ACCION INTERNATIONAL

WHAT MICROENTERPRISE CREDIT PROGRAMS CAN LEARN FROM THE MONEYLENDERS

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FOREWORD

Development practitioners and program designers often turn to existing successful microenterprise programs or to the experience of formal lending institutions to draw lessons for improving the design of future microenterprise programs. This discussion paper argues that the moneylender, although perceived as an exploitative source of credit among the smallest businesses, nevertheless provides useful lessons that are applicable to microenterprise programs. The discussion focuses on financial and economic factors in informal lending that lower the costs of borrowing for the microentrepreneur and result in greater income for the lender.

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I. INTRODUCTION

Development practitioners, donor agencies and policy makers have focused increasing attention on the role of very small businesses in the economic growth of developing countries. In the last decade, they have directed more development capital to promote these activities, principally through credit projects. These credit projects generally seek to a) increase microbusiness incomes and generate employment in the informal economy; b) provide less expensive alternatives to available informal sector credit; c) extend credit to business sectors not normally reached by formal lenders; d) educate informal sector entrepreneurs in credit use; and e) strengthen businesses not currently using informal credit sources due to insufficient profitability.

A microbusiness represents the smallest economic unit which functions independently, manages its own investment capital, and involves a manufacturing, commerce or service activity. Microbusinesses often have less than five full-time employees, usually other family members, are labor intensive and provide the primary source of family income for their owners and operators. These tiny businesses provide services principally to poorer sectors of the economy, are informally organized and operate extra-legally primarily in urban centers. They almost never have access to formal financial market services. In Latin

America, the average amount of investment capital in a microbusiness is around US $1,000, although a great majority have considerably less.

By this generally accepted definition, the microbusiness sector in most poor countries is enormous. As a result, hundreds of microbusiness credit projects in the developing world have been implemented. Yet, by almost any evaluation criteria one chooses, most of these projects have fallen short of their potential. If one judges a credit program's success by traditional measures such as loan default levels or economic viability, or in terms of net economic benefits, findings demonstrate that most traditional credit projects are simply too expensive to be replicated on a large scale. Further, the lack of data on economic benefits of most programs increases the difficulty of drawing conclusions regarding their overall impact (Boomgard, 1989).

Multilateral and bilateral assistance agencies are reluctant to invest significant resources in expensive programs with questionable net economic impact, or in programs which cannot cover their operating costs from interest income. Hence, research and analysis continues on what constitutes a program that has the potential to increase the generation of national income through its support of the economic activities of poor microentrepreneurs.

The shortcomings of traditional microenterprise credit projects can be traced primarily to their reliance on credit methodologies copied from formal sector banking. For example, application procedures and established loan terms seldom reflect the real needs of microbusinesses which operate very differently from the larger enterprises generally financed by banks. In fact, lengthy and complicated loan application procedures, demanding guarantee requirements, and slow service, turn formal lenders into the least likely credit sources for the smallest businesses.

A. Moneylenders: The Smallest of Informal Lenders

Unlike banks, informal moneylenders have been financing microentrepreneurs since commerce began. These individuals operate as credit providers within certain geographic locations that they know well. They develop a ***modus operandi*** with each client, based on a personal relationship that relies on constant interaction, a tacit establishment of mutual trust, and an offer of quick access to financing. This method of operation is very distinct from that of a formal lender and provides important advantages for the microbusinesses. If microbusiness credit programs are to reach their stated goals, they will have to learn from these moneylenders, and beat them at their own game.

It is important to clarify that an effective methodology for promoting the growth and prosperity of microbusinesses may involve other components in addition to credit, such as business management and technical skill training, marketing assistance, organization of microbusinesses into cooperative groups, etc. This document focuses on the lessons learned from informal lenders and does not extend its analysis to the relative role and importance played by credit in a broader microbusiness support program.

Further, comparing a microbusiness credit program to the activities of an individual who operates exclusively to make money and in a fashion perceived by many as questionable runs the risk of oversimplification. Nevertheless, this paper argues that there are proven methods of operation by moneylenders which, from a financial perspective, should be emulated by microcredit programs without diverting them from their broader social and economic development goals.

The handful of credit projects which have integrated into their lending strategies some of the characteristics of informal lenders have often performed exceptionally well. Among the most well known and established of these are the Grameen Bank in Bangladesh, the Badan Kredit Kecamatan (BKK) in Indonesia, and FEDECREDITO/PRIDECO in El Salvador. All of these programs generate considerable income, perform well at maintaining the value of their loan portfolios, and reach large numbers of needy microbusinesses in the informal economies where they operate (Hossain, 1988; Goldmark and Rosengard, 1983; Fraser and Tucker, 1981).

