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TIJARA

Provincial Economic Growth Program

MICROCREDIT TECHNOLOGIES MAIN PILLARS

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Profile of the Small and Micro Entrepreneur

- Usually low educational levels
- Small volume of operations
- Rudimentary/obsolete equipment
- Few employees (0-9) mostly unpaid family members
- Family and business are entangled
- Multiple income generation activities
- Basic or none business records
- No marketable collateral to offer
- No access to formal sources of credit/ no credit history
- Active participation in informal sources of credit
- Large, extended families
- Basic financial skills

Environment

- Most SME are not registered, however, they have been in operations for many years
- While SME may have property and assets, most do not have property titles /ownership documents
- Registry of guarantees is cumbersome, time and resource consuming. The cost is often too high for both client and lender
- Execution of guarantees through the legal system may take take years
- Contradictions in the legal system (e.g. creditors cannot seize a person's means of production) make executing guarantees very difficult.

Rationale behind Microcredit Technologies

Each feature in the MC technologies is built around 4 objectives:

- Facilitating client’s access to credit
- Minimizing the risks of lending to a client that has no credit history; questionable business information; no marketable collateral to offer.
- Reducing costs.
- Rapid loan disbursement

Summary of Loan Terms and Conditions

- Loan amounts start small and scale-up as the client develops a credit history with the program.
- Initial loan amounts are set up to $500 to $3,000
- Repeat loans for larger amounts
- Amounts for subsequent loans increase in 20 % to 30% depending on the repayment behavior of previous loans.
- Terms are kept short - 3 to 6 months for working capital loans
- Weekly, bi-weekly, monthly installments of capital and interest
- Innovative guarantees: household business assets, co makers
- Interest rates that are similar to or above market rates

The Client

Client

- Low income, lower middle income entrepreneurs
- With credit needs above $500
- With capacity to offer some form of collateral
- With a business already in operation for over two years
- With or without credit history
- 18-65 years of age
- Resident in the area for at least two years

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Terms and Conditions Loan Destination

- First loans are granted mainly for working capital purposes
- Fixed asset loans are only approved for repeat clients who have built a credit history with the program,
- Activities include agriculture, animal husbandry, agro industry, commerce, services, and manufacture.
- Usually no start-up loans unless they involve small amounts

WHY WORKING CAPITAL LOANS ONLY?

- Fixed asset loans are too large to be granted to a client with no credit history
- Working capital is the most pressing need for micro and small entrepreneurs.
- Start-ups requiring large sums are too risky when the client has no prior experience in building a business

Loan Amounts

Loan amounts start small and scale-up as the client develops a credit history with the program.

- Initial loan amounts are set up to USD 500 – 3,000 per individual.
- Amounts for subsequent loans increase in 20 % to 30% depending on the repayment behavior of the previous loan and repayment capacity

WHY SMALL SCALE-UP LOAN?

- Given the lack of collateral; lack of reliable information on the business and lack of credit history, loan amounts need to start small as to minimize risks and test the client
- As the client develops a credit history with the institution and , the credit officer develops knowledge on the client, loans amounts can scale-up.
- Experience has proven that SME benefits the most from "continuous" injections of capital.
- Most SM E are used to the small amounts they borrow from informal sources
- It reduces the need for expensive business check ups and loan analysis while enabling a quick loan disbursement, a key to successful SME lending.

Why Small, Scale - Up Loans

NOTES:

- Amounts are small relatively to the size of the business
- Loan increases are not automatic but determined by repayment capacity

and cash flow

- The amount of the first loan is not necessarily tailored around what the client needs, but around what the institution is willing to risk with a client who offers no collateral, no reliable information, no credit history.

Loan Terms

Loan Terms are kept short

- Working capital loans are up to six months to be paid in installments of capital and interest.
- Fixed asset loan terms are based on the life/productivity of the asset but would not exceed 24 months.

WHY SHORT TERM?

- Most ME are involved in activities (commerce, services) of rapid cash flow which allow them to pay in shorter terms.
- Experience has proven that micro and small enterprises benefits the most from continuous cash injections in increasing amounts than from one long shot.
- Because in the microentrepeneur's life business and family are entangled, problems in the family affect repayment.
- It works as incentive to the client for planning business growth.

Loan Payments

- Payments are made in frequent installments (daily, weekly, bi-monthly, monthly) of capital and interest

WHY FREQUENT PAYMENTS?

- Easier for clients to make small, frequent payments
- They are used to daily, weekly and bi-monthly payments typical of informal sources.

