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Certified Expert in Microfinance

Unit 2: Managing Micro Credits

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Certified Expert in Microfinance

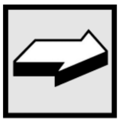
Unit 2: Managing Micro-Credits

Symbols

Initial Scenario

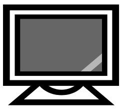
Definition

Example



Remember

Further Reading



Video Link

7th edition 07/2016

Content

Abbreviations

APR	Annual Percentage Rate
CC	Credit Committee
CGAP	Consultative Group to Assist the Poor
COGS	Cost of Goods Sold
EAR	Effective Annual Rate
LO	Loan Officer
MFI	Microfinance institution
MIS	Management Information System
MORFA	Market, Objectives, Resources, Financial, Ability and Commitment
NGO	Non-governmental organization
PAR	Portfolio at Risk
PESTLE	Political, Economic, Social, Technological, Legislative, and Environmental
ROSCA	Rotating Savings and Credit Association
SWOT	Strengths, weaknesses, opportunities, and threats

Learning Outcomes

This unit focuses on the loan cycle and the two main different lending methodologies in microfinance: group lending and the individual lending approach. In the first two chapters we explain both approaches including their main characteristics. We also discuss the challenges of each methodology from an institution's as well as from a client's point of view.

In the following chapters, the loan officer, who plays a key role in each MFI, will be the centre of our attention. By going through each step of the loan cycle, we will discuss all his tasks and duties in detail. We will explain how to carry out a proper loan analysis. You will learn how to do effective site visits, how to assess the character of the loan applicant and what to take into consideration when assessing his business and family income.

In order to decide on the appropriate loan amount and repayment schedule you will learn the most important differences between the balance sheet, income statement and cash flow statement; the pros and cons of each financial element and its relevance in the loan decision process.

To make it more authentic, we have included examples of each financial statement from typical microfinance clients. Based on these examples, we will show you different ratios and tools that are important for the credit analysis and how to calculate and interpret them. A strong emphasis has been put on the cash flow statement, since it is the key element in the credit decision process in microfinance.

It is much easier to prevent loan delinquency than to solve it! Hence we have dedicated an entire chapter to loan monitoring which includes a set of practical tips to support the loan officer in his daily work. Dealing with problem loans requires special skills from the loan officer and strong delinquency management. Recommendations and practical solutions for handling difficult clients are described in the last chapter of this unit.

By the end of this unit you should:

- Have a clear picture of both lending approaches including their challenges for clients and MFIs.
- Be familiar with the loan cycle and its steps.
- Be able to interpret the three financial elements with regards to loan decision.
- Be able to calculate relevant ratios and the cash flow including loan repayment on a declining balance.

For the purpose of brevity, we have used the male gender form in many instances that apply to both males and females.

Please note that the definitions used for microfinance might differ from standard definitions used in finance.

In our course glossary, we have summarized all the definitions given in this Unit. The course glossary can be found on the LinkEd online platform under Unit 1.

3 The Loan Cycle

India by babasteve

Initial scenario (continued)

Tigist's husband has discovered that she had to borrow money from the village moneylender to pay back a loan on behalf of the group president's niece. He became very angry and shouted at Tigist: "Why didn't you listen to me?! I told you to go to the bank and get your loan straight from them."
The next day Tigist walked to town. She went to the bank and asked a loan officer whether she qualified for an individual loan. The man asked: "Do you already have a loan from somewhere else?" Tigist said she didn`t because she was ashamed to admit that she had borrowed from the moneylender.. The loan officer asked why Tigist needed the loan and she replied that she wanted to buy a cow. The loan officer then explained: "We have two kinds of loans: a short-term loan and a longer-term loan. The short-term loan is for one year and a maximum of Birr 3,000. The longer term loan is for three years and a maximum of Birr 10,000. I will give you the application form for the short-term loan which is more suitable for you, I think. You have to fill in the form and hand it in to me. Then I will come to visit you in your village to look at your house and farm and ask some questions. Once I have all the information I require, I will prepare a loan file and hand it on to our credit committee who will decide whether you will get the loan."
Tigist asked who was on the credit committee. "Our branch manager and a senior loan officer", explained the loan officer and told Tigist their names.