B. Moneylenders and Microcredit Programs: The Case of ACCION International

ACCION International (ACCION), a U.S. based private development organization specialized in microenterprise assistance programs, presents another example of an organization that has made use in its work of lessons learned from informal lenders. ACCION provides technical assistance to microbusiness support organizations throughout the Americas. About 40,000 businesses currently participate in over 35 ACCION affiliated programs in 13 Latin American countries and the U.S.

When ACCION began its work 17 years ago with urban microbusinesses in the UNO Project in Recife, Brazil, it implemented a classical formal sector credit model within its broader technical assistance and training program. Since that time, ACCION has learned from the shortcomings of this traditional approach and has studied the credit mechanisms used by moneylenders. The results have been promising. The lending methodology which ACCION developed over these years permitted several recently-initiated programs to attain self-sufficiency and reach large numbers of microbusinesses.

Today, a variety of programs exist within ACCION's network that relate part of their success to the application of methods learned from informal lenders. Acción Comunitaria del Perú (ACP), an ACCION affiliate, is fully self-sufficient and currently reaches 11,000 microbusinesses in Lima, Peru, after only six years of operation. Programs located in major cities throughout Colombia reach an estimated 7,000 microentrepreneurs. Several Colombian programs completely cover their credit portfolio costs, and many of the newer programs are well on their way to do the same. The Association for the Development of Microenterprises (ADEMI), in the Dominican Republic, has financed over 6,000 participants, operates on a national level, and covers operating expenses with interest income. The Foundation for the Promotion and Development of Microenterprises (PRODEM) in Bolivia, has in two years also recorded similar accomplishments. In works with about 5,000 tiny businesses, covers its costs of operation, and is now embarked on a national plan. Programs in Paraguay, Costa Rica, Guatemala and other countries demonstrate similar results.

Given this experience, the discussion in this paper focuses on the key lessons that can be learned from informal lenders and transferred to development credit programs for very small entrepreneurs. The emphasis is to highlight those areas that

most contribute to the program's sustainability and its capacity to operate in an effective manner. These lessons may be divided into four primary areas:

- **credit risk;**
- **total borrower cost for credit obtained;**
- **borrower selection; and**
- **collection mechanisms.**

II. CREDIT RISK

The first lesson from moneylenders is that microbusinesses are good credit risks due to their inherent profitability. Attempts to understand the nature of this profitability demonstrate some important yet often ignored characteristics of microbusinesses.

The smaller the microbusiness, the greater the return to assets, prior to taking out the owner's wages. A recent study conducted among 320 of the smallest businesses in 40 poor neighborhoods that participate in the ACCION affiliated program in Costa Rica, AVANCE, demonstrated their capacity to generate returns. For businesses with an average of US $833 in total assets, the gross return on assets was 700 percent annually (Christen, 1987). A similar study of small commerce in La Paz, Bolivia, conducted in relation to the PRODEM program, revealed gross rates of return of over 100 percent a year for businesses with an average of US $545 in assets. Rates of return for the very smallest approached 3,000 percent annually (Christen, 1985).

In the Costa Rica study, microbusinesses had a gross profit margin on sales of about 12 percent, which means that the smaller the business, the faster it rotated its assets. In fact, the smallest businesses rotated their assets 48 times a year, while the largest microbusinesses rotated only four times annually (Christen, 1985). The same is true for the Bolivian microbusinesses studied. Many of the street peddlers rotate their entire inventory every day or two, and earn profit margins from 50 to 100 percent per day. An average return of 12 percent on total sales with inventory turnover every 1.5 days during 300 days a year, means an annual rate of return on assets of 2,400 percent.

One should also note that in a microenterprise, the owner is also the primary source of labor, who must be paid implicitly a wage equivalent to that of a skilled worker in the same profession. Taking this factor into account would reduce a gross return of 700 percent in the case of Costa Rica to about 400 percent for businesses with average assets of US $833.

With such impressive returns it would seem that everyone would want to become a microentrepreneur. Indeed, in the face of diminishing marginal returns, microbusinesses obtain important income gains from additional units of capital. This high marginal return to additional units of capital is precisely what makes informal lenders prefer microbusinesses as borrowers.