Interest Rates

Interest rates are set at market or above market rates

- This rate will be revised periodically and adjusted accordingly to inflation and/or the cost of capital.
- Given the short-term nature of the loans, the intermediary could also reconsider to raise the effective interest rate through fees and compensatory balances.

WHY MARKET INTEREST RATES ?

- .Providing small loans is expensive. The interest rates must reflect the cost of capital, administration and loan loss reserves.
- M E are willing to, and actually do, pay high interest rates (to money lenders) if other terms and conditions (easy access; no collateral) are adequate.
- For the M E what counts is the total costs of credit. This is interests plus transaction costs (fee, transactions, time). If the transaction costs are low, the interest rates can be high

Fees and charges

Fees and other charges can function like interest rates in providing revenue to the banks

- They can be proportional to the size of the loan or fixed, and they can be collected in advance or repeatedly (e.g. at renewal monthly) while a loan is outstanding.

- They may appear more acceptable to the borrower if they are linked to specific loan services (e.g. preparation of documents, inspection, etc.).

Loan Guarantees

- Innovative guarantees
- Collateral may include co-signers, household items, equipment and tools, inventory, land or any other property.
- In most cases the collateral requirement keep close relationship to the size of the loan and its destination (working capital or fixed assets)
- When household items are used as collateral, the spouse authorization is also required.

WHY INNOVATIVE ?

- Most ME do not have guarantee to offer (land, property, equipment). They use rudimentary/ obsolete equipment, of little or none marketable value.
- For those who do, the value of the guarantee or the cost of registering it far exceeds the amount of the loan
- In all instances, executing a guarantee is a time and resource consuming process which in most cases far exceed the amount of the loan.
- The relevance of collateral is not its market value for the intermediary but its intrinsic value for the client

Savings

- Many institutions require mandatory savings from borrowers.

- Savings can act as compensating deposit balances that could have also substantial impact on effective interest rates

- However, mandatory savings can limit demand and affect the institution's ability to achieve scale

LOAN PROCEDURES

Promotion

Application

Analysis

Approval

Disbursement

Follow-up and Collection

Summary of Loan Process

- Loan officers reach out to clients at their workplace (loan promotion)
- Simple loan application, often one to two pages. The smaller the loan amount the simpler the process
- Loan analysis is based on character rather than on business's analysis
- Loan approval is decentralized. Loan officers approved loans for up to a certain amount.
- Quick disbursement, usually 7 days for a first loan and automatic disbursements for repeat loans
- Repayment is based on incentives to both clients and staff and timely follow-up

Loan Process

Promotion

- The message to the potential client would refer first to the bank's philosophy (*non-governmental, non-subsidized, loans must be repaid).*
- Secondly it must emphasize the zero tolerance to non-payment
- Thirdly, it must refer to the features which make the product attractive *(non collateral, simple loan application, quick disbursement, repeat larger amounts).*

Loan Process

Promotion

- Notes:
- Promotion is not a substitute for high quality services
- The best and least expensive promotion a credit program could have is that of a satisfied client.

Loan Application

- The loan application is simple, often one or two pages
- The Credit Officer assist the client in filling out the loan application
- Most of the information in the application for first borrowers refers to the client's "character" (stability, responsibility, entrepreneurship, repayment behavior)
- Most of the information in repeat loans refers to repayment behavior of past loans

WHY SIMPLE LOAN APPLICATION ?

- Low educational levels of the Micro and small micro entrepreneur; lack of familiarity with financial terms
- The small amounts usually associated with micro enterprise loans do not require complex procedures.
- The information required and application process must be proportional to the size of the loan.
- The application process for a $50.00 loan must be simpler than for a $20,000 loan.

Loan Analysis

- Loan analysis is based on character, not on business analysis and collateral

- Character-based lending relies on information generated by the borrower and his/her peer group on aspects related to:

- Stability
- Responsibility
- Reputation in the community
- Entrepreneurship
- Payment behavior

WHY IS LOAN ANALYSIS BASED OHARACTER?

- The M E rarely has financial statements and never audited ones. For business analysis, the credit officer would need to rely on information that is at best questionable.

- The M E has no marketable guarantees to offer. For those who do, the value of the guarantee or the costs of the registering it, far exceeds the value of the loan.

What is Character Based Lending?