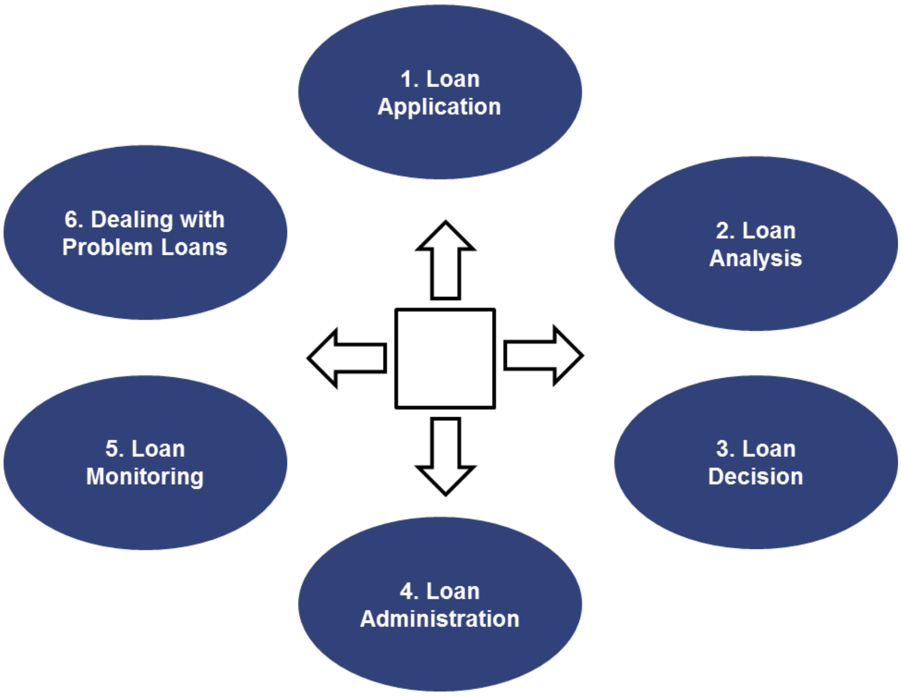
Tigist did not know these people and thought: "How can they decide whether to give me a loan when they've never met me?"

The trade-off between risks and costs is crucial for the success of individual micro-lending operations. The key to balancing risks and costs in individual lending are **loan cycle management** and proper **portfolio management**. We will now focus on loan cycle management (portfolio management will be covered in unit 4).

Six steps of the loan cycle

The **loan officer** (LO) plays a **key role in microfinance.** He is in charge of managing the loan cycle of his client portfolio. The **loan cycle** consists of **six major steps** that are shown in the next figure and described in detail below.

Figure 1: Loan Cycle



Step 1: Loan application: The loan application offers the first opportunity to assess credit risk. Clients who are not eligible, not suitable, or not trustworthy must be screened out.

Step 2: Loan analysis: The loan analysis entails a visit to the applicant's home and business, cross-checking information and various calculations (a financial analysis). The result is either negative or a loan recommendation to the credit committee.

Step 3: Loan decision: The loan recommendation is reviewed by the person(s) who is/are authorized to approve loan applications (usually the so called 'credit committee'). They cross-check the risk analysis and may ask for further information and evidence.

Step 4: Loan administration: If the loan is approved, loan administration begins with opening an account and disbursement.

Step 5: Loan monitoring: The loan officer must monitor the repayment of all loans that he recommended for approval. Monitoring can be done on-site (visiting clients to detect problems that may lead to delinquency) and off-site (checking the daily loan repayment reports).

Step 6: Dealing with problem loans: If a borrower misses a payment the loan officer should immediately contact the client to work out a solution.

The loan cycle is also essential for the implementation of the **client protection principles**, as defined by the Smart Campaign (www.smartcampaign.org). For example, loan officers must respect the privacy and confidentiality of applicants' data; provide clients with full product information to ensure that credit applicants can make fully informed financial decisions; and prepare a thorough and conservative loan analysis to avoid a client's over-indebtedness.

> Although loan decisions must be taken by superiors (the credit committee), the loan officer is responsible for the performance of his loan portfolio. He manages the entire credit cycle and must act in the best interest of both the MFI and the client.

J. Schicks; R. Rosenberg*: Too Much Microcredit? A Survey of Evidence on Over-Indebtedness,* CGAP (2010).

Paula Tjossem, et al*, Toolkit for Individual Lending for Credit Officers.* MicroSave (2007).

The Smart Campaign Tool*, Avoidance of Over-indebtedness: Guidelines for Financial and Non-financial Evaluation* (undated).
http://www.smartcampaign.org/tools-a-resources/514

Check your knowledge: Exercises for Chapter 3

Read session 2 of Tjossem's "Toolkit for Individual Lending for Credit Officers" and answer the following questions:

1. How much time should a loan officer spend in the field?

2. How many accounts (clients) is a loan officer expected to handle?

3. What are the goals of applying a step-by-step lending process?

Solutions: Please refer to Chapter 13.