In spite of these findings, formal lenders are not willing to invest in this sector. The transaction costs to process a loan application are too high and microbusinesses are perceived as high risk clients. Country level studies show that in general, only about 10 percent of microbusinesses have access to formal sector credit (Christen, 1985; Blayney and Clark, 1987; Christen, 1987).

III. TOTAL COST OF CREDIT TO THE BORROWER

Formal and informal lenders ration the supply of credit they offer by taking into consideration any of the three components of total borrowing cost: a) direct financial costs; b) transaction costs; and c) accessibility costs. This section considers approaches to credit rationing that exist for formal and informal sector lenders, and suggests lessons for microbusiness credit program implementors.

A. Direct Financial Costs

When a borrower obtains a loan he or she incurs several different types of costs. The most obvious of these is direct financial costs such as interest payments, commissions, fees or other direct charges. In order to standardize the effects of up-front charges or required compensating balances left on deposit with lenders, this cost must be calculated as part of the effective rate of interest charged on the loan.

There is normally a great disparity between what banks and moneylenders charge microentrepreneurs for loans. As noted above, very few formal institutions lend to microbusinesses, and when they do, they utilize the same procedures applied to standard borrowers. Thus, they find it impossible to make a profit. Those few large lenders such as development banks which operate a specific line of credit for microbusinesses often conduct this activity to improve their public image or to respond to inducement from international assistance agencies or local governments. As a result, formal sector lenders usually charge subsidized interest rates on loans to this sector.

When compared to formal lending, informal credit is expensive. Moneylenders are the microentrepreneurs of financial markets. Most of them operate on a very small scale, the same general scale as their borrowers. They face similar investment opportunities and constraints as their borrowers in markets that are characterized by relatively free entry and exit.

A second vital difference between formal and informal lenders focuses on the source of capital for lending activities. Formal sector lenders are financial intermediaries which leverage small amounts of personal capital into large credit portfolios by putting together savers and borrowers. They mobilize resources as well as allocate them. Informal lenders, however, invest their personal capital directly into their loan portfolios since they cannot easily access resources which are not their own.

Hence, the supply of informal credit is limited by the existence of alternative, lucrative, small-scale productive activities. The financial return to a moneylender must therefore be similar to the returns on productive capital for microbusinesses. As already noted, many microenterprises generate gross returns on assets of one to two thousand percent a year. A full time moneylender would not expect to earn less since he too would see his net profit shrink considerably once his fair wages were deducted for the time he invests. Again, the returns are very high to very small amounts of capital when a microentrepreneur's wages are excluded from calculations of gross returns.

Some informal lenders provide microbusinesses with supplies or services, or purchase their products. They offer credit as part of a total sales package in order to compete. They charge considerably less than moneylenders because they do not have to take their wage from the credit operation since credit is an integral part of a broader commercial activity. These lenders offer credit only if they can earn at least as much from this activity as from their principal commercial activity. In most cases, the competitive environment in which they operate does not enable them to charge an interest rate on loans equivalent to the profit on their normal commercial activities. This factor contributes to the limited supply of this type of credit.

B. Transaction Costs

Transaction costs represent the second type of cost that borrowers incur when they obtain credit. These are indirect costs imposed by lenders through their delivery systems, but not received by those lenders in the form of income.

When businesses work with formal financial institutions, they must take time from their productive activities to apply for and follow through on loan applications. They frequently must hire outside professional services to prepare feasibility studies or to produce financial statements. Additionally, they are responsible for obtaining the necessary documentation to support their collateral or mortgage guarantees. After assigning a fair shadow price to represent the opportunity cost of the time the borrower spends in this process, and adding this cost to the outlays of cash for professional services, transportation, and documentation, we find that formal credit for small borrowers may entail transaction costs which far exceed the direct financial cost of a loan.

Informal lenders impose virtually no transaction costs. These lenders take the credit to the client with a delivery system that is tailored to the client's particular business needs. This service constitutes one of the informal lender's unique specialties.

One of the most common and lucrative delivery systems is credit supplied by the purchaser of microbusiness products and services. In such cases, wholesalers advance money to microbusinesses when they place a particular order. Usually no explicit interest is charged, but the wholesaler pays less for the finished product than the microbusiness could get elsewhere.

Street commerce frequently makes use of supplier credit, at daily interest rates of 10 percent. The street vendor arrives at the warehouse early in the morning to prepare produce for the day's sales. His or her supplier provides the produce on credit, taking repayment at the close of the working day. In established produce markets, suppliers may make daily rounds of borrowers to collect payments.