- Character-based lending relies on information on the client's stability, responsibility, entrepreneurship repayment behaviour and reputation

- It also relies on information that neighbors and peers have on the client

An Alternative

- Character based lending help us to reduce the risks and costs of lending to an client unable to provide
  - Marketable collateral
  - Credit history
  - Reliable financial information

Indicators on Client's Stability

- **1. Stability**
- Married
- Married with children
- Children attending school
- Resident for over two years in the same community
- Home owner
- Business in operations for over two years
- Business in the same location for over two years

- HOW THESE INDICATORS HELP US TO ANALYSE AND REDUCE RISKS?

Indicators of Entrepreneurship

- **2. Entrepreneurship**
- The applicant (and/or spouse) has multiple businesses
- The applicant has provided concrete examples of how the business has grown since start up
  - Diversification of products or services
  - Expansion in the number of clients
  - Increasing production
  - Increasing number of employees

Indicators of Entrepreneurship (contd)

- The applicant has provided clear explanation of plans for business expansion
- The applicant has a clear vision of his market and how to compete
- The applicant keeps financial records
- The applicant explains clearly how he is going to use the loan
- The business is located in a commercial area
- The business has been in operation for many years

Indicators of Reputation

Reputation

- The applicant belongs to and/or holds a position in a community association.
- The applicant has a good reputation as confirmed by CIBI with neighbors.
- The applicant has a good reputation as confirmed by CIBI with peers
- Barangay captain certifies to applicant's reputation
- Suppliers confirm good reputation

Indicators of Good Repayment Behavior

- The applicant has had loans from other sources.
- The installments of any relevant loan have been paid on due date as confirmed by payment receipts
- Phone bills are paid on time as confirmed by last three receipts/payment slips.
- Rent is paid on due date as confirmed by last three receipts or confirmed by landlord
- School fees are paid on time as confirmed by last three receipts
- Payments to suppliers are made on time as confirmed by last three receipts or supplier

Indicators of Good Repayment Behavior (cont'd)

- Electricity bills are paid on time as confirmed by last three receipts.
- The applicant has an active savings and/or checking account.
- The last three bank statements show increasing savings balances
- The applicant has credit from suppliers.

RED FLAGS ....

- The applicant inquires about donor financing
- The applicant provides contradictory information
- The applicant does not have a clear understanding of his market or business
- The applicant does not provide a convincing explanation about his need for a loan
- The spouse contradicts the information provided by applicant
- The spouse refuse to sign collateral authorization

RED FLAGS ....

- History of violent behavior
- History of spouse/child abuse
- History of alcoholism
- Spouse refuse to sign authorization
- References reluctant to express opinion on applicant.
- History of gambling
- Applicant unable to provide receipts supporting information.

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Reference Checks

- Verifying references is a key step in character based lending.   Main sources are:

- Suppliers
- Landlord
- Colleagues, friends and neighbors

Reference checks with Suppliers and landlord :

- How long the relationship between supplier and the applicant?
- How often does the applicant place orders?
- What amounts?
- Have the supplier provided credit to the applicant?
- How much ? On what terms? ___
- Does the applicant pays on time?
- What is the supplier's opinion on the applicant?

Reference Checks With Colleagues, Friends and Neighbors

- **Relationship with the applicant:**
- Colleague
- Neighbor
- Friend
- Other

- How long have you known the applicant)?
- What reputation does s/he have as a businessman? neighbor?
- Is s/he known to have any problems with debtors? Family? alcohol? Violence?

Loan Analysis
Cash Flow

- Once established the applicant’s creditworthiness through character analysis, the AO (?; spell this out!) proceeds to prepare cash flow to determine repayment capacity

Loan Analysis

Analysis of Repeat Loans

- Analysis of repayment behavior of past loans
- Results of monitoring visits to determine changes/ potential problems in the client's situation
- Cash flow to determine repayment capacity and possible increases in loan amounts

Loan Approval

- Loan approval is decentralized
- Credit officers have discretional approval for up to a defined amount according to experience and portfolio performance.
- A credit committee acts as a mechanism of internal control and evaluation on the quality of the approvals.
- The committee analyzes sample loans and assess their quality in a forum where promoters and other field staff can learn.

WHY IS LOAN APPROVAL DECENTRALIZED?

- Centrally approving small loan is too expensive and time consuming.
- The credit officer is the one who knows the client.

Loan Approval

- In all cases, only branches with PAR30 < 2% keep discretionary approval.

- Once PAR goes over the defined limit the branch loses approval automatically

Loan Approval

- The Credit Committee acts as a mechanism of internal control and evaluation on the quality of the approvals.
- It would analyze sample loans and assess their quality in a forum where Account Officers and other field staff can learn.