4 Promotion and Application

Chennai, Mylapore - 21-02-2007 - 17h37 by Panoramas

Initial scenario (continued)

Tigist has decided to apply for an individual bank loan to buy a new cow. She looks at the loan application that the loan officer has given her. Although Tigist can read and write, she does not really understand what to write in the blank spaces of the form.

Therefore, she asks the loan officer to help her. He takes the form from her and starts on the list of questions: "Your full name?" Tigist tells him and he writes it down. "What is the number of your ID card?" Tigist takes out her card and hands it to the loan officer who copies the number into the form. Then he goes on asking more questions and writes down Tigist's answers: her husband's and children's names, the name of the village, the purpose of the loan, the amount of the loan requested, the size of the farm, the number of animals they own, the average monthly income and expenses of the household, and so forth.

"Well", says the loan officer, "according to your information, you are eligible for a short-term loan. However, I have to verify the facts. Can I come to your village tomorrow to meet you and your husband? I have some questions, and I will look at your house and farm." Tigist agrees and says goodbye. "How will I explain this to the other women in my group?" she asks herself on her way home.

Efficient credit promotion

Promotion and **loan application** can be considered to be part of the loan analysis because an experienced credit officer can pre-select good clients and keep away bad clients even at this early stage. However, there is a conflicting objective: expenses for the promotion must be kept down and staff should not waste time on applicants who are going to be rejected anyway. How can both of these objectives be achieved?

Here are some recommendations:

- Explaining the **product design** (maximum amount and duration, etc.) to the public will dissuade people who are not eligible or not part of the target group. The message must be easy to understand.
- In addition, it should be made absolutely clear that the MFI has a **zero tolerance of delinquency**. One could also ask for savings first or for loan graduation in order to put off people who just want one big loan and then plan to run with the money.
- **Direct promotion** among the MFI's target group may be the most effective way to attract the right people, e.g. door-to-door; village promotion campaigns, etc.
- However, **indirect promotion** is more cost effective, e.g. TV, radio, newspapers.
- **Cluster promotion** has proven to be useful, especially in rural areas.
- **Client-to-client promotion** is another tool to attract good clients. A bonus could be paid to existing clients who refer new clients.
- **Business-to-client promotion** can also be very cost-effective, e.g. the MFI can ask fertiliser dealers to offer credit information to their best farm clients.

Information in the loan application

The loan application process should not take much time: in fact, **no longer than 20 minutes**. Generally, the loan officer should fill out the application form along with the applicant.

Key information with regard to the applicant includes:

- **Family:** Parents? Spouse? Children? Health?
- **Education / Experience:** School? Professional qualifications? Professional experience?
- **Business:** What kind of business? When started? Who owns / manages / works in it? Competition? Suppliers? Buyers?
- **Cash Flow:** Average? Seasonality?
- **Assets:** Fixed assets? Current assets? Bank savings?
- **Liabilities:** Current liabilities? Long-term liabilities? Previous loans? Repayment history?
- **Insurances:** Private? Business?
- **Plans:** Private? Business? Source of finance? Loan amount required? Purpose of loan? Proposed repayment schedule?

If possible, the loan officer can, even at this early stage, ask for evidence and take notes so that at a later point the evidence can be followed up on.

The purpose of the loan application is to check if the client is **eligible** for a loan (eligibility criteria are defined by the MFI, e.g., minimum age of applicants and loan purpose). In addition, the loan officer can already make a **first estimate of the credit risk** based on the client's character, abilities, existing debt level and banking history.

Acid Test

At the end of the application, the loan officer should apply the so-called **Acid Test,** namely a quick assessment of the client's repayment capacity, which is calculated as follows:

Average cash inflow per month for the entire household

MINUS

Average cash outflow per month for the entire household (including other debt repayments)

= Average monthly net cash balance (up to 50% of this amount is the client's repayment capacity)

As a rule of thumb, if the Acid Test shows that 50% of the net cash balance would not be sufficient to repay the loan applied for, the loan officer can either reject the application or seek alternatives (e.g., a smaller loan amount).

If the Acid Test and the interview are positive, the loan officer can proceed to fill in the application form. Finally, the loan officer should make an appointment for a site visit.