In most cases, the borrower interacts with the lender constantly in the course of his or her normal business routine. Therefore, the lender can provide credit without imposing virtually any transaction costs. This factor creates a fundamental difference between informal and formal lending procedures to the informal sector.

C. Accessibility Costs

The third type of cost that small borrowers must confront when financing their economic activities is the cost of investment opportunities lost due to inefficiencies in lender delivery systems. Borrowers often ask lenders to finance some special business opportunity available only in the short run, or they risk losing it. When lenders cannot deliver credit in a timely manner, borrowers forego opportunities to purchase inputs or equipment under favorable conditions or lose important contracts. Of the three components of the total costs of obtaining financing, this accessibility cost is frequently the greatest.

D. Total Borrowing Costs

Informal lenders structure their total borrowing costs very differently from traditional formal sector credit programs. In relatively free informal financial markets, it is counterproductive for lenders to impose any cost on borrowers that they cannot collect as direct financial charges. Therefore, credit delivery systems are designed for maximum efficiency and lowest borrower cost. Informal lenders can make substantial benefits by offering fast and responsive service.

Formal lenders, on the other hand, often lend to microbusinesses only to fulfill mandates or in response to external incentives. Since these motivations can be considered more political or ideological rather than financial, the lenders maintain lower than market interest rates on microbusiness loans. They find that demand is practically infinite for these apparently cheap resources, and ration their credit by imposing very high transaction and opportunity costs. This approach resolves the problem of excess demand, since microbusinesses will not find this apparently inexpensive source of credit useful for their needs.

Ironically, through the rationing process described above, cheap credit becomes very expensive. What appeared to be very inexpensive credit, in fact emerges as more expensive than a moneylender's. The following example illustrates this situation:

> Assume that Juan Rodriguez needs US $200 for 60 days to finance the leather he needs to fulfill a contract. He needs to repay in one payment at the end of the period.
>
> In one scenario, Tito Vargas, a local moneylender, will lend him $200 for 60 days at 10 percent a month, since he knows Juan and has worked with him before. Tito will send Juan the money and will send someone to pick up the payment. Tito also has cash, which he can send to Juan immediately. Therefore, Juan's total borrowing costs are $40 since there are no transaction or accessibility costs involved.
>
> In another scenario, Juan Rodriguez is a member of a credit union since he knows that a bank would never lend to someone as poor as he. His credit union would charge him 2 percent monthly for the loan and require a 20 percent compensating balance to be left on deposit. This means he will have to borrow $250 in order to take home the $200 in cash that he needs.
>
> Since Juan lives in a big city, it takes him a half day to travel to the credit union office, including the time he spends on the bus each way. He normally would need to travel four times to the credit union office to obtain and repay his loan. He needs one trip to get a loan application, a second trip to bring the required paperwork, a third trip to receive the loan and a fourth one to repay it.

Juan Rodriguez earns approximately $350 each month and works approximately 240 hours each month, for an hourly wage of $1.46.

The credit union did not have the loan ready quickly and Juan had to take two extra trips and wait an extra week. As a result, Juan lost an opportunity to obtain a 20 percent discount on his leather purchase and has to buy at the normal price in order to complete his contract on time. The distribution of Juan's total borrowing costs would look like this:

	COST	TOTAL
Direct financial costs	$ 10	$ 10
Transaction costs		32
4 half days / 16 hours	23	
Transportation to offices	4	
Paperwork	3	
Misc. expenses	2	
Accessibility Costs		54
2 half days / 8 hours	12	
Transportation to offices	2	
Lost discount	40	
Total borrowing costs	$ 96	$ 96

This figure appears in relation to what the moneylender, Tito Vargas, would have charged him for the loan, $40, with no additional transaction or accessibility costs. The telling comparison is that although the credit union would have charged $96 in total borrowing costs, it would have received only $10, while Tito Vargas, by charging less than half of those total costs, still generates $40 of direct income.

E. Cost Structure Lessons for Microbusiness Credit Programs

In summary, the second important lesson to be learned is that informal lenders reduce their financial transaction and accessibility costs to a minimum by using lending practices which reflect the needs and realities of microenterprise clients. While feasibility studies, traditional guarantees, and financial statements are all essential components of formal sector lending methodologies, they are expensive and ill-suited to effective microbusiness lending. On any small loan which requires three or four office visits, transaction costs would exceed direct financial costs, and total borrowing costs may well exceed the cost of borrowing from informal lenders.