Loan Disbursement

- First loans have a disbursement period of seven days.
- Subsequent loans would have automatic renewals - 24 hours disbursement-.
- Loan processing of subsequent loans must be done well in advance as to ensure the automatic disbursement
- Loans are disbursed in checks issued to the client

Loan Process
Loan Disbursement

- Loan proceeds will be disbursed in cash in a single disbursement

Analysis of Repeat Loans

Credit History: Repayment Behavior

Loan	**Amount**	**# of insts.**	**Paid on** Due Date	**Paid in arrears** 1/7 days	8/15 days	16-30 days	31+ days	Class.
Loan # 3	80,000	10	8	1	1			B
Loan # 2	60,000	8	7	1				A
Loan # 1	40,000	6	6					AA

Repeat Loans

- **Repayment behavior.**

- The client has paid all installments on due date or with a delay no longer than three days (
- The repayment over the last three loans have been constant or improving.

- Business location remains the same.
- Home address remains the same.
- Site monitoring visits show that the business is still solid and growing.
- The number of employees have increased or remain stable.
- Savings balances are increasing

Red Flags……….

- Payments over 3 days past due indicate that the loan amount is too large
- Partial payments indicate that the loan amount is too large
- A steady decline in the number of installments paid on time could mean the loan amount is becoming too large
- A sharp drop in savings balances could mean liquidity problems

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LOAN FOLLOW UP AND COLLECTION

Loan Repayment

- Loan repayment is based on
- Client close monitoring
- Borrowers incentives
- Staff incentives
- Well-defined policies and procedures
- Efficient MIS
- Good internal controls

Loan Monitoring

- Close and timely monitoring of the portfolio performance and delinquency is essential to the product's success

- Institutions must have well-defined collection policies that clearly guide AOs on appropriate actions accordingly to PAR

Client Loan Monitoring

- In order to perform effective follow-up the Credit officer must count on up-to date information on the status of his/her portfolio and arrears by client.
- Follow-up on clients must be pro-active not reactive. In this regards visits to client focus on preventing arrears; not on collecting arrears
- Institutions need up-to-date credit administration systems, including computerized MIS, which would rapidly alert field staff and management to delinquencies.
- Management need information on relevant characteristics of each loan in order to isolate those that typify overdue loans for consideration in the future.

Loan Monitoring (On-site)

- Few days after disbursing the loan the Credit Officer visits the client . Supervision on the use of the loan as planned is not intended but to instill in the client the idea that the credit officer is keeping close follow-up
- If a client misses a payment, the credit officer must visit him/her within two days of due date.
- In this regard, close and timely monitoring of the portfolio performance in terms of delinquency and of the repayment record for each loan is essential.
- The institution must have well-defined recovery policies that clearly guide the credit officer regarding appropriate actions accordingly to age of arrears

Borrowers incentives

- A borrower's incentive motivates the clients to pay on time.
  - Quick disbursement (new loans: within 7 days, repeat loans: within 24 hours
  - Larger amounts
  - Longer terms for good performance
  - Lower interest rate
  - Continuous access to loans: capacity to plan growth
  - Access to bank's other financial services.

- Borrowers incentives

- As clients want continued access to credit that is easy, quick and reasonably priced. they probably do not have many alternatives.
- The higher the value the borrower places on these services, the higher the chances of successful repayment.

