whose only real alternative is the moneylender, but realistic interest rates are a key to program viability.

Interestingly, most of the restrictions ACCION programs face as to maximum interest rates they can charge come from within. Ethical and political arguments almost always force interest rates below what sound financial management would dictate as optimal levels. Almost never do program participants pressure interest rates downwards. In fact, most ACCION program participants consider program loans made at commercial rates to be 'cheap money'.

LESSON #6:BE TOUGH ON DEFAULTERS

Moneylenders' bad public image is a result of the high interest rates they charge and the extremes to which they go to collect bad debts. Abundant literature exists which puts usurious interest rates in perspective. Less exists related to the extremity of sanctions moneylenders employ.

In Latin America, informal lenders to microbusinesses seldom resort to criminal means such as assault, arson, theft, or other such techniques to enforce repayment in spite of what the general public might think. The loan amounts are not large enough to risk the resulting sanctions if caught.

As we have already mentioned, the most common form of informal finance used by Latin American microentrepreneurs seem to be selling of third party checks and supplier or purchaser credit, rather than direct moneylending backed by collateral guarantees. In either case, informal lenders immediately suspend their entire commercial and financial relations with a defaulting borrower, spread the word around about the default, and pursue repayment through informal pressure. In those few instances when microentrepreneurs sign legal documents (checks or promissory notes) backing loans, informal lenders may even have legal recourse.

While these sanctions do not seem too drastic when compared to images of broken legs and bombed businesses, they are probably even more severe. Microbusinesses usually operate within a relatively small market and their commercial relations are few. To risk losing these good relations is to risk bankruptcy and even the possibility of future business opportunities. That means that the defaulter risks his entire economic future, probably a much stronger sanction than losing everything he currently possesses.

Formal lenders are reluctant to enforce sanctions against delinquent borrowers, primarily because of the negative publicity generated by punishing poor borrowers for being too poor to repay. At least that is the standard thinking. ACCION programs, on the other hand, largely avoid this dilemma by structuring their incentives systems similarly to those informal lenders mentioned above.

Most ACCION programs reach the poorest of all businesses with a credit methodology which is not based on real guarantees but rather on the loss of future commercial relationships should borrowers default. The solidarity group mechanism mentioned above is not legally enforceable. Should the program attempt legal proceedings to recover loan losses, they would certainly spend substantially more on the court process and lawyers than it would recover.

Rather, the incentive to repay in order to obtain an additional, potentially larger loan and maintain a permanent credit relationship is more powerful than any negative real sanction. If the program offers, in addition to credit, other attractive features such as training, medical attention, or legal services, then the incentive is even stronger.

This incentive is stronger yet if its enforcement comes not from the program, but rather from the other members of the potential defaulter's group. The potential defaulter risks not only the loss of access to a future relationship with the program but also damages his future relationship with other group members and potentially his entire commercial community.

Other group members will suffer a tangible financial loss due to his default, and therefore will be much more negative in their future relationships than if they merely heard through third parties that the defaulter had not paid an obligation to a formal institution. In fact, in many countries and cultures there seems to be a sort of perverse status in being able to defraud formal lenders without being caught. This doesn't happen in a solidarity group program.

MACRO POLICY RECOMMENDATIONS

If financial sector policy makers continue to deepen formal financial markets and wish to extend their coverage downwards to include all productive and commercial actors in local economies, they must design large lending institutions which can make far smaller loans more efficiently than any which currently exist. Large lenders which hope to meet the financial needs of the informal productive and commercial sectors will most certainly need to be a specially created, decentralized, private enterprise.

Even though these institutions will need to be private enterprises, the profit motive will not suffice. Microbusiness lending will probably never be tremendously profitable under commercial interest rate regimes and large institutions will have difficulty charging higher rates. Thus it will be necessary for them to offer an attractive array of complementary services in order to compete with informal lenders.

Central banks will have to legislate the creation of specialized banking institutions to fulfill this purpose, again due to the relatively low rates of return on bank assets which would be expected. The challenge will be to create dynamic, publicly supported financial intermediaries which operate under the strictest efficiency parameters of the best private sector companies.

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