One way informal lenders reduce transaction costs is by taking credit to the client. At most, the borrower must complete a simple guarantee document before receiving his or her loan. There is no application process other than a casual conversation, and both disbursements and repayments are handled by the creditor. This process allows the microentrepreneur to dedicate his most precious commodity, time, to productive activities.

No credit is more expensive than delayed credit. When microbusinesses turn their limited capital over 20 to 50 times a year, unkept promises to deliver credit quickly can be very costly. Delays in loan disbursement help no one. They usually result from poor liquidity management or from lack of professionalism on the part of formal lenders.

The more successful microenterprise programs have incorporated these cost structure lessons into their lending methodologies. Credit programs such as the Badan Kredit Kecamatan in Indonesia, the Grameen Bank in Bangladesh and FEDECREDITO in El Salvador take loans to the borrower's place of work or home village. ACCION's programs do a significant portion of the loan application and renewal process in the borrower's workplace, and office time is kept to a minimum.

In a typical ACCION program, borrowers are granted a line of credit for working capital. After the initial loan, which may take up to four visits to obtain, subsequent loans require only two office visits. In one visit, borrowers fill out simple loan applications, and in the other they pick up their loans. All repayments are made in local branches of banks, which cuts down on repayment transaction costs. In some programs, when the borrower is in good standing, the application is filled out in the workplace, and the borrower makes just one trip per loan, to pick up his check.

Loans are almost never delayed. The day a participant in good standing makes his last payment, his subsequent loan is waiting. This feature, perhaps more than any other, represents the programs' strength. They are dependable. Should there be a liquidity problem, ACCION affiliates restrict credit to new participants before they allow participating microbusinesses to suffer delays in credit service.

The success of these programs in reaching large numbers of microenterprises with credit is that they are formal sector lenders who have adopted informal lender total borrowing cost structures, and in most cases have lower total costs than those same informal lenders. They beat them at their own game.

The total cost structure for Juan Rodriguez in a typical ACCION affiliated program might look like this:

Direct financial cost	$ 15
Transaction Costs	
2 half days / 6 hours	9
Transportation to offices	2
Paperwork	2
Misc. Expenses	2
Total borrowing costs	$ 30

In addition, most programs offer a variety of other services and benefits which create a strong identification between the institution and the program participant. This relationship enables microcredit programs to compete with informal lenders on other than strictly economic grounds.

One can conclude from the experience of informal lenders that many microbusinesses can survive, and in some cases even prosper and grow, with usurious rates of interest. Clearly, these businesses would do better with less expensive credit, but it is also important that this less expensive credit need not be subsidized. For a microbusiness with a 500 percent annual rate of return on assets, the difference between an unsubsidized commercial loan rate of 36 percent and a subsidized loan rate of 18 percent is insignificant to overall business cash flow and returns. Given the nature of microbusinesses, a business that is not viable at a commercial rate of interest is not likely to do well at a subsidized rate of interest either, and the appropriate support methodology is probably not a credit program.

This difference is of great significance to the lender because it relates directly to institutional viability. Substantially positive real rates of interest constitute one of the keys to long-term program stability and permanence. Only by reaching self-sufficiency and maintaining the value of the loan portfolio will programs that reach microbusinesses be able to expand to the degree necessary to reach very large numbers of needy people.

IV. BORROWER SELECTION

The third key lesson garnered from an analysis of moneylenders' practices is that they know their clients well, develop a relationship with them and know their clients' general business environment. As indicated in the discussion of credit delivery systems, informal lenders frequently are involved in other commercial aspects of the microbusinesses. They sell raw materials and purchase final products from microbusinesses. These activities give them ample opportunity to understand the microbusinesses over time and in different situations, and not to perceive them only as credit customer.

Lenders, both formal and informal, focus on two principal areas when evaluating a potential borrower's credit worthiness: character and repayment capacity. In other words, the lender wants to know if the potential client is likely to be both willing and able to repay his/her loan. The discussion in this section compares how informal and formal lenders select their clients and make lending decisions.

A. Character Assessment

First, the lender must establish the potential borrower's willingness to repay a loan. For an informal sector borrower, the best and only references are persons with whom he/she does business - suppliers and customers. The lender determines whether or not the potential borrower fills his/her orders and pays suppliers on time, and how stable he/she is, both on a personal or family level and in his/her business. In some cases, the lender may also seek character references who would be willing to co-sign a loan.