Borrowers Incentives

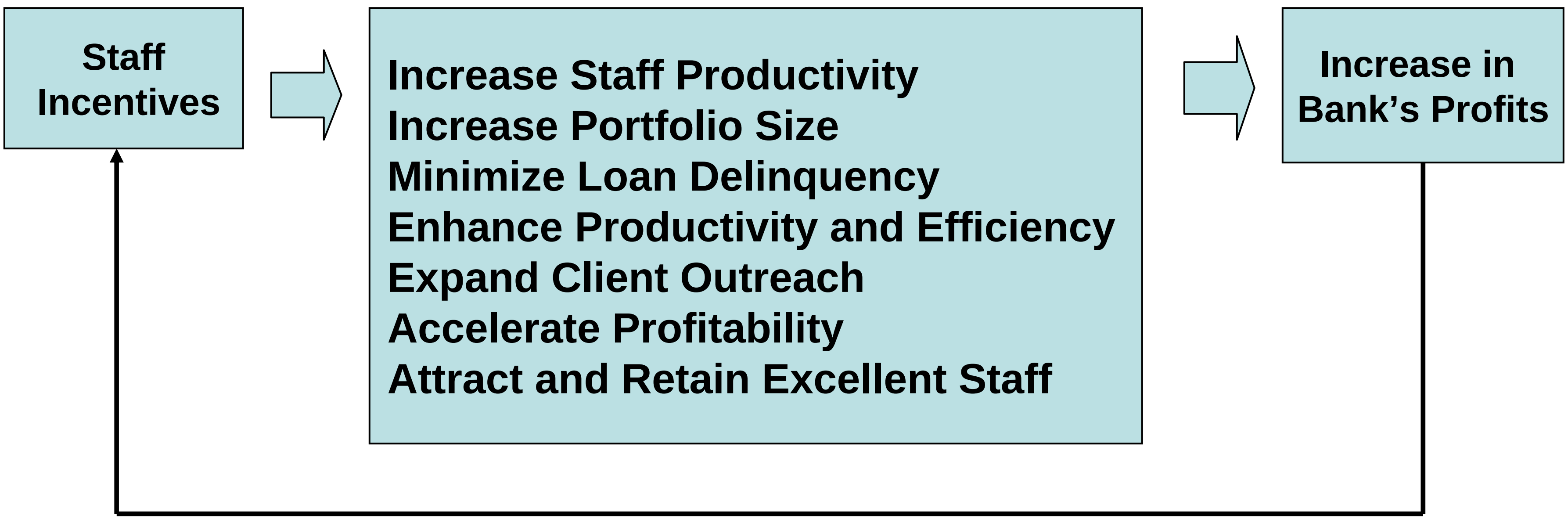
- Some individual lending programs also have a rebate incentive based (e.g. Reimbursement of 20% of the interest payments to the borrower; reimbursement of 100% of loan fees)

Staff Incentives

- Staff incentives based on productivity and portfolio quality are key to controlling delinquency

- While they are not a panacea, incentives define management expectations in quantifiable terms

Why Staff Incentives?



How to design effective incentives

- Use measurable and objective performance indicators
- Define indicators around institutional objectives and targets
- Offer incentives that are large enough to make extra efforts worthwhile
- Make incentives reachable to make them attractive

How to design effective incentives

- Pay incentives frequently, usually monthly
- Incentives are transparent, simple to apply and understand

Staff Incentives

- Most incentive systems are based on the following variables:

- Number of new clients: fixed bonus
- Number of repeated loans: fixed bonus
- Number of loans granted: fixed bonus
- Outstanding portfolio: a sliding scale bonus tied to delinquency and recovery rates. This bonus would have the highest weight .
- Delinquency rate: a pre-defined threshold level of delinquency above which no incentives are paid to ensure that overall quality of the portfolio is always maintained (4%)
- Recovery rate: a pre-defined threshold level of recovery below which no incentives are paid (95%).

Staff incentives

- Incentives are not supposed to become an award that only the best AOs have access to.
- Instead they are indicators against which managers and supervisors can assess if the AO is doing his/her job
- In this regard, incentives must be structured in such a way that 75% or more of your AO earn them

b. Who should benefit from the incentives?

- Design and implement an incentive scheme that begin at field level (account officers and supervisors).
- Account officers should get the biggest percentage for two reasons:
- - AOs are primarily responsible for loan production and recovery;
- - Incentives can have a direct and immediate impact on their
- performance, and, as a result, on bank's profitability
- Once tested and proven effective at AO and supervisors level, incentives can be expanded to the next level (BMs, support staff, Head Office).

Staff incentives

- How many account officers earn incentives?
- What incentives AOs consistently fail to earn?
- If consistently less than 75% of AOs earn them, the incentive structure must be adjusted or in need of intermediate or temporary incentives