Repeat borrowers are a special case to be considered during loan application. Since they are existing customers of the MFI, who already had one or several previous loans, the MFI possesses reliable personal and business information, including on their loan repayment history (and probably even on their savings history). Obviously, it should be much easier for a loan officer to make an assessment of such clients' credit-worthiness. Therefore, many MFIs have a policy to give "good" customers preferential treatment. For instance, the loan appraisal procedure may be simplified, doing away with site visits or financial analysis. Some MFIs even grant credit lines to their best borrowers, thereby abolishing the need for loan application and appraisal altogether. In group lending approaches the graduation principle is one tool to manage credit risk (group members receive gradually increasing loan amounts from one loan cycle to the next).
Although it is not hundred percent guaranteed that a good borrower will remain a good borrower, there are many good reasons for giving preferential treatment to repeat borrowers with an immaculate repayment history.

- Finding and processing new borrowers is much more expensive than serving existing customers;
- Loans to repeat borrowers are relatively less expensive for the MFI because repeat borrowers usually take larger loan amounts than new clients (either because the MFI applies the graduation principle, or because the borrower's business is growing);

- The risk of loan default is generally higher with new clients than with existing good clients;
- Customer retention usually is a sign of customer satisfaction, and satisfied customers will recommend the MFI to their friends and family;
- Every time a borrower comes back for another loan she builds up her loan history, which provides more and more valuable information to the MFI;
- And, of course, repeat borrowers also benefit from preferential treatment (e.g., larger loans, quicker processing, lower cost).

If done properly, promotion and loan application can help to pre-select good clients and keep away bad clients. It is important to give clear messages and simple information to potential clients, especially with regard to eligibility and zero tolerance. Repeat borrowers with a good loan repayment history should get preferential treatment.

Paula Tjossem, et al., *Toolkit for Individual Lending for Credit Officers.* MicroSave (2007).

Check your knowledge: Exercises for Chapter 4

Read Session 3 of Tjossem's "*Toolkit for Individual Lending for Credit Officers",* and answer the following questions:

1. Why are existing clients more attractive and important to an MFI than new clients?

2. How can an MFI achieve a successful market outreach?

3. How can an MFI measure its marketing outreach effectiveness?

Solutions: Please refer to Chapter 13.

5 Site Visit and Interviews

Chai Time by Meanest Indian

Initial scenario (continued)

Tigist has applied for an individual bank loan to buy a new cow. However, she has not yet explained this to the other women in her group. Today, the bank's loan officer is coming for a first site visit. When he arrives, he greets Tigist and her husband respectfully and goes into their house. Tigist makes the loan officer a cup of tea and her husband offers him a chair. The loan officer sits down, drinks his cup of tea, and asks Tigist's husband the questions he has already asked her.

Tigist's husband gives the same answers as his wife, but when the loan officer asks him whether they have any other loans outstanding, the husband nervously looks at his wife. Tigist immediately interrupts and says: "Well, there is a small loan with the local moneylender. It is not a lot." The loan officer raises his eyebrows: "Not a lot?!" "Well", explains Tigist, "it is only Birr 340 which I needed to help a friend." The loan officer asks for the name of the friend and also for the name of the moneylender.

Finally, Tigist gives in and tells the loan officer the whole story about the group and the president's niece. The loan officer makes some notes in his diary. Then he asks whether he can inspect the house and the farm, whereupon Tigist's husband takes him around. After the inspection, the loan officer says goodbye to Tigist and her husband and goes out to the main street.

At that moment, the group president and her niece are walking down the street and see the loan officer. "Oh no!" thinks Tigist, "now I will have to tell them that I have applied for a bank loan." The loan officer greets both women and talks to them in a friendly way. Tigist is surprised because, as it turns out, she discovers that the president and her niece have also applied for a bank loan!

The **site visit** is the first part of the loan analysis and also the most important one. During the site visit, the loan officer gathers all kinds of information from his own observations, interviews, and the evidence collected.

The loan officer should meet the client at the **business site** and at **home.** Interviews should be conducted with relevant informants, such as clients, employees, customers, buyers, suppliers, family members, and employers of family members. The timing is important: the business should be visited during working hours so that the daily work can be seen, but not during peak hours, as otherwise the client will be too busy to talk; the family should be visited when everyone is at home.

The site visit allows the loan officer to ascertain the financial data, and household and business information necessary to prepare the loan analysis. As much evidence as possible should be collected: e.g. on the inventory, cash box, cash book, assets (especially collateral), savings, employment contracts, pay slips, etc.