It is essential for the informal lender to determine the potential client's attitude toward repayment, based on prior experience and general level of responsibility. Even if a borrower should offer a very solid guarantee and have a demonstrable repayment capacity, if he/she cannot assure the informal lender of this willingness to repay, he/she will not likely get a loan.

B. Repayment Capacity Evaluation

Since informal lenders usually know both the potential client and his/her business, they have a reasonably good idea about that client's productive capacity. This, in turn, reflects the client's repayment capacity. Unlike formal lenders, informal lenders are not particularly interested in the potential borrower's specific investment plans. Instead, they want to know if the borrower is generally financially solid. If the investment plan were to fail, the lender wants to be sure that the borrower can repay from income sources other than those committed to the investment plan.

While informal lenders do not pay attention to investment plans, their general knowledge of their client's business allows them to veto clearly dangerous plans. If Juan Rodriguez has been making ten pairs of shoes a week for the past five years and requests a loan to begin producing 30 pairs a week, Tito Vargas is likely to discourage such a dramatic increase in production.

Those lenders who also work in the same product markets as their borrowers have superior knowledge about the borrower's credit worthiness. If Tito Vargas also happened to own a retail shoe outlet, he would know the shoe market and would be able to determine readily not only Juan's ability to produce, but also the feasibility of selling 30 pairs of shoes a week. The same is true of suppliers who provide credit.

C. How Formal Lenders Gain Knowledge About Potential Borrowers

Formal lenders often must gather second-hand credit information about potential clients. Standard credit reference checks and financial analysis for microenterprises are useless since no information generally exists in formal sector data banks. After all, microbusinesses operate in the informal sector.

It is virtually impossible for a formal lender to gather this information reliably. Certainly, it is prohibitively expensive. Traditional credit programs directed at small and micro industry frequently spend one dollar to lend one dollar. Most of this administrative cost is expended attempting to gather information for borrower selection (Liedholm, 1985). In spite of exorbitant cost, formal lenders are not able to gather good information due to the lack of record keeping on the part of potential clients. The inability to gather this information confirms the formal lender's concern with high transaction costs and unacceptable risks.

Formal lenders must incorporate persons with first-hand knowledge of potential borrowers into their credit review process. To achieve this, they would require a co-signer. However, in the informal sector, a potential co-signer is likely to be a microentrepreneur as well and thus probably not reliable in the eyes of a bank.

To emulate moneylenders, microenterprise programs must seek non-traditional means for identifying trustworthy clients. ACCION's affiliates and other entities have developed two such mechanisms. The first is the use of a group guarantee mechanism. In these programs, three or more microentrepreneurs form a solidarity group. Loans are made to the group, which in turn distributes the loan to its members. If one of the members fails, the others pay that person's portion. Should a group fail to repay the failed member's portion, no one in the group receives a new loan. In addition, solidarity groups sign documents which allow for legal action in the case of default.

These solidarity groups have worked exceptionally well, particularly at the level of borrower selection and pressuring loan repayment. Most ACCION affiliated solidarity group programs maintain delinquency rates of less than 10 percent. Loan losses are less than 2 percent of current portfolios. Most of the programs are either self-sufficient or well on their way in this direction. For programs which have reached their maturity, the unit cost per dollar lent is between 2 and 4 cents.

The reason that these solidarity groups have worked so well is that they are self-formed on the basis of mutual knowledge and respect in the participants' microbusiness community. ACCION affiliated programs, the Grameen Bank, FEDECREDITO and other programs transfer the weight of borrower selection to the borrower group.

The second mechanism is the use of a system of "stepped" or incremental lending. The concept is to offer a line of credit with small first loans and relatively short loan terms. In addition to providing a mechanism with which the borrower can absorb and take advantage of incremental amounts of credit this system allows the program to know the client, and if payback is on time, the loan amount and loan period are gradually increased. Because loan amounts are initially small (as little as $50), the need to do more traditional credit analysis is eliminated. As does the money lender, the program relies on its knowledge of the client which develops over time.

V. COLLECTION MECHANISMS

The final area in which microenterprise credit programs can learn from informal lenders is that of collection mechanisms. Timely repayment constitutes one of the most important elements in the success of a microbusiness program. In those cases where the program must exert pressure on a borrower that refuses to pay back, the procedures established by the program must be clearly established and consistently followed. The lessons in this area are simple, but crucial.