Efficient and Accurate MIS

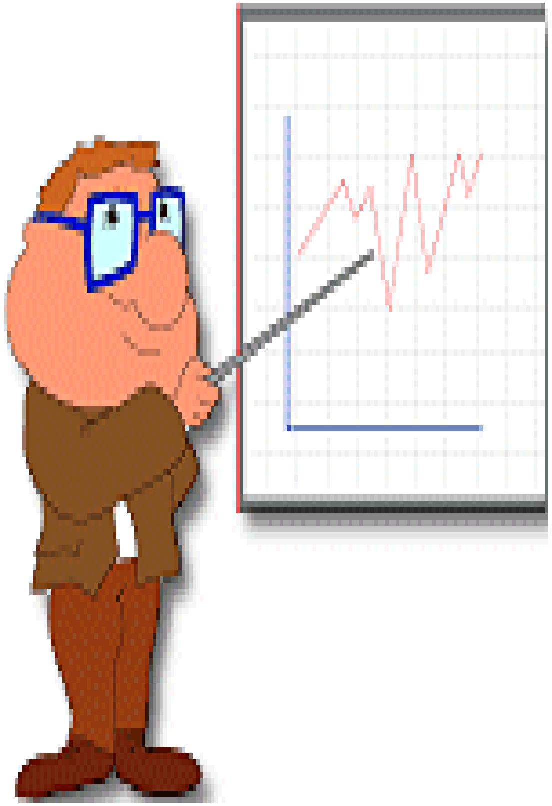
- Reports must be updated, simple, easy to access, accurate and reliable
- A good MIS should be able to provide portfolio performance information on a daily basis
- All portfolio information must be broken down by branch and AO.
- Portfolio performance reports must be easily accessible to all AOs and BMs

CONTROLLING DELINQUENCY

In addition to monitoring compliance with policies, what can Supervisors do to prevent, manage, and control delinquency???

Loan Portfolio Analysis

- Portfolio analysis is an easy and powerful tool in controlling delinquency
- It is key to identifying and preventing PAR
- It is key to planning the work of supervisors and BMs with every AOs



Definition of terms

- **Loans outstanding** – refers to the balance of all loan releases that remain outstanding
- **Loans disbursed** – refers to the total loans released
- **Arrears** – refers to the installments past due and not paid

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Definition of terms

- **Portfolio At Risk** – refers to the total outstanding balance (principal only) of those accounts with installments past due for one day or more

- **Loan Loss** – refers to principal amount written off from the portfolio

Key portfolio ratios:

- Arrears rate

$$= \frac{\text{amounts over 1 day past due}}{\text{outstanding portfolio}} \times 100$$

- Portfolio at risk rate

$$= \frac{\text{Outstanding principal balance of loans over 1 day past due}}{\text{outstanding portfolio}} \times 100$$

- Loan loss rate

$$= \frac{\text{amount written off from the portfolio}}{\text{average outstanding portfolio for the period}} \times 100$$

PAR ANALYSIS

	AO 1	AO 2
Apr 2005	2.0%	2.0%

Which AO has the best performance?

PAR 1 Trends

	Marlon AO	Joelan AO
Dec 2004	0.61%	7.00%
Jan 2005	0.90%	5.00%
Feb 2005	1.00%	4.50%
Mar 2005	1.75%	3.00%
Apr 2005	2.00%	2.00%

Who is the better performer of the two AOs?

PAR by AGE

AOs	1-7	8-14	15-30	31-60	60-90	90+
Joelan	2%					
Marlon						2%
Aris			2%			
Conrad		2%				
Donald	2%					

The Account Officers have the same PAR, but the Aging of PAR shows a different picture.

Loan Loss Rate

AOs	1-7	8-14	15-30	31-60	60-90	90+
Joelan	2%					
Marlon						0%
Aris			2%			
Conrad		2%				
Donald	2%					

If the PAR of AO 2 is written off, it will appear that he is the best performer.

PAR by AGE

AOs	PAR7	1-7	8-14	15-30	31-60	60-90	90+
Joelan	6%						
Marlon	2%						
Aris	3%						
Conrad	7%						
Donald	4%						

In this example, who is the best performer?

PAR by AGE

AOs	PAR7	1-7	8-14	15-30	31-60	60-90	90+
Joelan	**6%**	6%					
Marlon	**2%**						2%
Aris	**3%**					2%	1%
Conrad	**7%**	4%	3%				
Donald	**4%**	3%	1%				

The Aging of PAR now shows a different picture.

Cantilan Bank	PAR7 >1%	PAR 1.1%-3.0%	PAR 3.1%-5.0%	PAR 5.1%-10.0%	PAR 10.1%+	PAR higher than last month	PAR lower than last month	PAR the same
BANK			■			●		
Branch 1			●			●		
Ronie		●				●		
Allan			●			●		
Eddie				●				●
Tony			●				●	
Branch 2		●				●		
Ernie	●							●
Edwin				●		●		●
Ruel		●				●		
Andy	●					●		
Branch 3					●	●		
Daniel	●					●		
Bobby		●				●		
Rey					●			●
Samuel					●			●

PORTFOLIO AT RISK SUMMARY