A **standard checklist** for the site-visit ensures that the loan officer gathers the information needed. **The five Cs** can be extremely helpful for preparing and conducting the site visit:

Figure 2: The five Cs

Character	Personal information about the client and his household (honesty and integrity; family situation and status; abilities to manage a business; recent changes in business/family assets; reputation in community; openness & compliance with group (in group schemes); previous loans
Capacity	Client's ability to repay the potential loan (cash flow of household and business; demonstrated capacity from repayment of other loans
Capital	Client's business and household assets (cash, bank accounts, land, building, equipment, farm animals, stock, vehicles, etc.); quality of assets and market value; source of funding of assets (borrowed funds versus own funds)
Collateral	Business or household assets that can be used as loan security
Conditions	External conditions and risks that can impact the client's business or household (markets; competition; price fluctuations; production risks; natural disasters)

The quality of data collected during a site visit greatly depends on the loan officer's **interviewing skills**. Amongst others, a good loan officer should be patient, be able to create a good atmosphere, try to put himself in the client's place and also ask for evidence.

> The loan officer should visit the loan applicant's business and home to collect information. She/He should use the five C's as a checklist for the site visit.

Paula Tjossem, et al. *Toolkit for Individual Lending for Credit Officers.* MicroSave (2007).

Check your knowledge: Exercises for Chapter 5

Read Session 4 of Tjossem's "Toolkit for Individual Lending for Credit Officers" and answer the following question:

> Why is it important for the loan officer to know how the client will use the loan?

Solutions: Please refer to Chapter 13.

6 Character Assessment

Festival Preparations by Arfaoui

Initial scenario (continued)

The bank's loan officer has interviewed Tigist and her husband and inspected their home and farm. Just as the loan officer is leaving Tigist's home, he meets the group president and her niece by chance in the village main street. They have also applied for a bank loan.

The loan officer accompanies them to their home and asks about Tigist. The president says: "Tigist is a good woman. She is the treasurer of our group and there has never been a problem". The loan officer asks her whether she knows that Tigist is applying for an individual bank loan. The president doesn't say a word in reply but her niece replies: "Really? We didn't know that but, of course, why not? Tigist is free to do whatever she wants..."

The loan officer suspects that there is something strange going on and goes on to ask: "Have you recently had any problems in your group?" Both women shake their heads fervently and say: "No! No problems at all, sir! We've never had any!!"

The loan officer thanks the women and says goodbye. He drives off on his motor-bike and goes straight to the NGO officer who is in charge of the village group. There, he hears the full story about the president's niece who could not repay her loan and how the group members decided to pay it on her behalf.

In micro-lending, the **client's character** is of great importance as the MFI usually does not have legal collateral for security, nor business records to rely on for credit decision. The main objective of the character assessment is to screen out potential intentional and unintentional defaulters.

Based on the **"10-80-10 Rule"**:

- 10% of people are always honest
- 80% follow the rules as long as they have to, and
- 10% try to cheat

If an MFI can identify the 10% possible intentional defaulters in the screening process, it will be a gain for the MFI.
It is obviously a big challenge to **screen out clients who may fail** in their business operations **due to a lack of entrepreneurial skill**. A client who is a "nice and honest guy" but a "hopeless businessman" should not receive a loan because, even though this client may be willing to repay the loan, he may fail in his business and, therefore, become an unintentional defaulter. Where the loan officer has doubts about the client's entrepreneurial abilities, he may request the client to attend a business training course, or get a business coach.

The best way to screen out potential intentional and unintentional defaulters is to carry out a rigorous **character assessment**. If the client gives wrong information, exaggerates and/or underestimates, it may be on purpose (as a potential intentional defaulter) or due to a lack of knowledge and experience (as a potential unintentional defaulter). In either case, the loan officer should not present the case to the credit committee.

A **checklist for character assessment** may include the following questions:

- What is the family background of the client and his/her spouse?
- What is their lifestyle?
- What is the family's reputation in the community?
- Are there any signs of gambling, drug abuse or illegal activities?
- What kind of social relationships do the family members have (e.g. with friends or neighbours, club memberships and politics, etc.)?
- Were the persons interviewed forthcoming and honest with information?
- What reputation does the client have as a farmer or entrepreneur?
- Do both the person's home and farm/enterprise make a good impression?
- Has the client ever defaulted on a loan?

> The loan officer should be able to assess a client's character and screen out potential intentional and unintentional defaulters.

Paula Tjossem, et al., *Toolkit for Individual Lending for Credit Officers.* MicroSave (2007).

Check your knowledge: Exercises for Chapter 6
Read Session 4 of Tjossem, et al. *Toolkit for Individual Lending for Credit*

Officers and answer the following question:

What sources of information can a loan officer use for a client's character reference?

Solutions: Please refer to Chapter 13.