A. The Certainty of Sanctions

Borrowers repay informal lenders because they know that should they default they will be sanctioned. Such sanctions may include legal prosecution, repossession of assets, community ostracism or even the threat of physical abuse. This certainty of sanctions is the backdrop on which informal lenders operate. If a potential borrower knows that he/she will suffer the consequences in the case of default, he/she will not borrow more than he/she can manage. The borrower will be doubly careful about entering into a loan agreement and will do so only when he/she is convinced that it is absolutely necessary.

This is the simplest yet toughest lesson for microcredit programs to learn. Since a microbusiness program begins in order to respond to the needs of a low-income population, the establishment of sanctions appears counter to its intended social and economic goals. There are a number of cases where true calamity strikes a borrower and impedes repayment. These, however, are relatively rare, can be identified easily, and the program and borrower can reach an agreement to renegotiate the loan based on circumstance and need.

However, the overwhelming frequency of loan delinquency in most traditional programs is the direct result of institutional laxity or borrower irresponsibility. A microenterprise program which manifests anything other than total certainty of sanctions in the event of default invites gamesmanship. When the institution appears unconcerned by repayments, some borrowers will estimate the probabilities of sanctions and default on what they think the program will tolerate. In this case, the greater good for the greater number dictates that sanctions be defined and strictly enforced.

B. Appropriate Guarantee Mechanisms

Informal lenders are experts at finding simple, inexpensive guarantee mechanisms and at avoiding the complexities and delays that characterize the guarantees obtained by formal lenders. They may accept as a guarantee a personal asset from the borrower such as a watch or TV set which often is worth more than the value of the loan.

Formal sector guarantees are usually complicated and costly to constitute. Further, they cannot be executed quickly, thereby diminishing their effectiveness. In the case of a delinquent microbusiness loan, the use of a complex legal process will make the cost of loan recovery higher than the amount owed. Most of the indirect costs associated with a court proceeding, such as salaries of personnel and overhead, cannot be collected from the borrower.

Simple and inexpensive guarantees are an important element in maintaining low borrowing costs. They also reduce the lender's operational costs. Every program must determine what guarantee mechanism, which varies from country to country, is most appropriate for its needs. Most ACCION affiliated programs have discovered legal mechanisms which provide adequate guarantees but are also simple and inexpensive. Further, most include preventive measures in the manner that they extend credit, making use of solidarity groups and other approaches to enhance the borrower's credit worthiness.

In cases of negligence among borrowers, ACCION affiliated programs do not hesitate to take legal action against delinquent borrowers. All programs have legal department or lawyears on retainer who administer loan collection once the program staff recommends their involvement. Often, they are paid a salary or a commission based on recuperation.

VI. CONCLUSIONS AND GENERAL RECOMMENDATIONS

Microenterprise credit programs can draw important lessons from informal lenders. To the extent that they are able to eliminate transaction and accessibility costs, they will be able to lower total borrowing costs significantly and to provide an attractive alternative to moneylenders. By lowering these costs dramatically, microcredit programs can raise interest rates to levels which can ensure long term program viability and provide potential for large scale impact while still maintaining total borrowing costs at levels below those of moneylenders. From the point of view of financial analysis and from the experience of informal lenders, it is clear that microentrepreneurs are willing and able to pay commercial and even higher than commercial rates of interest for excellent credit service.

Even more importantly, credit program staff must recognize the importance of first-hand knowledge when assessing credit worthiness of potential borrowers and their businesses. Further, they must understand the futility of gathering this necessary information themselves. Microcredit programs should integrate individuals knowledgeable about potential borrowers and their firms into the credit evaluation process. The successful microbusiness credit programs use the solidarity group methodology as one effective way of including microentrepreneurs in the credit review process.

Finally, microenterprise credit programs must recognize that unless they are insistent about pursuing delinquent borrowers, their programs will fail. If there is any doubt about a lender's willingness to pursue a legal action to its final consequences, that lender invites gamesmanship on the part of the borrowers. Once this process takes hold, it is very difficult to control, and a program's repayment rate begins to fall.

Some microenterprise programs, such as those assisted by ACCION International and others mentioned in this paper, have successfully incorporated these lessons into program methodology. If all microenterprise programs apply these lessons and develop excellent service quality, they can have the potential of reaching truly significant numbers of microbusinesses in the coming years.

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